Strengthening the Resilience of the Banking Sector

A Survey by the Professional Risk Managers' International Association

June 2010

www.PRMIA.org

PRMIA

ACKNOWLEDGEMENTS

SUNGARD®

SunGard's Adaptiv – providing solutions for enterprise-wide risk management

SunGard's Adaptiv provides enterprise-wide credit and market risk management and operations solutions for financial services institutions. Adaptiv assists institutions of varying size and complexity to deploy technology to meet both internal and regulatory requirements for risk management and operational control. Adaptiv helps financial services institutions from the banking, hedge fund, asset management, insurance and corporate sectors with our deep understanding of risk management and operational processes. Find out more at ***www.sungard.com/enterpriserisk.***

SunGard is one of the world's leading software and technology services companies. SunGard has more than 20,000 employees and serves 25,000 customers in 70 countries. SunGard provides software and processing solutions for financial services, higher education and the public sector. SunGard also provides disaster recovery services, managed IT services, information availability consulting services and business continuity management software. With annual revenue exceeding $5 billion, SunGard is ranked 380 on the Fortune 500 and is the largest privately held business software and IT services company.

PRMIA
The Professional Risk Managers' International Association

The Professional Risk Managers' International Association (PRMIA) is a higher standard for risk professionals, with 60 chapters around the world and more than 68,000 members from 198 countries. A non-profit, member-led association, PRMIA is dedicated to defining and implementing the best practices of risk management through education including the Professional Risk Manager (PRM) designation and Associate PRM certificate; webinar, online, classroom and in-house training; events; networking; and online resources. More information can be found at ***www.PRMIA.org***.

INTRODUCTION

In the immediate aftermath of the financial crisis it was clear that radical changes would have to be made to the banking sector and its risk management processes. The problem was that no-one could be clear as to exactly what these changes should be. In the intervening months and weeks and through a series of regulatory discussions and summits, a number of measures have been proposed and now we are seeing them put into practice.

For example, there has been a clear move to encourage a greater use of central counterparties (CCPs) and to migrate opaque OTC derivatives to the relative transparency of the exchange-based environment. Capital charges have been amended to include credit value adjustments and asset value correlations. Elsewhere regulators have focused their attention on areas such as collateral management, wrong-way risk, stress testing and counterparty credit risk.

What now remains to be seen is how prepared the banks are to implement these changes and whether they believe these measures will be truly effective in providing greater resilience to the banking sector or, alternatively, are merely kneejerk reactions to the crisis and the highly public criticism of the regulators' inability to police the banking sector and to prevent the financial meltdown that followed the crisis.

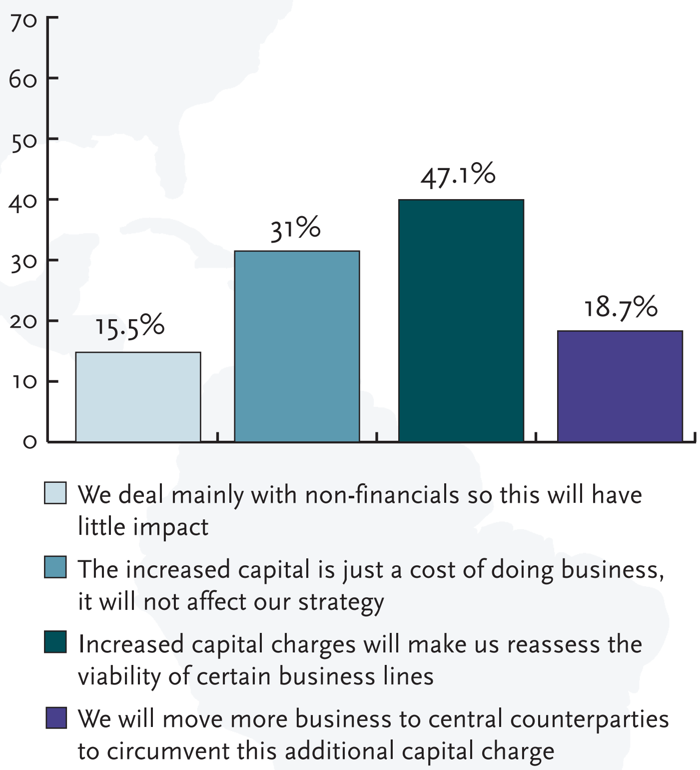
The Basel Committee recently produced a paper entitled *Strengthening the resilience of the banking sector* with the goal of promoting a more robust banking industry. In order to derive the level of accordance between the Committee and the risk managers it supervises, SunGard’s Adaptiv collaborated with the Professional Risk Managers’ International Association to produce the following survey based on the paper's recommendations.

More than 360 risk managers were asked a series of questions on various Basel Committee proposals such as the increases to capital charges and changes to credit and counterparty risk calculations as well as whether criticism of the risk management processes are warranted. Finally, risk managers were asked where they feel the greatest challenges lie in meeting these new requirements.

In some areas there was clear consensus but in others there was a range of responses that covered all possibilities and suggested that the industry is not yet at a stage of universal readiness for the changes that are due to be imposed.

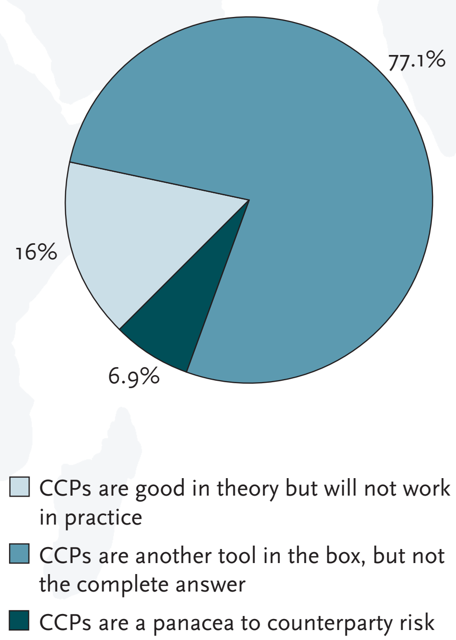
A multiplier of 1.25 is proposed to the Asset Value Correlation (AVC) used to compute regulatory capital. How will this affect your business?

A clear majority of the respondents (84.5%) agreed that this measure would have a significant impact on their business but there some clear differences as to what this impact would be. Almost half (47.1%) felt that the increased capital charge would led to a reassessment of the viability of some business lines, while others (31.0%) were more sanguine about the changes, agreeing that a higher capital charge is just a cost of doing business and would not necessarily lead them to change their practices. More encouraging for banking supervisors was the fact that 18.7% of respondents will move more business to CCPs in order to avoid a higher capital charge.



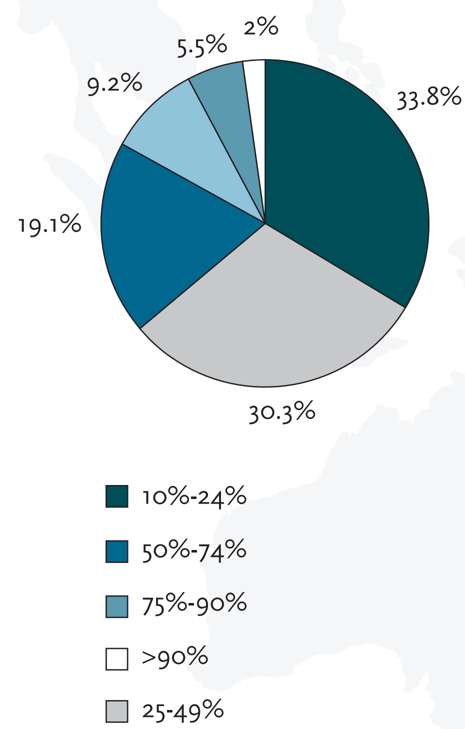
Central Counterparties (CCPs) are being pushed by regulators as a way of reducing counterparty risk. How this will affect the industry?

Regulators may be less encouraged by the fact that only 6.9% of respondents feel CCPs are a panacea to the problems with counterparty risk and disappointed by the fact that 16% feel that CCPs are good in theory but will not work in practice. The clear majority of respondents have a more balanced opinion, agreeing that while CCPS are another useful tool to manage their counterparty risk, they are not the complete picture – an opinion most supervisors would presumably agree with.



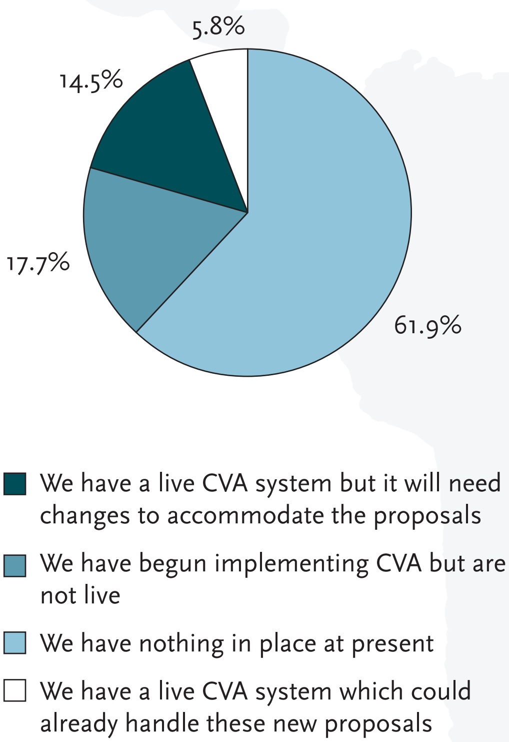
What proportion (by number of contracts rather than notional) of OTC trades do you think will be cleared by Central Counterparties by the end of 2013?

There was a cautious confidence evident in the responses to this question with the majority (64.1%) believing the proportion of centrally cleared trades to be between 10 and 50%. Fewer than 10% felt that the proportion of centrally cleared trades would fall below 10% and just 7.5% felt it would rise above 90% in the next three and a half years. The most interesting statistic, however, would be how close these estimates are to those of the unspecified goal of regulators and supervisors.



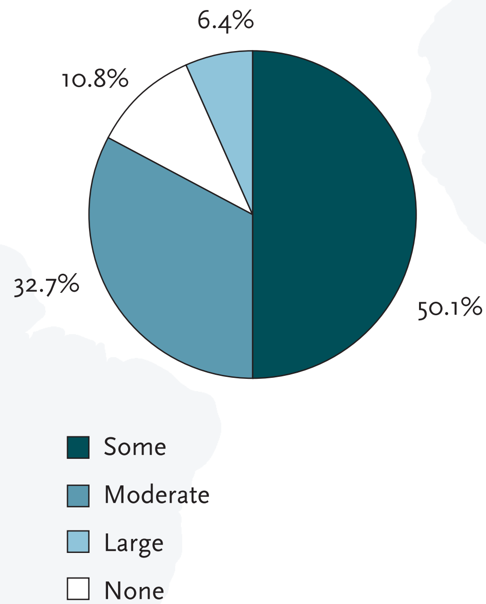
The Basel Committee proposes charging for Credit Valuation Adjustment (CVA) risk. How prepared are you for this change?

The Basel Committee may be concerned at the high percentage of respondents (61.9%) that admitted to having nothing in place at present to cater for a charge for CVA and with just 5.8% of risk managers having a live CVA system already in place. The remaining institutions are in the process of implementing a system, or will need to modify an existing CVA system to accommodate the new rules. Given the data and system infrastructure required to build such solutions this could prove to be one of the hardest parts of the regulation to comply with if a tight deadline is set.



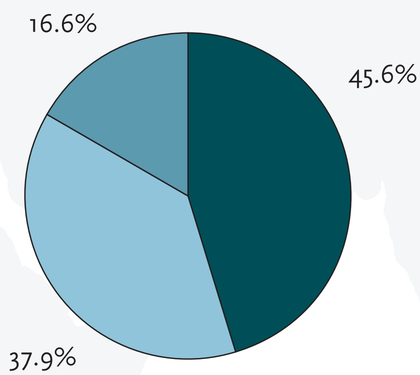
How much impact will this new capital charge have on your future investment in calculating and managing CVA?

The concern provoked by the responses from the previous question may be eased by the fact that most risk managers do not imagine the new capital charge will have a great impact on their future investment in CVA calculations with only 6.4% expecting a 'large' impact, possibly indicating that banks already have plans to use CVA in other areas and can apply these efforts to meeting this regulation.



Credit backtesting was identified as one area that needs further work at many institutions. Do you agree?

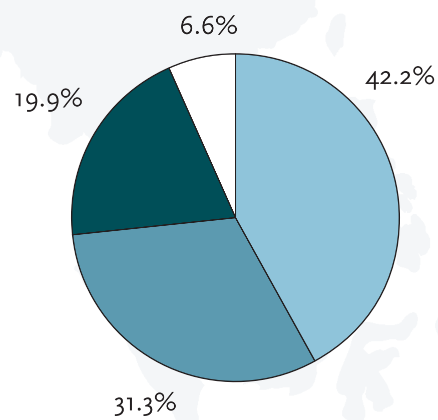
Credit backtesting does indeed appear to be a weak spot with only 16.6% professing to have a regular and robust process in place while 45.6% admitting to having no or very little backtesting in operation. This is another area that will require significant investment in data and systems going forward.



- We currently have little or no backtesting in place for our counterparty credit models
- We currently run regular and robust backtesting for counterparty credit risk
- We have piecemeal backtesting of parts of the process

The margin period for large (over 5,000 trades) or complex netting sets is to be increased from 10 days to 20 days. Do you welcome this?

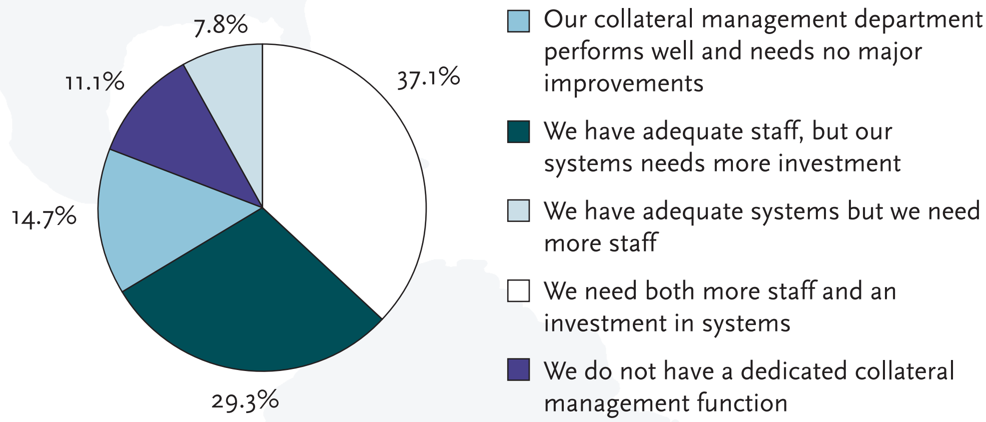
This question received the most varied responses of the survey, not least because more than half (42.2% plus 8% that skipped the question) had no netting sets that fit the criteria. For those that did have netting sets that fit the criteria, the responses were evenly split between those that envisage little impact to their capital requirement (31.3%) and those that foresee either some (19.9%) or a considerable (6.6%) impact.



- We have some netting sets of this type and extending the margin period will make an appreciable difference to our capital requirement
- We have some netting sets of this type, but extending the margin period will make little difference to our capital requirement
- We do not have any netting sets that fit the criteria
- We have some netting sets of this type. Extending the margin period will make such a difference that we will look to reduce the size of these netting sets rather than absorb additional capital charges

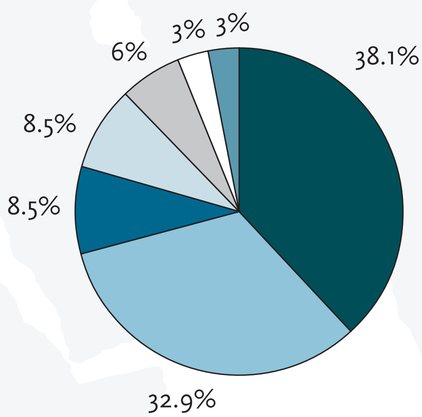
The Basel Committee's paper highlighted poor operational effectiveness of banks' collateral departments due to poor systems, data integrity and low staffing levels. It recommends that banks enhance the operational performance of the collateral department. Do you agree?

Only 14.7% believe that they already have a collateral management department that performs well across the board. When asked whether deficiencies in current capabilities was due to systems or people the responses were 4 to 1 in favour of needing better systems (29% vs. 8%) The highest response reflected the serious approach that risk managers are adopting in this area with 37.1% agreeing that they need both more staff and more investment in systems. Less encouraging is the somewhat alarming fact that more than one in ten banks (11.1%) have no dedicated collateral management department in place, a statistic that surely has to change in the immediate future.



The paper states there are shortcomings in how the industry measures and monitors wrong-way risk. Do you agree?

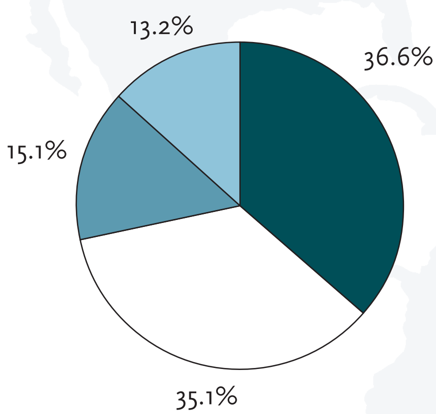
Clearly there are frailties in the industry's measurement of wrong-way risk with 32.9% having no active monitoring process in place and 38.1% relying on manual methods. Just 6.0% have reached the end-game on wrong way risk in that they are able to specifically measure wrong-way risk, quantify it and include it in pricing decisions.



- We monitor certain instances of wrong-way risk on a manual basis
- We have a system in place to flag instances of wrong-way risk automatically based on static identifiers
- Wrong-way risk is incorporated into our economic capital model so we do not monitor it specifically
- Wrong-way risk is incorporated into our economic capital model and we also monitor it separately
- We specifically measure wrong-way risk, quantify it and include it in pricing decisions
- We do not actively monitor wrong-way risk at present
- We have a system in place to flag instances of wrong-way risk automatically using a stress-testing approach

Greater emphasis is to be placed on counterparty stress testing. Do you agree?

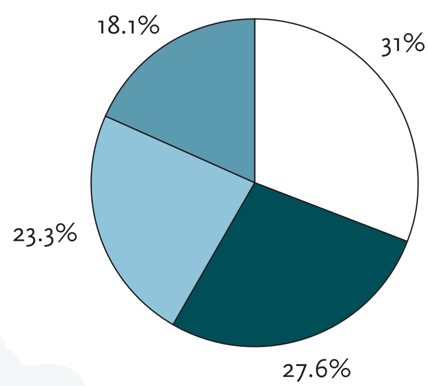
The responses suggest that the Basel Committee's assertion is hard to argue with. Over a third (35.1%) have nothing in place and an almost equal amount (36.6%) run static tests no more than four times a year. Once more this is slightly alarming that such a key area of risk management receives such little attention within so many banks.



- We run counterparty credit stress tests quarterly or less frequently, and these tests tend to remain static
- We run counterparty credit stress tests monthly or more frequently, and these tests tend to remain static
- We run counterparty credit stress tests monthly or more frequently, and the scenarios for these tests are reviewed quarterly or more frequently
- We do not currently have counterparty credit stress tests in place

How broad are your current stress tests for counterparty risk?

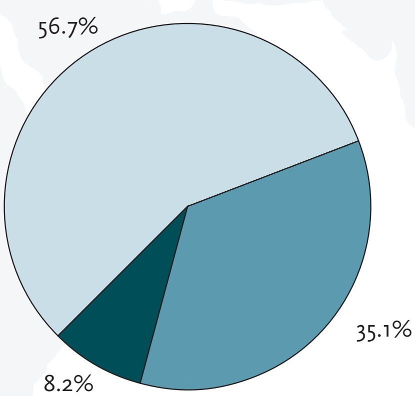
The variation in responses between individual market factors (31%), multiple market factors in aggregate (27.6%) and both market factors and counterparty credit grades (18.1%) suggest that this is still an immature area of risk management with best practice yet to be achieved at many institutions.



- We stress multiple market factors in aggregate
- We stress both market factors and counterparty credit grades in a consistent manner
- We do not currently have counterparty credit stress tests in place
- We currently stress individual market factors (interest rates, FX, equity etc.) in isolation

The Basel paper recommends banks undertake reverse stress testing to identify extreme scenarios. Is this something you undertake already?

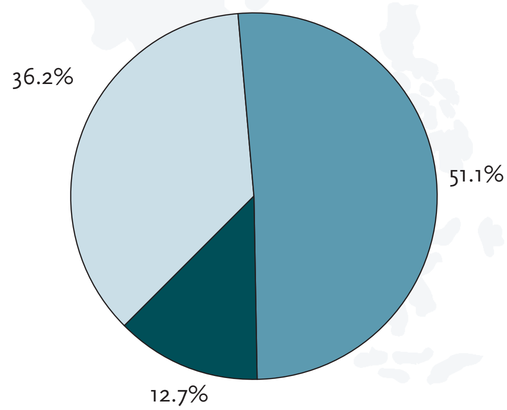
Unsurprisingly, given that so few banks have robust counterparty risk stress tests in place, even fewer banks perform regular reverse stress testing (8.2%), although 35.1% do undertake this on an ad-hoc basis. With 56.7% performing no reverse stress testing of any kind, the Basel Committee faces a challenge in making reverse stress testing a regular feature of risk management.



- We do not currently perform reverse stress testing
- We undertake reverse stress testing on an ad-hoc basis
- Reverse stress testing is an integral part of our current stress testing regime

Credit measures such as EEPE are to be calculated using historic market data that includes a period of stress (as required for the market risk Stressed-VaR calculation). How easy will it be to maintain the required data sets?

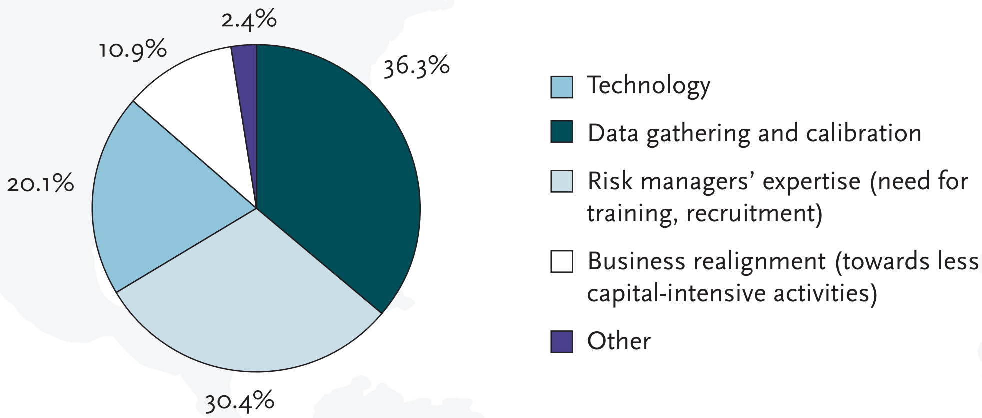
Encouragingly two thirds of respondents already have sufficient historical data or are well on the way to getting there. Whilst much of this data can be sourced from external sources, some will need to be gathered internally and the 36% of respondents who will need to start from scratch will have to start soon in order to build a representative set of historical data!



- We will have to start gathering data from scratch
- We have a partial historic data set already but it will need to be enriched
- We have all the required data today

What do you expect to be the greatest challenge in order to meet the latest Basel proposals relating to counterparty credit risk?

Again the varied responses are illuminating, not least the fact that such significant percentages responded in two very different ways. For example, 30.4% believe that a shortfall in risk management expertise is the greatest challenge while 20.1% believe it to be the limitations of their technology. The greatest response though was the data gathering and calibration that lies ahead.



CONCLUSION

The survey highlights that there is no clear consensus on almost any aspect of the Basel Committee's recommendations: there is division on the impact of increased capital charges and how this will affect their respective businesses; there is a range of opinions on how effective measures such as the introduction of CCPs will be; and most noticeably there is a lack of uniformity when it comes to the level of preparedness among banks in relation to the Basel Committee's proposed changes.

This lack of consensus may be explained by a number of factors, all of which have their own implications. For example, it may be that the banks surveyed all have vastly different set-ups when it comes to risk management and that the different activities of their traders and front-office staff lead to wholly different risk management approaches.

Alternatively, it may be that each bank devotes differing levels of resources to managing risk based on either the budgetary restraints across the whole institution or that different banks hold risk management in higher or lower regard than their peers.

Typically the truth will lie somewhere in between all of these possibilities but the clear implication is that the Basel Committee will face a significant challenge in pushing these recommendations through in a timely fashion as some banks are clearly way behind others in their preparation. This is most clearly seen in the respective attitudes to counterparty stress testing and collateral management – two factors that have been continually highlighted as key factors in the failure of risk management to adequately react to the financial crisis.

For those banks whose responses consistently testified to a low level of resources and systems, the message is clear – the Basel Committee's proposals will eventually come to pass and compliance will be mandatory. Given the long lead-times it takes to get new risk measures, systems and processes to a state where they meet regulatory approval we recommend that banks initiate feasibility studies in these areas as soon as possible. More importantly there are other banks within the industry that are clearly at a more advanced level. This will not only give them an advantage in meeting their Basel Committee requirements, it will also give them an even more important advantage: better management of their risk and, consequently, being more competitive in the ever-intensifying marketplace.

The survey was completed by multiple types of institution, consultants, software vendors etc. Therefore we cannot read much into the % of people skipping a question without further analysis of the results.

www.PRMIA.org

PRMIA

The Professional Risk Managers'
International Association