Basis Point Group

Measure, Improve, Evolve.

OPERA®

CASE STUDY

Basel II Wealth Management Capital Allocation

THE CHALLENGE

Global banks are preparing for the new Basel Capital Accord (Basel II), which ties a bank's regulatory capital requirements more tightly to the risks each institution takes in the market. Implementing the advanced quantitative approaches laid out in the Accord for measuring operational and credit risks is proving a major challenge for global banks that are involved in non-core banking services.

A top five, internationally active U.S. bank holding company began the process of assessing the business impact and risk modeling and data gathering requirements of the new Basel II requirements on its vast array of business systems and processes.

After an initial assessment of the potential impact on its wealth management activities, it was concluded, the bank's efforts would benefit from the Basis Point Group operational, system and process experience working with other wealth management organizations to provide business program management services in support of its Basel II risk assessment project.

Evaluating Capital Requirements for Non-Bank Activities

The wealth management group of a large, internationally active U.S. bank and bank holding company was engaged in an analysis of data, processes and procedures related to the bank's Basel II initiatives.

Basis Point Group (BPG) was retained to provide business program management to the bank's wealth management Basel II team. BPG was asked to create an analysis framework and implement an analysis that would allow the bank to quantify the impacts on the line of business arising from the new regulatory reporting requirements set forth in the business requirements documents by the bank's Basel II technology delivery team.

BPG began the assignment by meeting with executive, senior and mid-level management to determine their understanding and perceptions of the impact the Basel II requirements would have on the wealth management group's operations and cost structure.

Based on these discussions, BPG worked with the Basel II team to develop an analysis structure to evaluate the group's business requirements. The team was composed of operating, risk and technical participants from the bank's holding company, banking subsidiaries and financial services operations, including investment banking, brokerage and prime brokerage, asset management and leasing subsidiaries.

RISK FRAMEWORK

BPG worked with the team to develop criteria that mapped the line of business operations and system to the new risk categorization requirements.

The bank's preliminary assessment of requirements had focused almost exclusively on systems used to record and report credit or risk exposure. These systems tracked only activities where the bank was a principal in the transaction or where the bank already had a good understanding of capital at risk.

BPG determined that not all business units within the wealth management organization were required to satisfy the Basel II risk requirements.

BPG helped the bank separate wealth management activities into two fundamental risk groupings:

Bank Risk – activities the bank performs where it is "at risk" as a principal conducting:

- Corporate finance;
- Trading and sales;
- Retail banking;
- Commercial banking; and
- Payment and settlement.

Non-bank (Banc) Risk – activities the bank performs when it handles "other people's money" conducting:

- Agency services;
- Asset management; and
- Retail brokerage services.

Using these risk groupings allowed BPG and the wealth management group Basel II team to better understand their management organization, the specific systems of record involved, the business processes likely to be impacted, and the applicability of the business requirements set forth by the Basel II technology delivery team.

INITIAL ANALYSIS

In tackling the Basel II wealth management assignment, BPG started by revisiting the goals of the Basel II guidelines and the requirements defined by the bank's Basel II Implementation team. Senor management wanted to know:

- The overall impact of applying Basel II's credit, market and operational risk requirements to the wealth management group;
- The organizational activities, processes, applications and reporting that would be affected
- The sources and method of acquiring information from internal systems and processes for on-going capital requirements assessment and reporting.

BPG cautioned the team and the bank's executives that based upon past experience, the commonly accepted analysis of credit, market and operational risks were unlikely to provide an accurate assessment of capital allocation for the group.

BPG recommended a structured approach to assess the potential overlap in the ongoing processing in a way that;

1. Segmented credit risk between credit exposure assumed by the bank and credit exposure assumed by non-bank entities (e.g., fully-disclosed broker arrangements);
2. Differentiated between market risk where the bank was a principal in the transaction and where the bank was acting in a custodian, trust, fiduciary, investment management or broker capacity;
3. Highlighted current, on-going operational process risk indicators to dramatically improve the then current "afterto-fact" operational risk loss tracking.

BPG based its guidance and approach on the fact that the bank had sophisticated processes in-place for determining capital allocations under the current regulations and had passed all internal and external audit and regulatory reviews.

BPG's experience with standard risk controls and actuarial loss measurements show they are measurement frameworks well-suited for credit and market risk purposes but unlikely to benefit management analysis when assessing operational capital requirements. The mix of classic bank and non-bank operations further complicated understanding and confused the analysis.

With this perspective, the team started with an analysis of the functions performed by the wealth management group. Each function was classified as a traditional, regulated 'Bank' or non-traditional 'Banc' activity.

The group's 'Bank' activities were then analyzed to determine where capital allocation was captured in the current regulatory process, whether the credit risk allocation would remain the same under the new Basel II requirements and where the new operational risk requirements should reside in the future.

The 'Banc' activities were analyzed to determine how the new requirements impact the categorization on non-traditional bank activities, as well as changes in the overall process of capital allocation analysis and reporting.

To identify how the organization of people, process and systems within the wealth management group might give rise to the type of unexpected losses for which the bank was expected to allocate capital, BPG led the team in an analysis of it's 'Banc' activities on credit and market risk. Activities such as securities and margin lending were carefully examined to understand the bank's exposure under a number of different potential market scenarios.

This approach added a discipline and framework for decision making to the team's analytic efforts and thought process. The approach forced a focus on the logic used to categorize, assess and assign risks that could potentially exist in the many components of the bank's wealth management infrastructure. Further the approach involved the team in establishing the specific methods to verify group's credit, market and operational risk.

The analysis phase included analysis and line of business impacts including the appropriateness and completeness of the data from the banks mutual fund, investment management, trust, custody and retail brokerage systems.

Through a series of straightforward analytic steps, directed by BPG staff, team personnel were able to verify expected outcomes, quickly recognizing and isolating potential loss events using data from the bank's recordkeeping and reporting systems. Grouping these risks by process, functional and investment categories the team was able create a multi-dimensional view of the impact each had on the bank's capital requirements.

IMPLEMENTATION

Working with the wealth management group Basel II team, BPG helped design a flexible analytic framework and create a process the staff easily understood to evaluate Basel II business requirements.

During the initial analysis effort, weekly meetings with members of the wealth management group Basel II were conducted to review progress and verify understandings. These meetings highlighted;

- Progress made against the original project plan and target dates;
- Differences in understanding of current regulatory allocation requirements
- Progress analyzing the list of activities against the new regulatory requirements; and
- Areas requiring additional input from the bank risk organization or regulators

BPG continually reviewed the definitional approach, activity risk categorization, reasoning and quantitative findings with the staff and management.

Conclusion

In just over six month's elapsed time, the wealth management group was able to implement a structured Basel II analysis and reporting framework to track the capital allocation requirements for non-bank activities. BPG was able to help the bank efficiently complete its analysis of the Basel II business requirements and the impacts on the wealth management group systems.

The bank has also found that the process of tracking and trending data allows continuous improvement and benchmarking against the ultimate goal of zero errors and minimal processing risk. The bank also shares this data internally, as well as externally with custodians and fund accounting organizations further improving communications and processing efficiency.

Working with BPG over the three evolving stages of this project, the bank's executive management group and its staff vastly expanded their understanding of the complexity of assessing the effects of Basel II on managing their overall operations. Management and staff developed a greater knowledge of key operational process risks and they learned how to better manage these risks to minimize capital requirements, while improving overall operations performance.

BPG utilized its proprietary OPERA™ operations performance and risk measurement methodology to quantify operations quality and risk, showing how a small cluster of errors might be a warning sign of greater process risk.

The bank's risk management team was interested in understanding how consolidated metrics derived using the OPERA™ measurement approach could be unbundled to identify individual process quality or risk "hotspots", particularly where they might affect the quality of the investment management decisions.

Impact

Basis Point Group's unique 'Bank/Banc' risk analysis approach allowed the team to understand and quantify the impact on non-traditional service activities on the bank's capital structure. BPG's experience combined with this unique capital analysis framework enabled the bank to simplify a complex analysis and measurement process and clearly quantify each activity's impact on operating capital.

Basis Point Group's *OPERA*™ measurement framework allowed the team to better understand their operations and derive additional quality information from data they had been using in their day-to-day activities. By structuring this information differently, the team was able to gain insights and knowledge about risk activities and implement operating improvement.

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Operations Performance and Risk Consultants

Basis Point Group, LLC (BPG) is a specialist consulting firm focused on managing the critical organizational and systems changes needed to improve competitiveness, quality of client service and mitigating operational risk for investment management and capital markets firms. We are dedicated to optimizing the performance of the people, processes and systems within each client company.

BPG uses an unparalleled, structured discipline to assist Chief Operating Officers and their teams to analyze, measure and improve operational processes, cost-effectiveness and transparency. Our partners work directly with investment management, finance, compliance, risk, securities operations and technology management on productivity and process control improvement projects.

We achieve sustainable results for our clients by combining OPERA®, our proprietary operations performance and risk measuring methodology, with our depth of practical knowledge and experience. The result is the delivery of highly effective business support infrastructures and technology solutions across the financial industry, particularly for the largest investment and securities firms.