Basel II and Performance Management

Manage and report on risk

The Basel II Capital Accord ties a bank's capital more closely with its economic risks. The accord, a refinement of earlier international regulation, strives to stabilize the banking industry by ensuring consistency and competitiveness among banks. While critics argue that the accord actually works against these goals, banks in over 100 countries must now comply with Basel II.

The concept is simple: the more sophisticated a banks' risk management approach and, perhaps more importantly, its ability to demonstrate it, the less capital it must set aside to cover losses such as defaults. This minimum capital requirement is the first of the three pillars of Basel II, the second being internal controls and the third, market discipline and external disclosure.

From compliance to performance

For both senior executives and business managers, the ramifications of Basel II are significant: effective risk management can enable better use of capital. And of course, its corollary: the inability to demonstrate risk management can tie up capital or engender non-compliance penalties.

Banks are at various stages of compliance with Basel II. On the road to compliance, performance management has a major role to play. Performance management lets you consolidate and analyze data and communicate the conclusions you draw from it, enabling compliance by letting you determine and report on risk in your organization.

Along the way, however, many companies experience a shift in outlook. Compliance can uncover valuable business insights useful throughout a company. The risk information gathered in compliance teams can help customer relationship managers make more profitable, risk-based decisions. Performance management enables every step towards Basel II compliance, and lets your company use the intelligence it must gather to move beyond compliance and toward higher performance.

Gathering and calculating risk data

Banks never have a shortage of risk management expertise, technology, or data. The issue lies in consolidating and communicating it, within the company and externally, to regulators and to the market.

The first pillar of Basel II sees banks unifying risk data from many different systems into a warehouse. Historically, risk management systems have been considered back office functions, often administered by the finance function and accessed by relatively few. Basel II requires business and senior managers to have a single shared perspective of the bank's risk exposure, both at a high level and broken down by business unit, region, and other key dimensions. This is a highly complex task in most organizations because of differences in regulations from country to country, lack of coordination among branches, and so on. Basel II then demands that banks set aside varying levels of capital to reflect the risk inherent in different lines of business and product groups. The higher the risk, the more capital that must be set aside.

Cognos performance management unifies data from disparate systems into a single, consistent repository optimized for the risk analysis and reporting the later stages demand. A single metadata layer and conformed dimensions help you ensure the data quality and accuracy that regulators will require. Banks can also model capital requirements to optimize their mix of products, regions, and customers for maximum profits.

When a high-quality risk management repository is at hand, you can begin estimating measures such as the probability of default (PD) of an obligor or the loss given default (LGD) of an exposure. You can create and build on these initial estimates to compute regulatory capital, whether through the internal ratings based (IRB) approach or the standardized approach with external data.

Internal and external reporting

The second and third pillars of Basel II both involve reporting the risk exposures uncovered through the first pillar. This can be done with risk reports (production and ad hoc query), analysis, scorecards, dashboards, and event management.

Pillar two relates to internal controls. It asks a bank to self-assess its risk position across any dimension. When a single, aligned enterprise risk system and risk management process are in place, senior management can perform regular supervisory reviews and report the findings externally. Through pillar three, regulators actively review, analyze, and police a bank's risk position by product, region, risk class, business unit, and so on. Investors and rating agencies also need the data.

Through accurate and honest reporting, a bank avoids additional capital charges or reductions, as well as onerous investigations. The return on your compliance investment will be seen in these savings alone.

But understanding and communicating risk can also be a powerful performance driver. In many banks, branch and customer relationship managers are now using risk information and performance measures to make more calculated decisions based on risk considerations instead of on selling a particular product. Investors and rating agencies also have a legitimate demand for the information.

Keeping an eye on risk with dashboards

With a company-wide risk management system in place, senior management can stay in touch with risk-related issues. Cognos performance management provides a dashboard for monitoring critical measures and events. Instead of monthly or quarterly reviews of exposures, you can actively monitor exposures daily to ensure you remain within limits.

The risk dashboard in figure 1 combines notifications, reports, and risk performance indicators for an at-a-glance

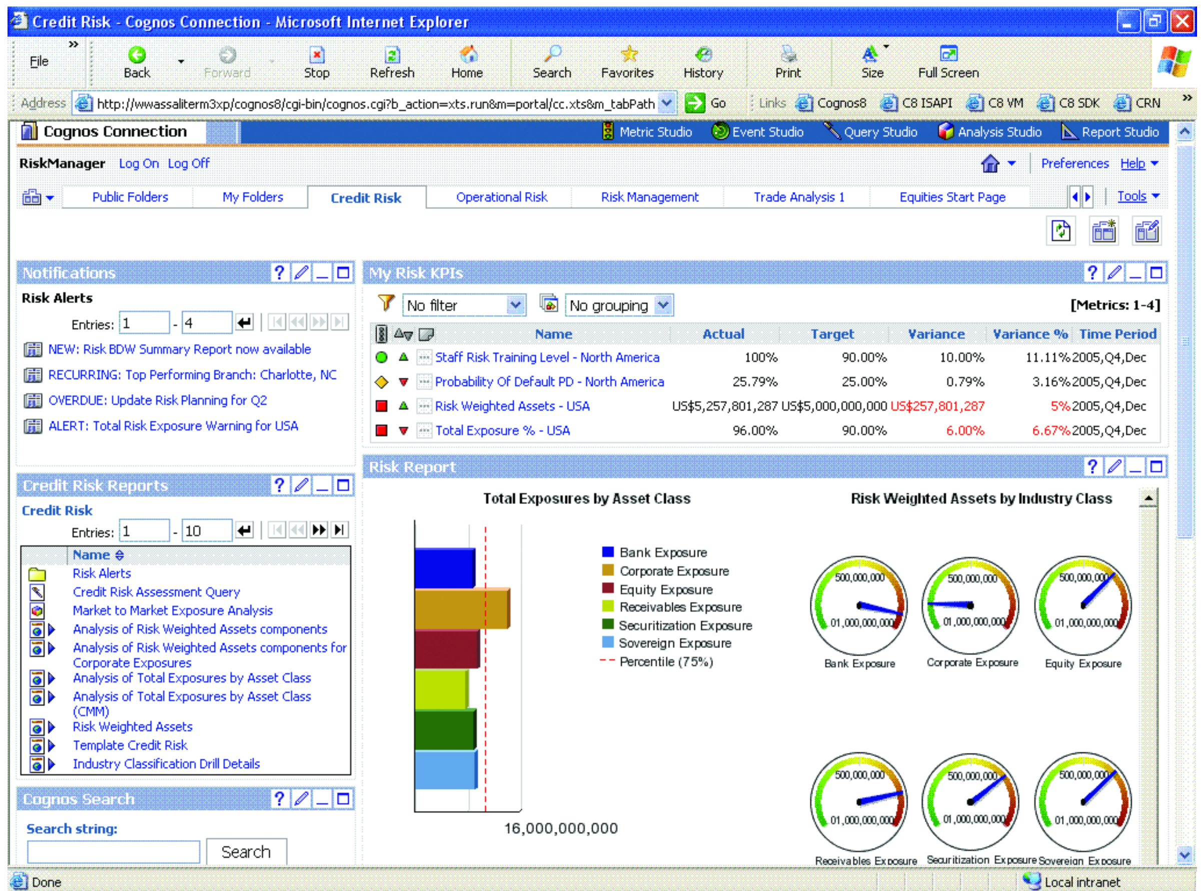

Figure 1: Risk dashboard

survey of risk-related issues. This current report shows credit risk measures by asset class, which is important for specific requirements within Basel II.

High-level dashboards provide senior management, risk management, and business managers with both risk oversight at varying levels of security and the ability to drill into specific detail. Create a balanced scorecard to watch key risk indicators across business units, regions, industries, and ratings dimensions. Highlight performance, trends, dependencies, and exceptions, and own your risk indicators and performance.

Fact-based risk management with analysis

Ongoing understanding of risk exposure, both for compliance and company performance, grows from the ability to analyze risk information from many perspectives. Cognos 8 performance management lets you drill down on any data, such as risk concentrations by customer, region, business line, industry, and credit rating. Slicing the data by different dimensions can give you important insights into how events in various realms affect your performance.

The risk analysis in figure 2 displays the internal rating of customers sorted by industry, broken up across four geographical areas. We can see the disproportionate exposure of European investment-grade bank customers as compared with other regions and industries. A risk manager might then analyze whether this concentration was reflected in credit utilization levels or the mark-to-market values of those instruments by simply dragging a new measure into the pane.

Cognos lets group and divisional risk officers and business managers identify concentrations and associations not captured through routine reporting. For example, aggregating information on a single account that is managed across multiple regions, business units, or product teams might highlight risk exposures within that account that might otherwise lie hidden.

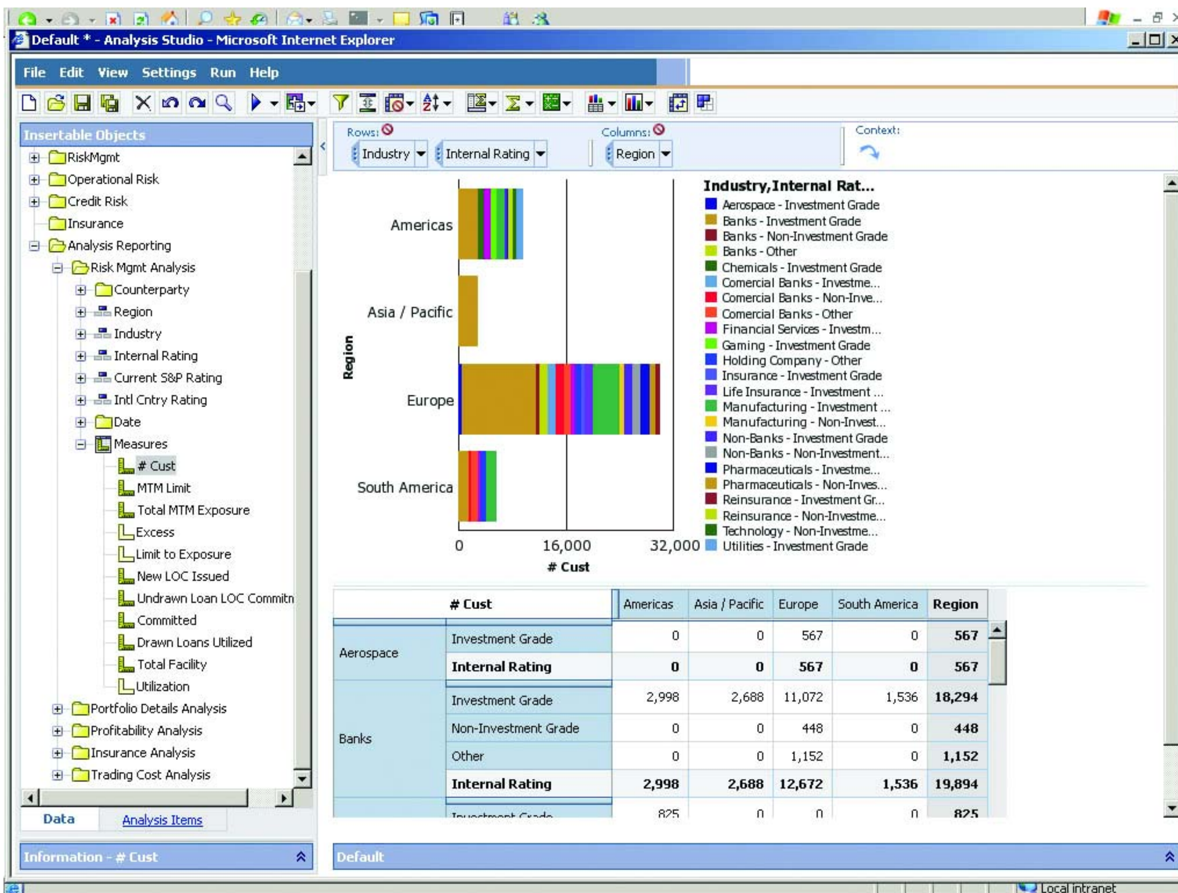

Figure 2: Risk analysis

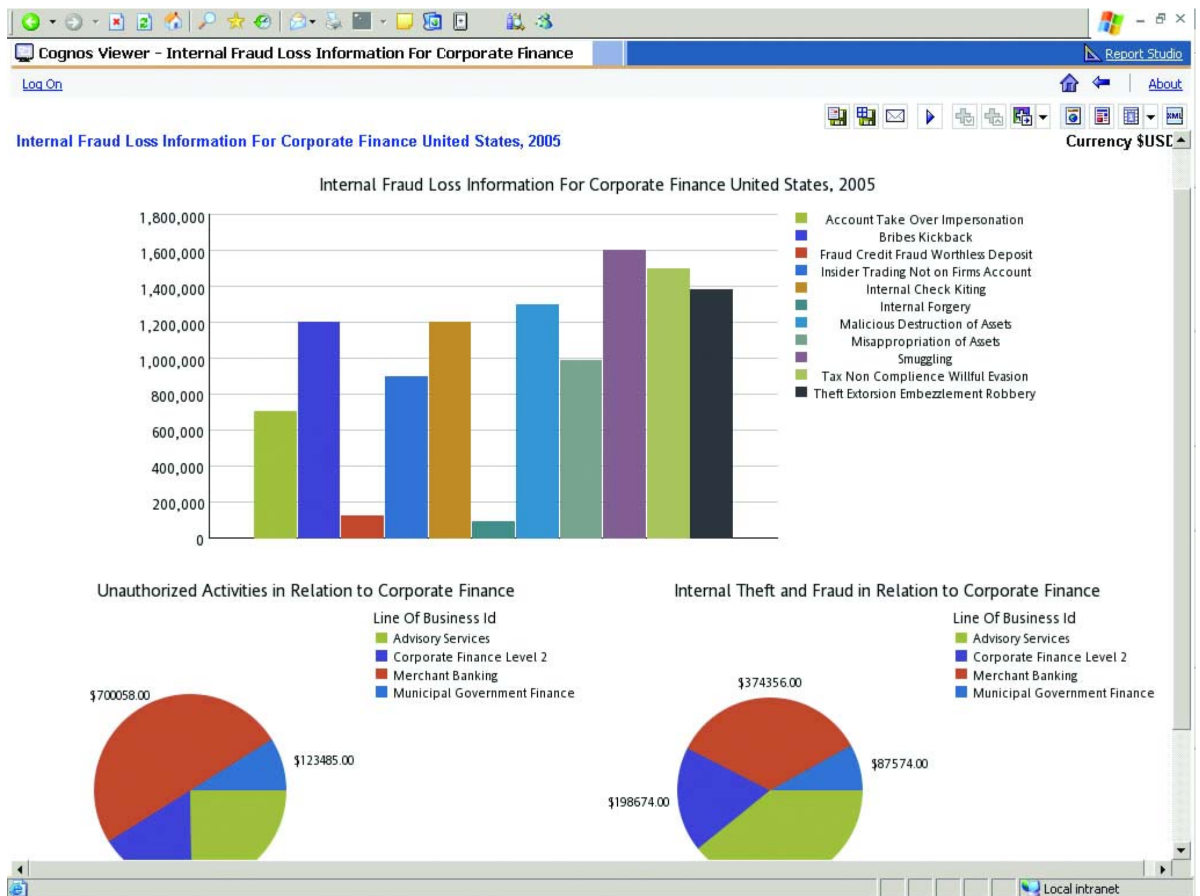

Figure 3: Risk report

Communicating risk with reporting

With Basel II, reporting on risk is as important as determining risk. Cognos performance management combines regular and ad hoc reports in a flexible package. Scheduled management reports, disclosures, and exception reports are equally simple, no matter what the level of user expertise.

The risk report in figure 3 shows the monetary value of internal fraud losses in the United States and correlates it with various business units, comparing unauthorized activities to internal theft and fraud. This information might prompt a bank to monitor the most vulnerable business units, both for vigilance against future losses and planning for more capital to be set aside for these high risk areas.

An integrated risk management environment

Cognos performance management creates a shared understanding of a bank's risk profile overall and within specific business units, regions, and functions. Cognos delivers visibility and control. It lets managers within the business, such as loan officers and account managers, see risk from the organizational perspective, not isolated to a particular product line, region, or group of branches. For risk managers and senior managers the benefits are obvious: not just adherence to Basel II, but risk management for better corporate performance.

About Cognos

Over 1,000 financial services institutions worldwide use Cognos performance management software to improve and direct corporate performance. Nine of the top 10 banks in Europe and all of the top 10 banks in the United States overwhelmingly choose Cognos. Four of the top five global insurance companies have selected Cognos to underpin their performance management requirements.

Cognos performance management software enables all of the key steps in the management cycle—from planning and budgeting to measuring and monitoring performance, to reporting and analysis. Founded in 1969, Cognos employs over 3,500 people and serves more than 23,000 customers in over 135 countries.

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