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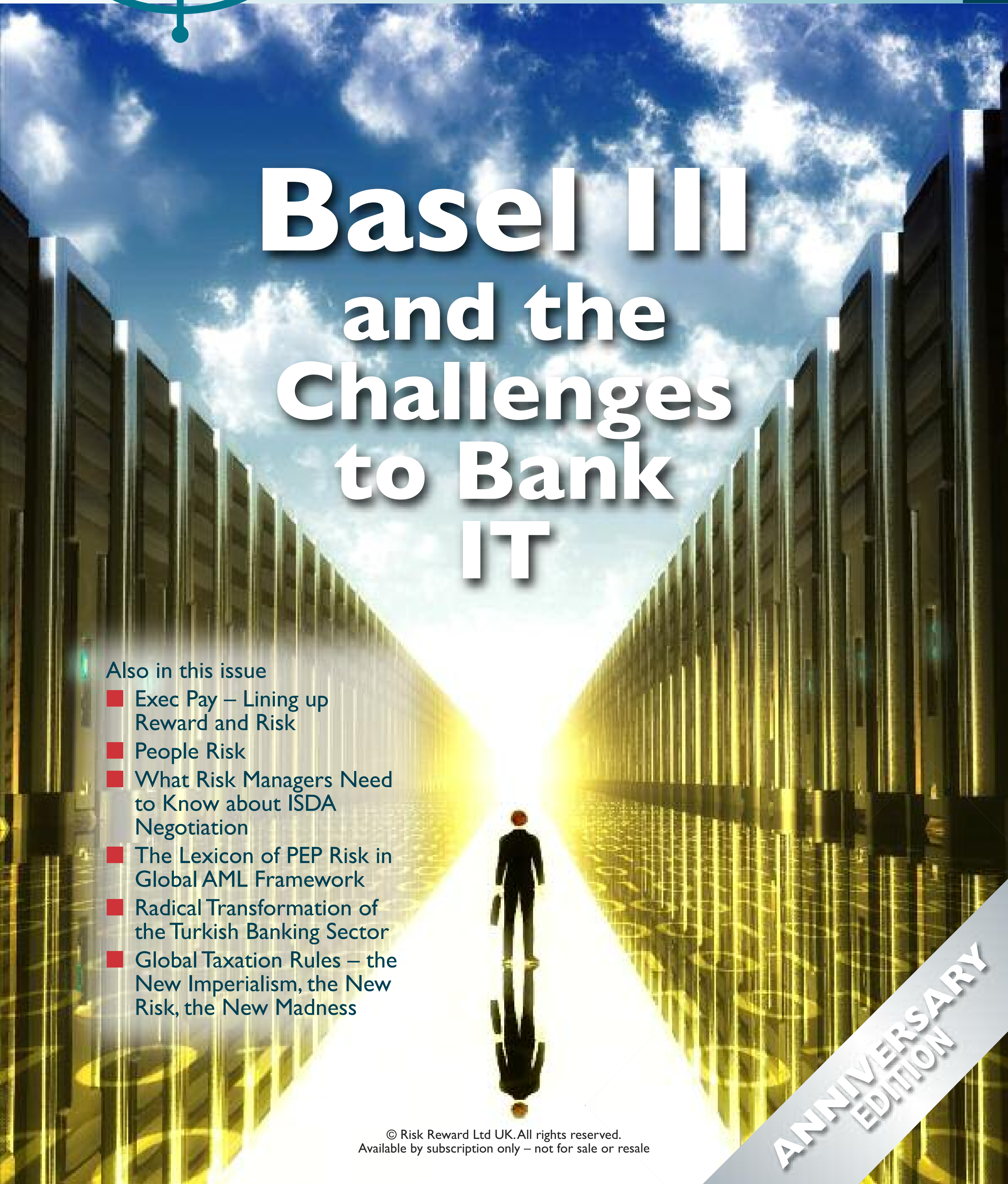

Basel III and the Challenges to Bank IT

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ANNIVERSARY EDITION

Basel III and the Challenges to Bank IT

Graeme Skelly is a member of the Risk Reward Risk Management Faculty since 2007 advising and training banks and financial institutions in emerging markets on topics including Basel II & Risk Management, Basel II Implementation and Compliance, and Measuring and Managing Operational Risk. Graeme offers a brief overview of the latest banking regulations and its impact on IT for practitioners.

The Banking crisis of 2007/08, the so called Credit Crunch, highlighted significant deficiencies within the banking system and the regulations adopted to manage financial risks. The crisis was caused by many factors and has been described by some as "a perfect storm". The U.S. Financial Crisis Inquiry Commission report of January 2011 summed it up: In response to the crisis the Basel Committee on Banking Supervision has released a series of amendments to the existing Basel II regulations to form "a comprehensive set of reform measures... to strengthen the regulation, supervision and risk management of the banking sector". These amendments and agreements are collectively referred to as "Basel III" and are intended to address the globally systemic nature of modern banking and provide a more risk sensitive framework for banks. The regulations address the deficiencies by adopting both a macro and microprudential approach as well as strengthening the risk management, governance, and transparency requirements. One key element is the requirement for banks to take account of 'stress conditions' when calculating their regulatory capital.

The Basel III Framework

The Basel III accord aims to strengthen the regulation of individual banks, micro-prudential, whilst ensuring the stability of the overall banking system, macro-prudential. It also looks to overcome the limitation of Basel II by minimising a bank's ability to benefit from regulatory arbitrage both between local implementations of the regulations and between the trading book and banking book. It also aims to strengthen the regulations for certain types of risks. Basel III framework defines: a simplified structure and improved quality of capital; measures to encourage banks to hold capital that can be utilised in periods of stress; improved risk coverage; improved capital requirements for both the banking and trading book including consideration of the impact of stressed markets; measures to improve counterparty credit risk considerations; the introduction of a leverage ratio to support the risk-based requirements; global regulatory standards to ensure banks hold sufficient liquidity buffers; measures to reduce the pro-cyclicality effect of Basel II; measures to address the systemic nature of important banks; improved governance; and improved transparency and disclosure. All of which will add up to much higher capital requirements for banks.

In November 2010 the set of enhancements were formally endorsed by the G20. Whilst most countries are aiming to ensure their local regulations are Basel III compliant by 2013 not all will do so. The most notable exceptions are in Asia where some countries will adopt Basel II/III in due course. Within those countries who adopt Basel III by 2013, Banks will have until January 2019 to be fully compliant with the new regulations. The implementation timescale for Basel III is phased to ensure that banks are able to fulfil the increased capital requirements whilst not adversely affecting their ability to lend.

Impact on IT

The impact of Basel III on a bank's IT will be far reaching and complex due to the interdependencies of the new regulations. Not only will the risk management systems need to change but banks will also be required to upgrade their balance sheet management and reporting systems. However the key factor will be ensuring there is sufficient data of the required quality to support the analytical and reporting systems. Add to this the resulting requirements for IT and operational governance, and Basel III will pose considerable challenges to banks. Consequently there will be no one-size-fits-all approach as banks will need to configure their implementation of the Basel III framework to the complexity of their organisation and its business.

If the challenge of implementing Basel III on its own is not daunting enough, all of the changes will have to be achieved against a back drop of significant change and turmoil caused by other regulatory changes, national initiatives and economic instability. For the immediate future IT departments will have to carefully prioritise and allocate resources with the right level of expertise, making sure they use them effectively and efficiently.

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