



Abstract

As part of the global implementation of its Basel II AIRB approach, the client was required to upgrade a number of credit processes and monitoring tools. In addition, an enhanced and consistent methodology was required for credit risk exposure equivalent measurements for banking book products. Avantage Reply provided a pragmatic solution for monitoring and reporting of these global exposures, by taking resource constraints into account.

Credit process enhancement within completion of Basel II AIRB application, including the review of credit risk equivalent measurement for global exposure monitoring

THE CLIENT

The client is a leading international bank offering custody and investment services primarily to investment funds and financial institutions.

THE CHALLENGE

The client is in the process of completing the global implementation of its Basel II AIRB approach for financial counterparties and investment funds.

In order to ensure proper integration of the AIRB approach in the day-to-day activity, a whole array of credit processes and monitoring tools needed to be upgraded. The client asked Avantage Reply to recommend, agree, and implement an enhanced and consistent methodology for the measurement of credit risk exposure equivalent ("CREs") for banking book products. The revised CREs would (a) enhance the day-to-day credit risk limit monitoring, (b) allow group-wide consistent measurement of global exposure risk and consolidated reporting, and (c) be compliant with the Basel II framework, including "use test" requirements.

The core challenge was to propose pragmatic CRE formulas taking resource (IT and human) constraints into account. Avantage Reply was also asked to support the development of a consensus view regarding the group's appetite for credit risk.

Upon successful of the above phase, Avantage Reply was requested to develop and implement enhanced credit risk monitoring reporting based on the revised CRE indicators.

APPROACH AND SOLUTION

Avantage Reply's approach was to anchor the solution around Basel II requirements, i.e. deriving the CRE from the current exposure and comprehensive approach formulas provided to determine exposure at default ("EAD"), yet adopting more conservative parameters than the supervisory ones in line with the group's risk appetite.

In addition to the mere implementation of AIRB, Avantage Reply reviewed the relationship between limit consumption and the scale underlying exposure for foreign exchange contracts to assess the reliability or else of supervisory add-ons. A pragmatic periodic review of haircut and add-on parameters was proposed as a follow-up to ensure the ongoing adequacy of the CRE indicators.

With regard to reporting, Avantage Reply proposed incorporating PDs, LGDs, internal ratings in the day-to-day monitoring tools in order to pave the way for the adoption of AIRB. In addition, indirect exposure measurement was added to the specifications of the Global Exposure Management System (e.g., exposure per currency, per underlying collateral type).

RESULTS AND BENEFITS

The client was provided with a harmonized set of pragmatic CRE indicators for all existing banking book products, and a set of related parameters, ready to be implemented in the Global Exposure Management System, until more refined internal models are proposed.

The Basel II compliant framework facilitated the supervisor's review of use tests and AIRB integration. The use of regulatory standards as a foundation also provided an undisputed reference for the setup of CREs on new products in the Group without committing to costly internal model developments. The upgraded reports enhanced the credit risk monitoring process.

Avantage Reply, part of the Reply Group, is specialised in Financial Services with a focus on Risk, Treasury and Capital and Financial Performance Management. With offices in Amsterdam, Brussels, Edinburgh, Frankfurt, Hamburg, London (head office), Luxembourg, Milan, Munich and Rome Avantage Reply counts some of the world's most significant financial groups among its clients, including well-known and respected organisations in the Banking, Insurance, Investment Management and Services, and Post Trading Services sectors. The firm's delivery capabilities cover advisory services (Risk/Finance/Treasury Subject Matter Expertise), Program and Project Management, Business, Functional, and Data Analysis. For further information: www.frm.reply.eu

Reply [MTA, STAR: REY] specialises in the design and implementation of solutions based on the new communication channels and digital media. Through its network of specialist companies Reply is helping some of Europe's leading industrial groups in Telco & Media, Industry & Services, Banks & Insurance, and Public Administration to define and develop business models suited to the new paradigms of Big Data, Cloud Computing, CRM, Mobile, Social Media and Internet of Things. Reply services include: consulting, system integration, application management. For further information: www.reply.eu