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Challenges of implementing Basel II and III

In this edition, Deloitte Risk Intelligent Enterprise takes a look at Basel II/III Implementation challenges, an unfolding and critical issue in the Nigerian banking sector as many banks are looking to meet the CBN regulatory requirements for compliance with Basel II and III.

Introduction

Basel II and III aim at building on a solid foundation of prudent capital regulation, supervision, and market discipline, and to enhance further risk management and financial stability. They also ensure that banks.

- Place greater emphasis on their assessment of risk,
- Provide a comprehensive framework for credit, market and operational risk,
- Encourages interactive and rigorous bank supervision
- Ensure market transparency, disclosure
- Ensure better alignment of regulatory capital with actual risk exposure
- Improve the quality and depth of capital and
- Increase their focus on liquidity management

All of the above is intended to spur banks to improve their risk management capabilities. The rationale is that ultimately, if banks come to a fundamentally revamped understanding of their risks they will be better positioned to manage them as well as provide good returns for their shareholders .This will be real value for their business, consumers and shareholders

Given the directive by the CBN for Banks to submit their road maps to comply with both Basel II and III, Banks have started to consider options and strategies to comply. However there are implementation challenges faced in achieving this requirement. We have attempted in this write up to share our insights from our experience in working with clients design frameworks and implement Basel II/ III

Challenges of Implementing Basel II and III

Six key challenges of implementing Basel II and III are discussed in this newsletter.

1. Strategy and Objectives

This is a fundamental challenge in implementing Basel II/ III. In most cases Basel II is purely a regulatory compliance initiative. It is therefore absent from the overall strategy of the bank and is not seen as a strategic priority nor accorded the right level of importance. Another challenge is the lack of clarity of a final goal of the Basel II/ III project due to absence of a target operating model. Basel II/ III project can also be derailed because there is no business case developed or due to lack of clarity on ownership of the overall and the key elements of the project. Even if all these are in place, projects could also suffer due to confusion on where the priorities and the budget lay.

In addressing these issues, the bank needs to establish a clear target operating model and determine whether to achieve minimal compliance or competitive advantage.

2. Programme Management, Communication and Reporting

Implementing Basel II/ III requires robust project management skills, infrastructure and commitment of resources. In most cases timelines are not managed according to Basel II/ III requirements and large number of complex sub-projects are not centrally controlled. In some instances, there are no procedures in place for change control despite changing Basel II/ III requirements. Lack of leadership from regulatory reporting and compliance groups could also affect the project.

To address these challenges, the project manager must understand major gaps through readiness assessment and establish plans to close them. There must also be consideration for how all in-scope business units are going to be addressed.

3. Credit Risk Issues

Basel II/ III is far more robust and sophisticated than Basel I with respect to credit risk in terms of approaches, data requirements and the use of information technology. Handling the new requirements often constitute challenges to implementing Basel II/ III. Typical challenges include:

- Absence credit risk loss database
- Lack of required skills
- Consistent probability of defaults with multiple exposures
- Validity of credit default models

Implementing Basel II/ III therefore requires uunderstanding calculation gaps through need assessment and establishing plans to close them. There is also a need for identification of skill gaps and continuous capacity building to address them. Models also have to be subjected to rigorous validation**.**

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4. Operational Risk Issues

In Basel II/ III, Operational risk is a new addition to Basel I and is at its infancy. However, challenges can arise from the lack of a central loss database for operational risks and poor self-assessment of data requirements due to varying business unit policies and procedures. The challenge could be met through the definition of group wide self- assessment procedures, pilot and roll out across business units.

5. Data Model and Processes

Our Global risk management survey as well as the survey conducted in Nigeria confirm that data and systems issues top the list of challenges encountered in implementing Basel II/ III. Many banks lack group-wide data meta model and there are no clear data structure or view of data requirements. While many banks have only identified around 20% of the required data, there is no understanding of how data fits together and there are no mappings of requirements to the Accord through financial calculations. Often the available data are not of audit quality.

Meeting these challenges requires banks to utilise models derived from Basel II/ III calculations for everyday business processes and determination of data gaps and plans to close them.

6. Information Technology

Information technology is very critical for efficient risk management under Basel II/ III. Data has to be aggregated from various sources seamlessly and processed for risk measurement, management, compliance and reporting on a real time basis. Often multiple IT solutions may be deployed across the various risk areas, some of which are connected directly to regulators and clients. Industry findings indicate that 60% of IT implementation fail or are suboptimal, especially in risk management.

This is because many banks implementing Basel II/ III have not started considering the technology impacts of Basel II/ III. They have not conducted vendor evaluations or there are no plans in place to evaluate them. Also some of the vendor solutions are currently immature to address Basel II/ III requirements. Banks therefore need to define the business, functional and system requirements and conduct robust vendor selection rather than base choice on price or copying their competitors.

Conclusion

Basel II/ III implementation is an opportunity for a bank to improve its risk management and ultimately economic capital management. There are many challenges along the way but Deloitte has both the local and global expertise to assist you in actualizing your Basel II/ III objectives.

Through our proprietary tools, we offer support in assessing and benchmarking your Basel II/ III compliance and the related decision-making process. All of this is done in consideration of the local regulatory requirements. Our consulting approach is to work with clients in an integrated and combined team. This approach has proven to yield significant benefits in terms of solution design quality, knowledge transfer and client acceptance to a new way of working.

Contacts

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