

Abstract

The client initiated an Economic Capital (EC) project to embed a stronger risk culture throughout the institution reflected in a more robust risk-based decision-making process, by building an EC application “in-house” with the assistance of Avantage Reply. The objective of Avantage Reply’s solution was to enable the provision of consistent and reliable information appropriate to each decision maker, with the requisite sophistication and enterprise-wide coverage. The EC model provides many benefits including capital management reporting and strategic portfolio planning, the effective management of risk profiles, and the allocation of EC to each transaction to facilitate risk pricing calculations for lending decisions.



Economic Capital: Risk-based decision making and risk culture

The client

The client is a leading financial institution with global footprint that boasts an extensive line-up of financial structured products in very specialised areas.

The challenge

The Economic Capital (EC) project was initiated to embed a stronger risk culture throughout the institution reflected in a more robust risk-based decision-making process.

The client sought to leverage the investment previously made in improving the reporting infrastructure to not only comply with the new Basel II requirements but also embed risk and Economic Capital consumption measures throughout the business. Formerly, the client had employed credit measures such as Risk Adjusted Return on Capital (RAROC) and Economic Value Added (EVA). However, to be aligned with the latest developments brought about by Basel II, the client required a more sophisticated and flexible portfolio credit risk application.

The client investigated a number of solutions but found that none could deliver the requisite sophistication or specific calculation and enterprise-wide coverage. Senior management decided to build the application “in-house” with the assistance of Avantage Reply.

Approach and solution

Avantage Reply developed an approach to aid the design and development of the future platform. This approach ultimately included the preparation of detailed business and technical specifications. The objective of Avantage Reply’s proposed solution was to enable the provision of consistent and reliable information appropriate to each decision maker. Such information would allow the decision maker to take action within an overall risk appetite defined in terms of RAROC and EVA measures.

The platform would be used to provide comparative figures with regulatory capital. The client would be able to calculate economic capital across all portfolios and ensure that the amount of capital available is consistent with current and planned levels of activity. The platform would also define clear risk boundaries, enabling the effective management of risk profiles and aid business decisions. In commercial terms, the platform would facilitate an increase in the origination of more profitable business.

Initial integration of the portfolio EC model, internal and external data sourcing and prototype build took just four months, allowing the first reports to be released to the senior management very quickly. Computation and data management processes were automated shortly after that, bringing the total implementation, validation and acceptance testing period to less than six months.

The speed and success of the implementation contributed significantly to building credibility with the front office staff and senior management and boosted their confidence in Economic Capital as a management philosophy.

Results and benefits

The clear, comprehensible and wide-reaching management reports produced by the platform illustrate the main benefit of the project. The reports are a key component of capital management and strategic portfolio planning. The client also uses the risk calculations provided by the application as a central part of its lending process. The model's results help decision making on loan issuance through risk pricing calculations by enabling the client to allocate Economic Capital to each transaction and use that information as part of the pricing model.

Avantage Reply, part of the Reply Group, is specialised in Financial Services with a focus on Risk, Treasury and Capital and Financial Performance Management. With offices in Amsterdam, Brussels, Edinburgh, Frankfurt, Hamburg, London (head office), Luxembourg, Milan, Munich and Rome, Avantage Reply counts some of the world's most significant financial groups among its clients, including well-known and respected organisations in the Banking, Insurance, Investment Management and Services, and Post Trading Services sectors.

The firm's delivery capabilities cover advisory services (Risk/Finance/Treasury Subject Matter Expertise), Program and Project Management, Business, Functional, and Data Analysis.

For further information: www.frm.reply.eu

Reply [MTA, STAR: REY] specialises in the design and implementation of solutions based on new communication channels and digital media. Through its network of specialist companies, Reply supports some of Europe's leading industrial groups in Telco & Media, Industry & Services, Banks & Insurance, and Public Administration to define and develop business models, suited to the new paradigms of Big Data, Cloud Computing, Digital Media and the Internet of Things. Reply services include consulting, system integration and application management.

For further information: www.reply.eu