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Understanding Basel III, Basel II, and effective ICAAP framework

Objective

Towards the end of 2008, following the Western banking crisis, the Basel Committee announced a full-scale review of the banking capital framework. As a result, during 2009 and 2010, the industry was flooded with proposals, consultative papers, impact studies, and firm decisions. This process was due to be completed by the end of 2010, although some parts will continue into 2011. Many banking activities will be affected, and the broad consequences will severely impact banking strategies.

This 4-day course is designed to discuss the changes in Basel III and their impact on the banking industry. This course focuses on Pillar 2, Internal Capital Adequacy Process (ICAAP), and its paramount importance to the soundness of banks' financial position and ability to withstand economic crises.

How will this course assist you?

- The evolution of the Basel II rules for bank capital adequacy
- The recent amendments to Basel II applied to the definition of capital
- Regulatory updates for market, credit, counterparty, and liquidity risk
- Stress testing for various risk measures, including how to formulate and articulate stress tests
- The likely effects of "Basel III" on the international banking industry
- the conceptual framework of ICAAP, its importance, and development

Who should attend?

- This course has been specifically designed for the benefit of:
- CROs
- Heads of Compliance
- Risk Managers
- Risk Controllers
- Auditors

Outline

DAY 1

Overview of BASEL II

- Overview of the Basel II capital regulations
- Basel structure and Pillar 1,2 and 3

- Pillar 2 supervisory review and ICAAP
- Pillar 2 is a holistic view of capital, not just an "add-on."
- Business benefits of ICAAP and Basel Pillar 2
- ICAAP aims and definitions
- ICAAP principles
- Embedding into management processes and decision-making
- Global regulation for ICAAP

Brief Overview of Events Before and During the Banking Crisis

- Securitization and the mortgage markets
- CDO markets, super senior tranches, the chase for yield, and the role of the rating agencies
- Point of Sale accounting and mark-to-market valuation
- Reliance on wholesale funding and the creation of funding liquidity risk
- Use of structured investment vehicles and implicit support
- Impact on the interbank markets
- Limitations in stress testing
- Pro-cyclicality
- Deficiencies in senior and risk management oversight

Case study

Changes to the Definition of Capital

- What are some of the significant problems with the current definition?
- Was capital indeed loss absorbent?
- An outline of the proposed changes
- The concept of "going" and "gone" concerns
- Removal of hybrid securities
- Elimination of Tier 3 and harmonization of Tier 2
- Treatment of minority interests and other investments
- Harmonization with IFRS

Changes to the Regulation of Market and Credit Risk

- Why has traded market risk been highlighted as requiring attention?
- Reinforcement of the approval process for internal models
- Introduction of Stressed VaR
- How is this to be calculated?
- What is the estimated impact?
- Introduction of the Incremental Risk Charge to replace Specific Risk

- What are the broad requirements?
- Netting and other mitigation
- Specifying and implementing the liquidity horizon
- An overview of credit portfolio modeling, including both default and migration, to estimate the IRC
- Criticisms of the IRC and likely modifications
- Estimation of a capital charge for counterparty credit risk (CCR)
- What is the current state? Background to the existing formula
- Introduction of the Credit Valuation Adjustment (CVA)
- How to model expected positive exposure
- Proposed Bond Equivalent approach
- The comprehensive risk approach
- Practical applications: There will be computer demonstrations to reinforce how the calculations may be performed
- Centralized clearing for OTC derivatives
- How is the credit default swap market operating?

DAY 2

Changes to the Securitization Framework

- What went wrong, and what are the broad intentions?
- Recalibration of the Supervisory Formula
- Specific risk charges and SF charges
- Multi-Dimensional Risk Measures
- Is capital the only mitigant?
- Introduction of a leverage constraint
- What is proposed – how is it likely to work?
- The overall timetable for parallel running and future calibration
- Should this move into Pillar 1?

DAY 3

Introduction of a Liquidity Framework

- Funding liquidity: what happened during the crisis?
- Estimation of the Liquidity Coverage Ratio
- What are eligible liquid assets?
- Estimation of run-offs
- Estimation of the Net Stable Funding Ratio
- Proposed calibration
- The supervisory stress test
- Regulatory metrics to estimate liquidity

Counter-Cyclical Capital Buffers

- Why is the current Accord pro-cyclical, and what are its dangers?
- The broad intention – and what are the current proposals?
- Early warning signs of a boom-bust cycle
- Estimation of credit to GDP and other measures for each jurisdiction
- Estimation of capital buffers
- Home-host responses

Day 4

Stress Testing

- Why stress test? What are the recent lessons?
- How was stress testing viewed before 2007?
- What happens in times of stress?
- What constitutes a good stress test?
- What are the management messages from stress tests?
- Senior management responses to stress tests
- Regulatory stress tests: results from European tests

Pillars II (ICAAP) and Pillar III

- Increased focus with Pillar II
- Changing emphasis for the ICAAP
- How the SReP may be adjusted
- Revised disclosure requirements under Pillar III
- Setting risk appetite
- Quantitative and qualitative measures,
- Setting risk appetite in terms of earning volatility
- Economic capital and regulatory capital
- The growing importance of the use of economic capital measures
- Economic Capital modeling
- The importance of inclusion of risks beyond Basel Pillar 1
- Interest rate risk in the banking book
- Credit concentration risk
- Liquidity Risk
- Strategic Risk
- Regulatory and Compliance Risk

- Qualitative and quantitative measures for risk assessment Basel II provisioning rules

Corporate Governance

- Lessons from the crisis
- Getting the basics right
- Continual risk monitoring
- Enhanced oversight – the role of the Board Risk Committee