



Straight-through processing and Basel II benefits

intelligent financial software

Straight-through processing and the route to Basel II benefits

The New Basel Capital Accord (Basel II) introduced a new part to its three supporting 'pillars' of *disclosure and market discipline*, *regulatory review* and *capital requirements*, with 'operational risk' added to the last. Alongside credit and market risks, the ways a Lender can demonstrate lower operational risk can allow for less capital to be tied up to support a loan portfolio.

Basel II defined Operational Risk as... "The risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events".

The challenge

Basel II allows Lender's capital adequacy allowances to be mitigated under three headings.

1. **Systems and processes carry a capital charge and so:**
 - a. reduce number of different systems for same processes
 - b. reduce processing sites
2. **Systems and processes will be scored and so:**
 - a. improve efficiency/effectiveness of systems
 - b. minimise global mitigation effort
3. **"Outsourcing" to utilities (own or external), which:**
 - a. improves effectiveness
 - b. reduces sites, systems, processes and people

The solution

The lending community looked at Basel II and saw two issues. Clearly, it brought new considerations of operational risk for the calculation of capital adequacy. However, to achieve best benefit, Basel II required increased systems intervention to remove inadequacy and failure from operations and placed strong emphasis on consistent historic data being available to back up claims of lower risk.

As Basel II regulatory increased, lenders recognised they would need smarter systems solutions to manage embedded risk, through consistent application of their lending policies and product features and auditing change. Key to this would be to apply system based control (rules) early in the loan lifecycle, ideally at point-of-sale, and then maintain the same rules throughout the loan to completion and during its life as a serviced contract.

Consistent and effective, 'straight-through processing' (STP) was the goal, and Basel II's impact on STP initiatives can be simply summarised: Credit risk calculations and disclosure required improvements to: Data accessibility, Data storage and Provision of

common data; Risk in systems and processes must be quantified; STP developments can be allocated a capital benefit: Improved speeds (reduced exposure), Increased efficiency (reduced risk), Centralisation or outsourcing (reduced risk and regulation).

Lenders also recognised that they needed to be able to show at least five years of data to prove their operational risk had been applied consistently and proven effective. On this point, many Lenders looked at their databases and shuddered. Implementing new and smarter systems solutions was one thing, consistent and Basel II-auditable data would flow and build. But, what to do with the legacy data?

Could a consistent story be built with the existing data-stack, to a depth of five years, to start the Basel II capital allowances to flow? A great deal of activity would ensue to purify, align and enhance legacy data. (Readers of MFG March 2008 issue article 'Integrating solutions – the power of legacy systems' will already have an insight into the type of systems strategies already brought into play to address this problem.)

In summary, to enjoy the best Basel II benefits, systems would need to deliver:

- Event replication
 - all components of an incident or decision
 - five years data
- Effective reduction in error rates
 - assessable
 - recoverable
- Support for efficient defined processes
 - uninterrupted procedures
 - reduction of manual intervention
 - effective reporting

Systems development since Basel II

The drive for STP solutions existed before Basel II, of course, as Lenders sought to improve speed to market and offer more and more sale-speeding features to the growing Intermediary sales channels. However, Basel II increased the focus on the process and a significant increase in pace ensued.

Legacy-system enhancement and replacement has been impacted as the requirements of Basel II embedded themselves in Lender's systems developments. Alongside this, software providers have been busy developing solutions accordingly.

In all this, high on the Basel II-enabling systems feature list are such elements as centrally controlled, rules based product shaping and qualification engines; these to ensure lending risk is automatically assessed and risk-priced products are both flexibly built and offered.

Additionally, manual underwriting intervention had to be allowed, but carefully controlled with underwriter foot-fall recorded and audited. Then again, sales and origination activities need to be integrated and passed to point of sale without loss of control by the central product shaping and qualification rules engines. Against all this, loan data has be



attributable over time to the originating rule sets, empowering data usage to demonstrate risk control as market and lending conditions change.

The prize in all this, as we said at the start is the potential for Lender's capital to be able to work that much harder, thanks to Basel II allowances. In these times of capital shortage, software providers demonstrating solutions that deliver these features, and others, will find a growing audience.