

Financial Services Alert

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Developments of Note

► **Basel Committee Issues Report on Issues Concerning Banks' Economic Capital Models and Survey on Banks' Implementation of Compliance Principles**

Economic Capital Models. The Basel Committee on Banking Supervision (the "Basel Committee") issued a consultative paper (the "Paper") discussing the issues that banks face in designing and implementing models allowing for sufficient economic capital. Economic capital is defined as the methods or practices that allow banks to attribute capital to cover the economic effects of risk-taking activities. As a result of advances in risk quantification methodologies, the internal capital management needs of banks and regulatory initiatives, economic capital is being increasingly used by banks. This increase in the use of economic capital has led to the evolution of economic modeling and measurement practices. The Basel Committee notes that in some aspects these practices have converged and become more consistent over time, however, the notion of economic capital has broadened as its use has expanded.

Economic capital can be analyzed and used at various levels, the Basel Committee states that Pillar 2 (supervisory review process) of the Basel II Framework may involve an assessment of a bank's economic capital framework. The Basel Committee cautions that there remain significant methodological, implementation and business challenges associated with the application of economic capital in banks, particularly if economic capital measures are to be used for internal assessments of capital adequacy. The Paper contains ten recommendations by the Basel Committee that address these challenges.

The Basel Committee recommends that a bank wishing to use an economic capital model should, in its dialogue with supervisors, be able to demonstrate how the economic capital model has been integrated into the business decision making process. The board of directors of the bank should also be able to demonstrate awareness of the gap between gross (stand alone) and net enterprise wide (diversified) risk when they define and communicate measures of the bank's risk appetite on a net basis. The Basel Committee states that the viability, usefulness, and ongoing refinement of a bank's economic capital processes depend critically on the existence of a credible commitment by senior management to the process. The economic capital models should be effectively integrated into the bank's decision making process in a transparent and auditable way.

The Basel Committee emphasizes the importance of risk identification, and warns that if relevant risk drivers, positions or exposures are not appropriately quantified, there is great potential for slippage between inherent risk and measured risk. A bank should understand the limitations of the risk measures it uses, and the implications associated with its choice of risk measures. The Basel Committee further recommends that a bank's aggregation methods address the implications stemming from the definition and measurement of individual risk components, stating that the accuracy of the aggregation process depends on the quality of the measurement of individual risk components and the interactions between risks embedded in the measurement process.

Rigorous and comprehensive validation of the economic capital model is recommended by the Basel Committee. A bank should assess the extent to which its dependency structures are appropriate for its credit portfolio, under both normal and stress circumstances. The Basel Committee suggests that a bank should understand the trade-offs involved in choosing between the currently used methodologies for measuring counterparty credit risk. Complementary measurement processes such as stress testing

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should also be used, although such approaches may still not fully cover all counterparty credit risk exposures. Finally, the Basel Committee recommends that close attention should be paid to measuring and managing instruments with embedded option features which if not adequately performed can present risks that are significantly greater than suggested by the risk measure. The Basel Committee notes the importance of recognizing the trade-offs between using an earnings based or economic value based approach to measuring interest rate risk in the banking book.

Compliance. Separately, the Basel Committee released a survey of the implementation of the compliance risk principles it adopted in the April 2005 paper entitled “Compliance and the compliance function in banks” (the “Compliance Paper”). In the survey, the Basel Committee states that the results indicate that in a substantial majority of the respondent jurisdictions, banks manage and supervise the compliance function as an important risk management control function, and are in line to varying degrees with the Compliance Paper. The Basel Committee asserts that the survey shows that the high-level principles described in the Compliance Paper remain relevant and are reflected in current supervisory frameworks or in reforms still under way. Twenty of the twenty-one jurisdictions surveyed reported some form of compliance requirements, and the Basel Committee stated that a large majority of the respondents have a compliance framework that closely follows the principles described in the Compliance Paper. The survey found that market conduct (such as conflicts of interest, fair customer treatment and suitable customer advice) and prudential laws and regulations were the areas most frequently involved in compliance incidents; the prevention of money laundering and terrorist financing was also frequently mentioned.

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