Global Regulatory Reform

Make capital work harder—take action

Basel III: capital optimization
Basel III – with new capital buffers and much higher requirements for trading books – substantially increases the need for bank capital:

- Equity capital required increases between 40% and 100% for different banks.
- €1 trillion more capital is needed by the European banking industry, with €450 billion yet to be raised.
- Systemically important banks will have to carry higher overall buffers.

This will put considerable pressure on Return on Equity and make some business areas uneconomic. European banks are also under immediate pressure to meet the European Banking Authority’s 9% core tier 1 ratio by June 2012.
Challenge
Banks will need to optimize the use of capital. One way to do this is to review business areas and retreat from activities with too high a capital consumption relative to return. We are already seeing some banks withdraw from some markets.

However, before making such decisions, banks should review the efficiency of their capital calculations. Basel capital calculations are complex, with different owners for many components: customer data, individual models, collateral information and capital calculators. The calculations are also affected by the bank’s internal processes in the bank. This makes it difficult for owners of components of the calculation to identify areas where capital are being calculated inefficiently – a decision in one area can have a domino effect in another area.

Substantial savings can be found by changing bank processes, reviewing data issues and evaluating how models have been implemented. This can change the economics of some activities, making capital usage more effective with no change to the underlying business. Capital savings of 15% or more can be found across core business units.
Optimizing capital
Although the new higher Basel III capital requirements are being phased in up to 2019 and beyond, there is pressure from the market to comply more quickly. Therefore, it is important to look at efficiency of the calculations urgently.

To optimize capital we look at each element

Business processes and practices
Allowable capital Tier 1 + Tier 2 = (shortfall and other deductions)
Data quality
Capital calculation
Models

Risk-weighted assets

The focus is on the end-to-end calculations covering processes and data, as well as the calculations themselves. Reducing conservatism across the board is not an option. However, by increasing risk sensitivity, capital requirements can be reduced.

Approach
A typical project will last three months and focus on all the areas that impact the calculations. Given our wide experience of managing these projects, we can efficiently work with your team to examine potential savings and the feasibility of implementation. We will:

- Consider your interpretation of regulations versus how other organizations have implemented the regulations
- Challenge your treatment of data issues and suggest alternative approaches
- Review model parameters and structures to increase risk sensitivity
  Use our tools to identify quick wins for your organization

In our experience, large capital savings can be found in all types of business (trading books, wholesale banking books and retail portfolios) and in all types of calculation (standardized, slotting, counterparty risk, operational risk and internal ratings based). Our experience working with a range of large banks enables us to benchmark approaches and advise on any implementation issues regarding changes.
How Ernst & Young can help

We have extensive experience helping banks to economize their use of capital to make the capital calculations more efficient.

Working with our EMEIA team of more than 750 risk professionals gives you access to:
- Large teams on short notice
- Significant insight into varied markets and geographies
- Teams with deep regulatory, modeling, process and data knowledge – and a well-developed approach to realize capital savings

We have worked with leading financial institutions across EMEIA, covering all types of retail and wholesale portfolios, securitization and trading books.

Contacts
For more information on how we can help, please contact one of our team.

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