



Basel II

What are we **NOT** talking about

Alchemy Technologies

ICAP

03 August 2006

Action plan



- Introduction
- Risk Management Context
- What are we not talking about
- Practitioners and implementation orientation
- Qualifiers
- Q & A



- Actuarial & Enterprise Risk practice
- 4 Basel II Implementations
- PASHA-ICT 2005 Best Financial Application, KRL Labs
2005 Best Commercial Application
- APICTA 2005 Thailand Finalist Best Financial
Application
- 26 Professionals, 35 customers 100% growth, year on
year for the last four years.
- 90% referral and repeat business



Jawwad Profile

- Fellow Society of Actuaries
- MBA Columbia Business School
- BCS, FAST ICS
- 14 years consulting
- Pakistan, US, UK and Middle East
- Appointed Actuary at State Life
- Enterprise Risk, Derivative Instruments, Product Development

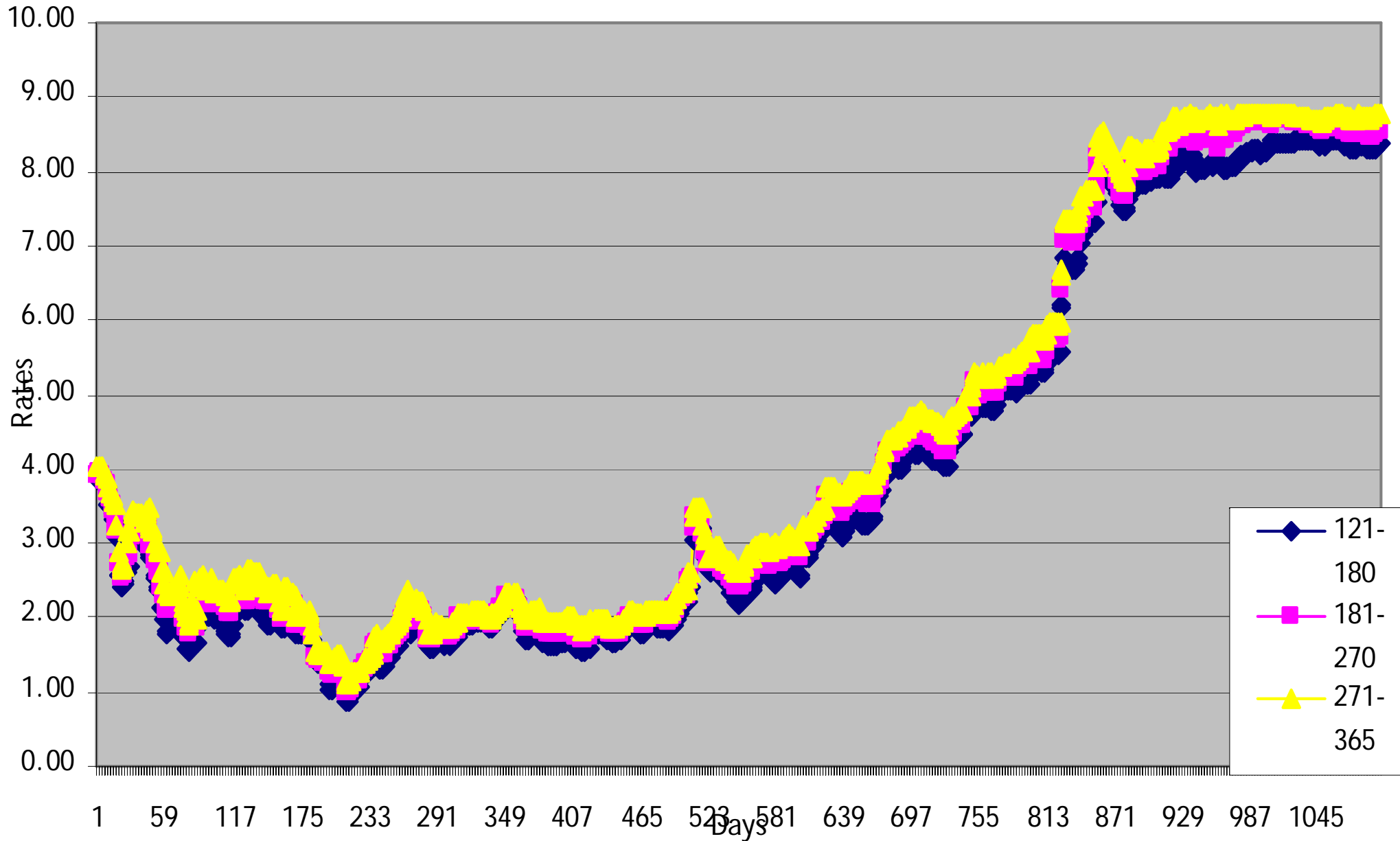


Interest rate change – so what?

Rate Snapshot – 2003 - 2006

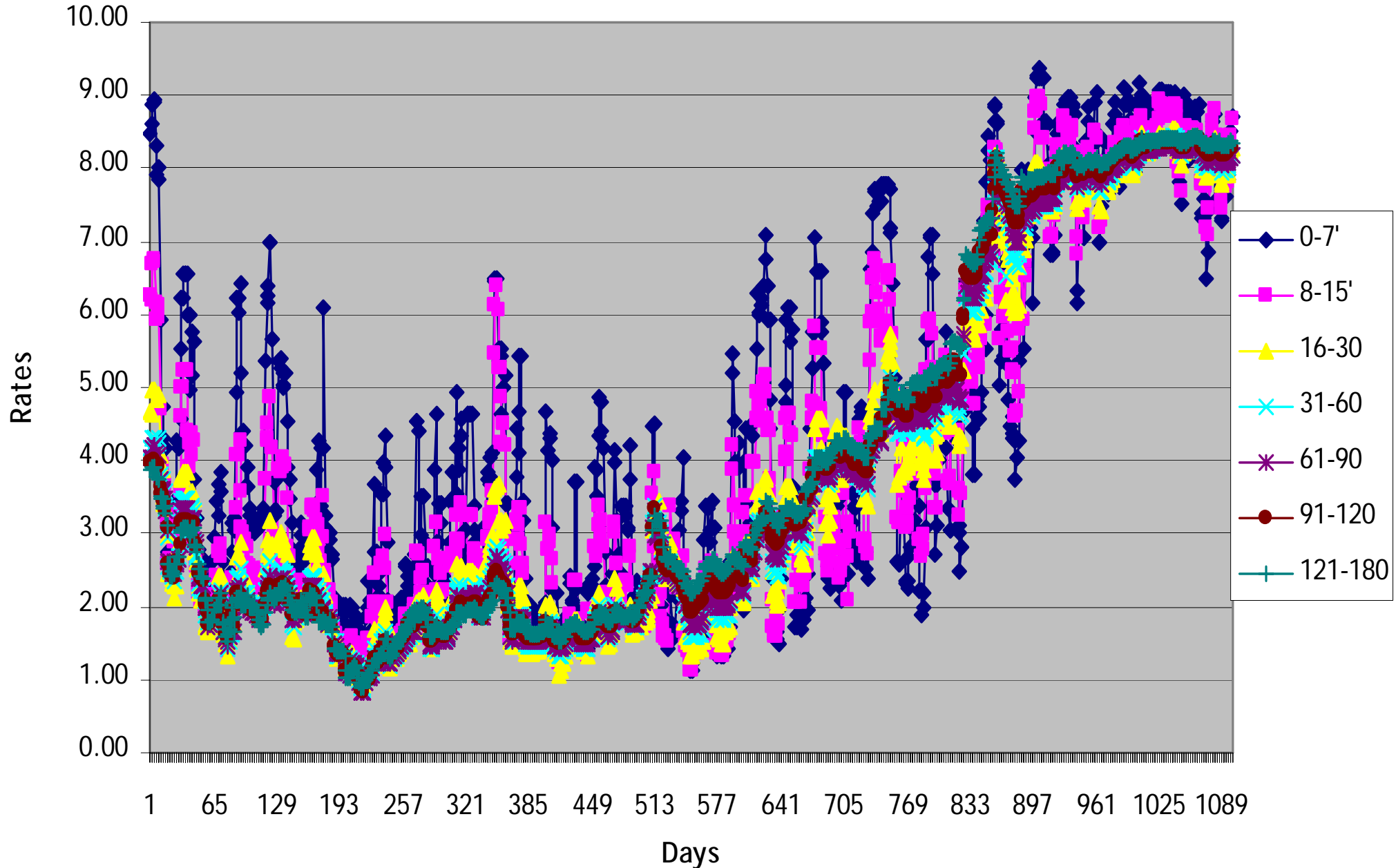


Pakistan - Rate Snapshot

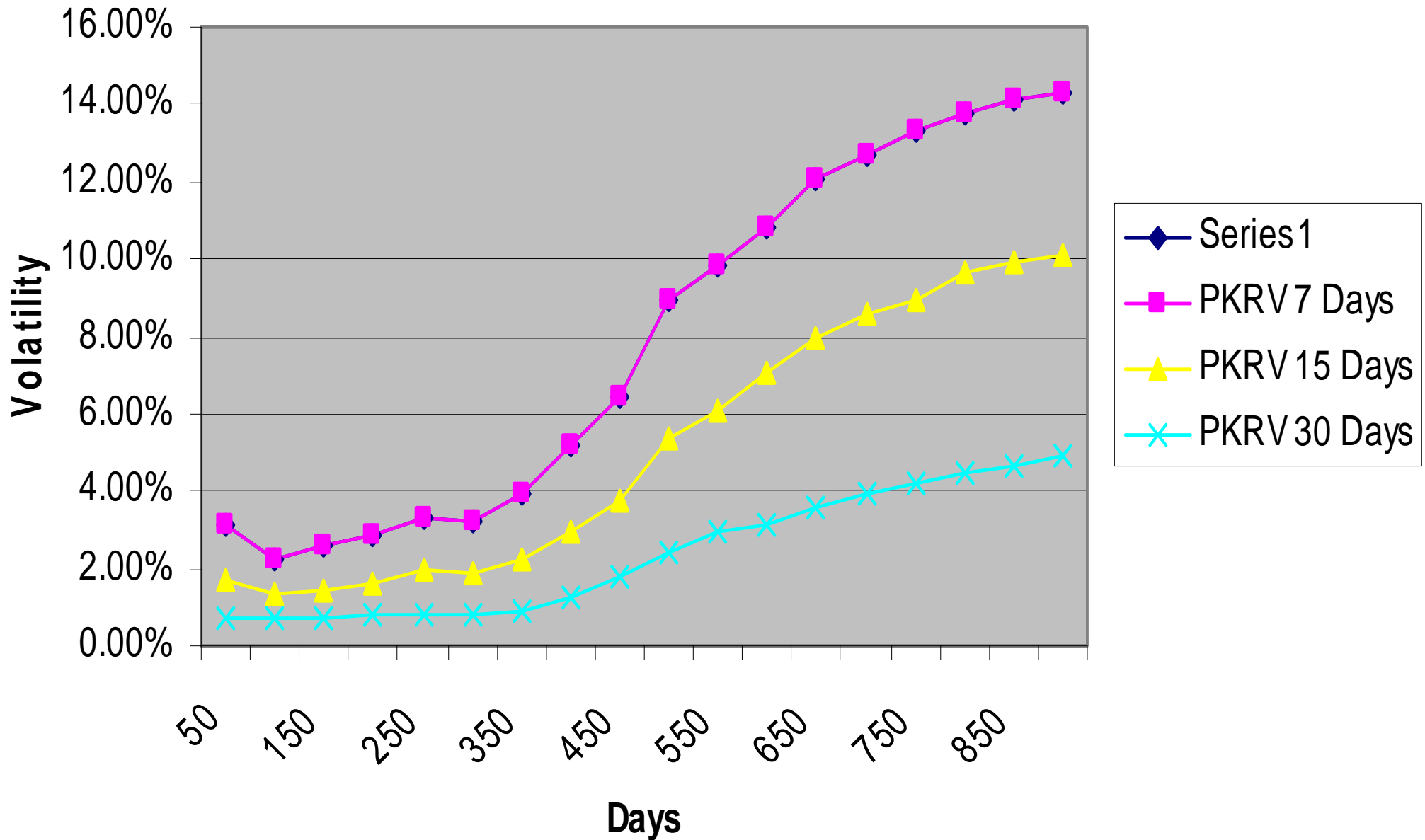




Pakistan - short term rates



Tracking Volatility





Risk Management Context



Risk Context

- Inherited structure
- Missing pieces
- Target state



Risk functions - before

2

ALCO
ALM

1. Interest Rate Mismatch
2. Price & Reset GAP
3. Net Interest Income at Risk
4. Duration GAP

C

EXCEPTION REPORTING & HANDLING

Limits Reporting, Monitoring & Follow up Actions

Risk – missing pieces



1

CAPITAL ALLOCATION

Trading Portfolio, Banking Book,
Derivative Products,
Value at Risk

3

MARKET RISK

Value at Risk, Market Risk Capital, Marginal Capital, Marginal
VaR, VaR Limits

A

PROCESS

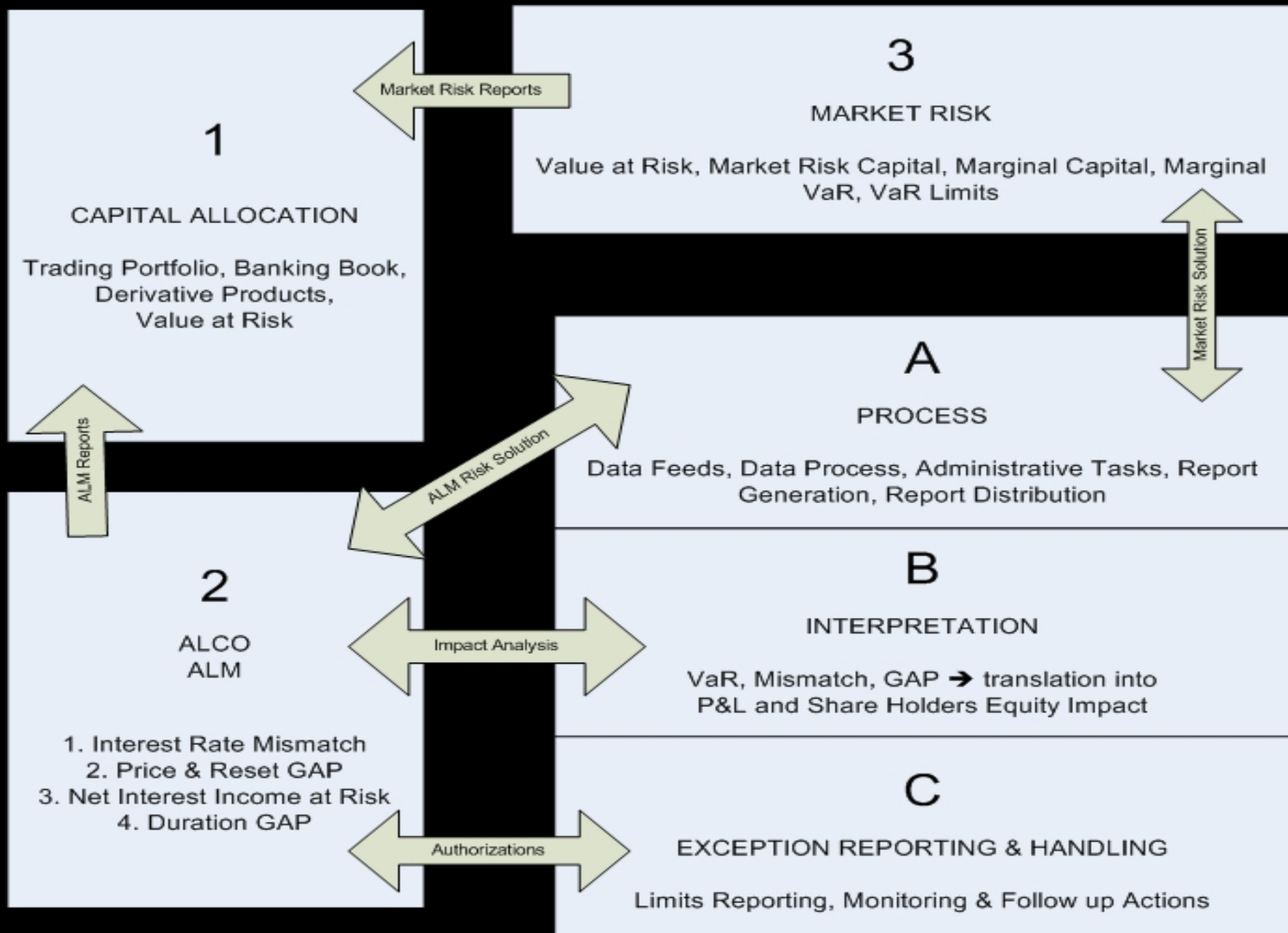
Data Feeds, Data Process, Administrative Tasks, Report
Generation, Report Distribution

B

INTERPRETATION

VaR, Mismatch, GAP → translation into
P&L and Share Holders Equity Impact

Risk – target state





Rumor has it?

- Compliance driven mindset
- Pillar II and Pillar III reporting
- Static versus dynamic risk
- Conflict between risk managers and risk takers
- Silver bullets and ambiguity
- The business case for risk management



Compliance driven mindset

- Checklists
- Post fact
- Internal control and audit
- Non-quantitative
- Limit management



Pillar II and Pillar III

- Trading book versus banking book
- Pillar II disclosure
- Pillar III disclosure – shared and public information

Risk manager and Risk taker conflict



1. Oversight
2. Whose neck is it
3. Gate keepers versus risk takers
4. Step up or a step down
5. Board interaction
6. Board responsibility
7. Reporting time frames, lines & mandate



Risk is dynamic

- Frequencies
 - Risk reporting
 - Market risk committee meeting
 - ALCO meeting
 - Board risk committee meeting
 - Limits review
 - Risk review
 - Portfolio rebalancing based on risk review
 - Risk budgeting

Risk is Dynamic



- The capital allocation challenge
 - Regulatory versus Internal View
 - Integrated Capital Allocation
 - Risk Adjusted Return on Capital
 - Transfer pricing and ALM questions
 - Spread Management



Sliver bullet and ambiguity

- All models are wrong, some are more useful than others
- There are no right answers
- Lots of room for subjective debate
- We have all seen this movie before



Volatility

- Variance ==> expectations not met
 - Std-deviation ==> square root (Variance)
 - Dispersion, Diffusion
 - Volatility
 - Vol
 - Trading Vol
 - Implied Vol
 - Optionality - Volatility - Convexity



Value at Risk



Value @ Risk

- Worst case loss with a **given** confidence interval over a period of time
- On our 100 Million portfolio we stand to lose 2 Million over any 5 day trading period at a 95% confidence level



The business case for risk management



Table I

		Economic	Capital
		Return	Adequacy
1	Faysal Bank Limited	10.6%	11.6%
2	Union Bank	2.9%	4.4%
3	Metropolitan Bank	2.8%	7.4%
4	Muslim Commercial Bank	2.7%	6.5%
5	Bank Al Habib Limited	2.5%	5.9%
6	United Bank Limited	2.4%	6.4%
7	Askari Commercial Bank	1.7%	6.4%
8	Bank Alfalah Limited	1.5%	4.3%
9	Soneri Bank	1.2%	7.4%
10	Habib Bank Limited	1.2%	7.8%
11	National Bank of Pakistan	1.0%	9.6%
12	Prime Commercial Bank	-4.2%	7.0%
13	Meezan Bank	-6.1%	11.1%
14	Saudi Pak Commercial Bank	-9.2%	7.3%
15	NIB Bank	-26.4%	16.0%

Table II



		Economic	Capital
		Return	Adequacy
1	NIB Bank	-26.4%	16.0%
2	Faysal Bank Limited	10.6%	11.6%
3	Meezan Bank	-6.1%	11.1%
4	National Bank of Pakistan	1.0%	9.6%
5	Habib Bank Limited	1.2%	7.8%
6	Soneri Bank	1.2%	7.4%
7	Metropolitan Bank	2.8%	7.4%
8	Saudi Pak Commercial Bank	-9.2%	7.3%
9	Prime Commercial Bank	-4.2%	7.0%
10	Muslim Commercial Bank	2.7%	6.5%
11	Askari Commercial Bank	1.7%	6.4%
12	United Bank Limited	2.4%	6.4%
13	Bank Al Habib Limited	2.5%	5.9%
14	Union Bank	2.9%	4.4%
15	Bank Alfalah Limited	1.5%	4.3%



Table III

		Economic Return	Capital Adequacy	Return / Adequacy
1	Faysal Bank Limited	10.6%	11.6%	0.91
2	Union Bank	2.9%	4.4%	0.65
3	Bank Al Habib Limited	2.5%	5.9%	0.42
4	Muslim Commercial Bank	2.7%	6.5%	0.42
5	Metropolitan Bank	2.8%	7.4%	0.38
6	United Bank Limited	2.4%	6.4%	0.38
7	Bank Alfalah Limited	1.5%	4.3%	0.36
8	Askari Commercial Bank	1.7%	6.4%	0.27
9	Soneri Bank	1.2%	7.4%	0.16
10	Habib Bank Limited	1.2%	7.8%	0.15
11	National Bank of Pakistan	1.0%	9.6%	0.11
12	Meezan Bank	-6.1%	11.1%	(0.55)
13	Prime Commercial Bank	-4.2%	7.0%	(0.60)
14	Saudi Pak Commercial Bank	-9.2%	7.3%	(1.26)
15	NIB Bank	-26.4%	16.0%	(1.65)

Table IV



Table I	Table III
Faysal Bank Limited	Faysal Bank Limited
Union Bank	Union Bank
Bank Al Habib Limited	Metropolitan Bank
Muslim Commercial Bank	Muslim Commercial Bank
Metropolitan Bank	Bank Al Habib Limited
United Bank Limited	United Bank Limited
Bank Alfalah Limited	Askari Commercial Bank
Askari Commercial Bank	Bank Alfalah Limited
Soneri Bank	Soneri Bank
Habib Bank Limited	Habib Bank Limited
National Bank of Pakistan	National Bank of Pakistan
Meezan Bank	Prime Commercial Bank
Prime Commercial Bank	Meezan Bank
Saudi Pak Commercial Bank	Saudi Pak Commercial Bank
NIB Bank	NIB Bank



Mindset - Closure

9 Rules of Risk Management (Risk Metrics Campaign)

1. There is no return without risk (compensation)
2. Be transparent (understand)
3. Seek Experience (people, not models)
4. Know what you don't know (question)
5. Communicate (openly)
6. Diversify (distribute)
7. Show Discipline (consistent versus changing strategies)
8. Use Common Sense (approximately right, precisely wrong)
9. Return is only half the equation (tradeoff)



Local challenges

- The middle office challenge
- The skill set & expertise challenge
- The capital allocation challenge
- The political challenge
- The system & technology challenge
- The interpretation challenge



Basel II Question?

1. Will Basel II make banks safer?
2. Is it possible to begin with Advance IRB and AMA approaches immediately? How real are the projected capital savings?
3. What will happen to cash flow lending, SME and other retail products under a risk based capital allocation framework?
4. How do you solve and address the credit rating issue?
5. What do transfer pricing, ALCO, and ALM have in common with Basel II?
6. Given the emphasis on risk, what is the impact on business distribution and loan pricing?



Basel II Questions?

7. Is this first world medicine? If yes is it applicable or even effective for developing countries?
8. Is Basel II cost effective? What is the typical cost of Basel II implementation in Pakistan?
9. Where is the value addition of the middle office function? Will it ever grow beyond a cost center? Can it ever become a profit center? Why should I care?
10. Are we ready on the IT side (technology infrastructure and reliable data) for the implementation of Basel II? If not, what good is Basel II?



The interpretation challenge - I

1. What do the numbers mean?
2. Value at Risk?
3. Volatility?
4. Monte Carlo simulation?
5. Capital Adequacy?



The interpretation challenge - II

1. How do I put them to work?
2. How much is enough?
3. How much is acceptable?
4. How do I explain these to my board?
5. Where do we go from here?
6. What is the worst that can happen?
7. What if I breach the numbers?



Q & A



Follow up

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