

Index

- Accountability, 33, 37, 155
- Advanced Internal Ratings Based (AIRB) approach, 201, 202, 219, 220, 231, 232
- Advanced Measurement Approach (AMA), 202, 203, 209–211, 221, 222, 227
- Adverse selection, 176–178
- Asset allocation, 124, 164, 186–189
- Asset/liability management committee (ALCO), 53, 99
- Asset/liability risk (mis-match risk), 16, 97, 209
- Asset products, 183, 184
- Assumptions
 - reviewing and challenging, 31, 32, 38, 76, 173, 181, 215
 - risk measurement, 75, 76, 79, 80, 83, 87, 88, 96, 102, 103
 - scenario analysis, 210
 - stress testing, 34. *See also* Stress testing
- Audit committee, 37, 38, 54, 218
- Audit department (internal audit) and CRO, relationship with, 46
 - and data accuracy and completeness, 60
 - role of, 23, 155, 218, 219
 - and validation teams, 216
- Australia, 47, 200, 207, 227
- Balance sheet
 - for business lines, 123, 124, 136
 - off-balance sheet items, 24, 93, 201, 225
 - and product structuring, 183–185
 - risks, 16
- Banker's Trust, 4, 33, 52, 53
- Bank for International Settlements (BIS), 192. *See also* Basel Committee on Banking Supervision (BCBS)
- Basel Committee on Banking Supervision (BCBS)
 - about, 191, 192
 - Bank for International Settlements (BIS), 192
 - Basel I Accord, 191–194
 - Basel II. *See* Basel II Accord
 - Basel III. *See* Basel III
 - regulator perspective on international regulation, 195–200
 - “sound practices” guidelines, 39, 204
 - validation, working papers on, 215
- Basel II Accord
 - about, 194, 195, 200
 - Advanced Measurement Approach (AMA), 202, 203, 209–211, 221, 222
 - boards and senior management, expectations for, 217–219
 - capital planning, 212, 213, 218
 - confidence intervals, 77, 102

- Basel II Accord (*Continued*)
 and COSO framework for
 enterprise risk management,
 163
 credit risk requirements,
 200–202, 204–206, 219, 220
 data requirements, 58, 81, 101,
 206
 economic approaches, key
 differences, 222, 223
 economic capital, 117, 217, 222,
 223
 G-10 countries, 191, 192
 global uniformity, lack of, 192,
 231
 impact of on financial institutions
 and financial markets, 231, 232
 insurance industry, 195
 internal capital adequacy
 assessment process (ICAAP),
 127–129
 internal models approach (IMA),
 193–195, 198–203, 209,
 219–222, 227, 230, 231
 key requirements, 204
 market risk requirements, 200,
 202, 209, 220, 221
 operational risk requirements,
 200, 202, 203, 209–211, 221
 “other risks,” 217
 Pillar I (minimum capital
 calculations), 200, 201, 227
 Pillar II (Supervisory Review of
 Capital Adequacy), 200, 201,
 203, 204, 211–213, 217
 Pillar III (Market Discipline),
 200, 201, 204
 rating agency assessments, 228
 rating systems requirements, 206,
 207
 and risk measurement, 64, 68,
 100
 risk quantification, 207–209
 and roles of CRO and CFO, 151
 scenario analysis, 101
 standardized method, 201, 202,
 209, 211, 219–221, 227, 231,
 232
 stress testing, 204, 216, 217
 traded-market risk, 200, 209,
 223, 227
 Use Test, 57, 58, 199, 214, 215,
 230, 231
 validation, 215, 216
- Basel III
 about, 223
 capital quality, 226
 forward-looking provisioning
 approaches, 73, 226
 interest-rate risk, 223, 227
 liquidity risk, 224–226
 operational risk, 223, 224,
 227
 rating agencies, 227, 228
 securitization, 227
- Basis risk, 16, 97
- Benefits of risk measurement, 65
- Beta distribution, 70, 71, 88, 89
- “Bidding” process for capital, 123,
 124, 136
- “Black box” effect, 31, 75, 76, 79,
 113, 173
- Board of directors
 active leadership, 35, 36
 Basel II responsibilities, 212,
 217–219
 responsibilities of, 23, 29, 35, 36,
 105, 155, 156
 risk committee, 54
 and risk models, awareness of
 limitations of, 31
 “words to live by,” 23
- Bottom-up implementation, 124,
 125, 128, 136

- Budgeting
 - benefits of managing downside risks, 5
 - and business rhythm, 159–161
 - and performance measures, 123
 - and risk forecasting, 35
 - for risk management, 39, 161
- Build versus buy, 61, 62, 89, 93
- Business cycles, 32, 34, 35, 58, 127, 158, 207, 208, 212, 223, 225
- Business Environment and Internal Control Factors (BEICFs), 101, 102, 210, 211
- Business failures, reasons for, 2–4
- Business lines
 - “bidding” process for capital, 123, 124, 136
 - independence of risk management team, 36, 45, 46
 - and reporting framework, 38
 - risk, 26, 27
 - and risk appetite, 131, 132, 136, 137
- Business of risk, 11, 12
- Business plan, 159, 161, 212
- Business process management risk, 17, 18
- Business rhythm, 159–161
- Business strategy. *See also* Strategic planning
 - risk and capital management as part of, 2
 - and risk management, 22–25
 - and role of CRO, 45
- Buy versus build. *See* Build versus buy
- Calibration and recalibration, 85, 86, 90, 181, 230
- Capital, “bid” process for, 123, 124, 136
- Capital, cost of, 112, 113, 115, 174
- Capital allocation, 115–119, 125, 132, 199, 214, 221
- Capital attribution, 118, 119
- Capital benefit, 109, 111, 121, 148
- Capital forecasting, 136, 161
- Capital multiplier approach, 76–79, 88, 89, 96
- Capital planning
 - Basel II, 212, 213, 218
 - reporting, 38
 - and risk appetite, 26
 - and strategic planning, 25
- Capital quality, 67, 106, 193, 199, 224, 226
- Capital requirements, 27, 71, 72, 79, 123, 131, 133, 161, 195, 211, 213, 221, 226, 229, 230
 - and target debt rating, 66, 67, 76, 77, 88
- Centralized/decentralized
 - data, 61
 - organization and governance, 42, 47, 48
- Certifications, 35, 149, 227
- Change
 - organizational culture, 28, 29
 - resistance to, 8
- Chief Analytics Officer, 45, 46
- Chief Executive Officer (CEO), 105, 106, 147, 154–156, 158
- Chief Financial Officer (CFO), 147, 151, 154
- Chief Operating Officer (COO), 154
- Chief Risk Officer (CRO)
 - and audit function, relationship with, 46
 - independence, 36, 45, 154
 - oversight responsibilities, 38, 154
 - reporting lines, 45
 - role and responsibilities of, 36, 44, 45, 151, 154, 155

- Chi-squared Automatic Interaction Detector (CHAID), 170
- Citibank (Citigroup), 30, 62
- Closed-form modeling, 75, 87, 88
- Collections, 69, 168, 181, 182
- Commercial risk, 18
- Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), 195, 229
- Committee of Sponsoring Organizations (COSO), 162, 163
- Committees
 - asset/liability management committee (ALCO), 53, 99
 - audit committee, 37, 38, 54, 218
 - board risk committee, 45, 54
 - for core risks, 53
 - executive and board-level, 36, 37
 - framework for, 37, 53
 - members of, 36, 53, 54
 - risk and capital committee, 37, 53, 137, 138
- Compensation
 - and Enterprise Risk Management, 147–149
 - and performance measures, 33, 34, 120, 122, 123, 125, 147, 148
 - and risk appetite, 147
 - and risk culture, 28
- Comprehensive risk assessment, 31, 32, 213
- Concentration of risk, 4, 15, 24, 74, 188–190, 204, 213, 220
- Concentration ratio, 190
- Confidence intervals, 76–78, 88, 89, 96, 98, 102, 203, 209, 230
- Contagion, 15, 18, 210, 227
- Continuing education, 35, 48, 144, 146, 147, 149, 150
- Continuous improvement, 2, 28, 39, 41, 50, 143, 161
- Contribution measures, 108, 109, 112
- Copula methods, 79, 94
- Core competencies, 12
- Correlation, 79, 83, 84, 91, 92, 94, 115, 118, 119, 210, 222, 223
- COSO. *See* Committee of Sponsoring Organizations (COSO)
- Cost measures, 178
- Cost of capital, 112, 113, 115, 174
- Cost of funds, 109, 111, 113, 114, 116
- Covariance, 91
- Credit card management, 16, 97, 115, 167, 181, 182
- Credit crisis, 32, 145, 181, 197, 216, 224, 225
- Credit ratings
 - of customers, 176, 178, 185, 220
 - of financial institution, 6, 77, 88, 90, 93, 96, 102, 106, 107, 130, 201
- Credit risk
 - Advanced Internal Ratings Based (AIRB) approach, 201, 202, 231, 232
 - Basel II Accord, 200–202, 204–206, 219, 220
 - committee, 53
 - concentrations, 204
 - corporate, 219, 220
 - counterparties, 204
 - credit portfolio, 91, 92
 - and customer lifecycle management, 167
 - described, 16
 - exposure at default (EAD). *See* Exposure at default (EAD)

- Foundation Internal Ratings
 - Based (FIRB) standardized approach, 201, 202
- loss given default (LGD). *See* Loss given default (LGD)
- measurement, 68, 74, 87–94
- as part of financial risk, 15
- probability of default, 68
- retail credit, 220
- securitized assets, 93, 94, 204, 227
- stress testing, 204
- trading portfolio, 93
- and Use Test, 214. *See also* Use Test
- Credit Suisse, 55
- Customer lifecycle management
 - about, 166–168
 - downside management, 179–182
 - monitoring customers, 180
 - upside, leveraging, 167, 169–179
- Customer limits, 56
- Customer relationship management (CRM), 166
- Dashboards, 54, 55, 156, 157
- Data
 - Basel II requirements, 206
 - for extreme value theory, 103, 104
 - for market risk modeling, 94, 95
 - for operational risk modeling, 100, 101, 210
 - for probability modeling, 68, 69
 - requirements, 40–43, 58–61, 81, 101, 206
 - role of in risk measurement, 79–81
 - validation of, 85, 86
- Data access, 58, 60
- Data gathering
 - external data, 101, 210
 - historical data, 59, 81
 - internal data, 101, 210
 - as obstacle to implementation of risk management, 9, 80
 - operational risk modeling, 100, 101, 210
 - reconstruction of data, 81
- Data marts, 61
- Data Steward (Data Czar), role of, 60
- Data storage, 44, 59, 60, 80, 85, 140
- Data warehouses, 61, 63
- Debt ratings, 66, 67, 76, 77, 88, 105, 107, 127, 130
- Decision-making
 - and Enterprise Risk Management (ERM), 141, 143–147, 150–153, 155–159, 161
 - and integration of risk management, 164
 - and performance measures, 124
 - and risk culture, 29
 - and risk/reward balance, 106
 - and systems infrastructure, 63
- Default
 - correlation, 223
 - counterparty risk, 230
 - and customer lifecycle, 166, 171, 172, 181, 182
 - and debt rating, 66, 67, 77, 106
 - expected loss, 66. *See also* Expected loss (EL)
 - exposure. *See* Exposure at default (EAD)
 - loss given default. *See* Loss given default (LGD)
 - probability. *See* Probability of default (PD)
 - and product structuring, 184, 185
- Delta Gamma Normal VAR, 94
- Delta Normal VAR, 94

- Deposit insurance, 139, 196, 197
 Deposit products, 167, 183
 Disclosures, 42, 133, 150, 200, 201, 204, 206, 229
 Discount rates, 113, 115
 Documentation
 assumptions, 76, 80, 173
 business process management, 17
 senior management/executive knowledge and oversight, 10
 validation of models, 85–87

 Earnings management, 72–74, 82
 Earnings volatility, 3, 5, 14
 Economic capital
 Basel II Accord, 203, 204, 216–220, 222, 223
 capital allocation, 115, 117–119
 capital attribution, 118
 and economic profit calculation, 112
 and enterprise risk management (ERM), 142, 143, 161
 limits and controls, 32
 liquidity risk measurement, 100
 risk-adjusted return on capital (RAROC), 109, 111, 173, 174
 and risk appetite, 127–129, 131, 136, 137
 risk measurement, 31, 33, 65, 76–79, 96–98, 100
 and unexpected loss, 14, 65. *See also* Unexpected loss (UL)
 Economic capital contribution (ECC), 115, 118
 Economic cycles, 68, 72–74, 81, 82, 86
 Economic downturns, 73, 74, 81, 82, 131, 216
 Economic profit (EP), 33, 109, 110, 112–114, 116, 121–123, 148, 173, 174

 Economic value added (EVA), 112, 120
 Efficient frontier, 19, 20, 186–189
 Elasticity modeling, 178, 179, 215
 Emerging risks, 24
 Employees
 and benefits of risk management, 6, 7
 education and training, 147, 149
 hiring process, 149
 incentives and compensation, 147, 148. *See also* Compensation
 and operational risk, 17
 and organizational culture, 29, 141, 142, 145, 146. *See also* Risk culture
 roles and responsibilities of, 29, 146, 149
 Enron Corp., 56
 Enterprise Risk Management (ERM)
 benefits of, 144
 business rhythm and integrating risk management with business cycles, 159–161
 Chief Executive Officer (CEO), role of, 154–156, 158
 Chief Financial Officer (CFO), role of, 151, 154
 Chief Risk Officer (CRO), role of, 151, 154, 155
 compensation, 147–149
 COSO standards, 162, 163
 and decision-making, 141, 143–147, 150–153, 155–159, 161
 described, 142–144
 employees, role of, 146, 149
 finance and accounting functions, role of, 150, 151

- human resources, role of, 149, 150
- incentives, 147
- integration as key element of, 143
- legal team, role of, 150
- lines of defense, 152–156
- monitoring, 143, 146, 150, 151, 154, 156, 161, 163
- reporting, 142, 143, 150, 151, 154, 156–159, 162
- risk culture, 143–152, 156, 158, 159, 163
- strategic partners, vendors, and service providers, 151, 152
- and strategic planning, 150, 159
- success factors, 143
- Estimates in risk measurement, 73, 74, 77–79, 81, 82, 85, 86, 88–90, 92, 95, 103
- Executives
 - Chief Analytics Officer, 45, 46
 - Chief Executive Officer (CEO), 105, 106, 147, 154–156, 158
 - Chief Financial Officer (CFO), 147, 151, 154
 - Chief Operating Officer (COO), 154
 - Chief Risk Officer (CRO), 36, 38, 44–46, 151, 154–155
 - committee members, 53, 54
 - responsibilities of, 155, 156
 - support, 10
 - tone at the top, 44, 50, 127, 146, 155, 156
- Expected loss (EL), 13, 14, 31, 65–67, 72–75, 78, 79, 82–84, 87, 88, 106, 109, 111, 116, 138, 154, 161, 226
- Exposure, 13, 56, 67–69, 72, 75, 87, 88, 93, 98, 187, 190, 193, 202, 204–206, 210
- Exposure at default (EAD), 87–89, 91, 202, 206, 207, 222
- External event risks, 17, 18, 162, 210
- Extreme value theory (EVT), 103, 104
- Facility ratings, 91, 206
- Finance and accounting functions, role of, 46, 150, 151
- Financial risk, 6, 13, 15, 17. *See also* Credit risk; Market risk
- Forecasting
 - capital, 46, 136, 161
 - risk, 35, 39, 54, 153, 138, 142
- Forward-looking provisioning approaches, 73, 226
- Framework for risk management
 - characteristics of success, 43, 44
 - components of, overview, 40–43
 - data requirements, 40–43, 58–61
 - development of, considerations for, 40, 41
 - governance, 40–44, 52–55
 - models and measures, developing, 40–43
 - policies and processes, 40–43, 55–58
 - and risk culture, 43, 44, 48–51
 - risk measurement, 40–43
 - roles and responsibilities, 40–42, 44–48
 - systems capabilities, 40–43, 61–63
- Fraud risk, 17, 210
- “Front page” test, 50
- Gaussian distribution (bell curve), 70
- G-10 countries and Basel II Accord, 191, 192

- Governance
 and Basel II, 163, 201, 204, 206, 214
 framework for risk management, 37, 38, 40–44, 52–55, 142, 143
 and risk appetite, 52, 129, 138
 and Solvency II, 229
 and validation of models, 86, 87
- Greek-Normal VAR, 94
- Grouphink, 37
- Heteroskedasticity, 84
- Historical simulation, 94–96, 98, 209
- “Home-host” regulatory compliance, 198
- House limits, 55, 56
- Human resources, role of, 149, 150
- Hurdle rate, 57, 113–115, 173, 174, 178, 179
- Idiosyncratic risk (specific risk), 14, 19, 101, 146, 153, 154
- Incentives, 147. *See also* Compensation
- Insolvency, 99, 138–140
- Insurance cost, 6
- Insurance industry
 and Basel II Accord, 195
 chief risk officer role, 154
 interest rate risk, 97. *See also* Interest rate risk
 product structuring, 183
 Solvency II, 195, 228–231
- Insurance products, 115, 167
- Insurance risk, 15, 17
- Integration
 of risk management and processes, 44, 141
 of risk management into organization, 141, 142. *See also* Enterprise Risk Management (ERM)
- of systems, 61, 62
- Interest rate risk
 Basel II, 199, 200, 203, 209, 217, 223, 224, 227
 basis risk, 16, 97
 interest rate risk in the banking book (IRRBB), 217, 223, 224, 227
 measurement, 65, 70, 83, 97, 98
 optionality risk, 16
 option risk, 97
 repricing risk, 16, 97
 stress testing, 83
 yield curve risk, 16, 97
- Interest rate risk in the banking book (IRRBB), 217, 223, 224, 227
- Internal Capital Adequacy Assessment Process (ICAAP), 127–129, 203, 211, 213
- Internal control, 28, 38, 101, 162, 201, 210, 212, 213
- Internal models approach (IMA), 74, 193–195, 198–203, 209, 219–222, 227, 230, 231
- International banking. *See* Basel Committee on Banking Supervision (BCBS)
- International Financial Reporting Standards (IFRS), 72
- Jump diffusion, 103
- Key man risk, 17, 45, 46, 75
- Key risk indicators, 101, 211
- Kurtosis (fat tails), 70–72, 103
- Leadership
 Chief Executive Officer (CEO), 105, 106, 156. *See also* Chief Executive Officer (CEO)
 proactive, 35, 36

- succession planning, 150
 - tone at the top, 44, 50, 127, 146, 155, 156
- Legal risk, 17, 18, 210
- Legal team, role of, 150
- Lending
 - Basel II credit risk classes, 205
 - credit portfolio risk, 91–94
 - credit risk. *See* Credit risk
 - and economic downturns, 73, 74
 - and pricing segmentation, 172, 176
 - process streamlining, 185, 186
 - products, 167, 172, 184–186
 - small businesses, 205, 206
- Leptokurtotic distributions, 71, 72, 84
- Limits and controls, 30, 32–33, 52–53, 55–58, 131–135
- Linear VAR, 94
- Lines of defense, 152–156
- Liquidity Coverage Ratio (LCR), 225
- Liquidity risk
 - and Basel III, 203, 213, 217, 224–226
 - described, 16
 - measurement, 65, 97–100, 111, 133
- Living will concept, 138–140
- Long tail events, 15, 71
- Look-through modeling, 32, 93, 94
- Loss distribution, 14, 15, 75, 77, 88, 89, 93, 94, 100–103, 222
- Loss Distribution Approach (LDA), 102
- Loss given default (LGD), 87–89, 91, 202, 206, 207, 216, 222
- Lowest level of use, systems capabilities, 61, 62
- Market risk
 - Basel II, 200, 202, 209, 220, 221
 - committee, 53
 - described, 16
 - historical simulation, 94–96
 - interest rate risk, 16. *See also* Interest rate risk
 - internal models versus standardized models, 220, 221
 - liquidity risk, 16. *See also* Liquidity risk
 - measurement, 68, 70, 93–100
 - Monte Carlo simulation, 94, 95
 - non-traded market risk, 16, 200, 209
 - parametric VAR, 94–96
 - as part of financial risk, 15
 - traded-market risk, 16, 70, 92–98, 200, 209, 223, 227
 - and Use Test, 214. *See also* Use Test
 - Markowitz, Harry, 19, 20
 - Master scale (rating systems for credit risk), 90, 91
 - Maximum probable loss (MPL), 77–79
 - Mean loss, 13, 14, 65, 72. *See also* Expected loss (EL)
 - Measurement of risk
 - assumptions, 75, 76, 79, 80, 83, 87, 88, 96, 102, 103
 - benefits of, 65
 - calibration of models, 85, 86, 90
 - capital multiplier approach, 76–79, 88, 89, 96
 - challenging, 34, 35
 - comprehensiveness of, 31, 32
 - confidence interval method, 76–78, 88, 89, 96, 98, 102
 - credit risk, 68, 74, 87–94
 - data, role of, 79–81

- Measurement of risk (*Continued*)
- data for extreme value theory, 103, 104
 - data for market risk modeling, 94, 95
 - data for operational risk modeling, 100, 101
 - data for probability modeling, 68, 69
 - data validation, 85, 86
 - economic capital, 65, 76–79, 96–98, 100
 - and economic cycles, 68, 72–74, 81, 82
 - estimates, 73, 74, 77–79, 81, 82, 85, 86, 88–90, 92, 95, 103
 - expected loss. *See* Expected loss (EL)
 - exposure, 67–69, 72, 75, 87, 88, 93, 98
 - extreme value theory (EVT), 103, 104
 - framework for risk management, 40–43
 - importance of, 64, 75
 - interest rate risk, 65, 70, 83, 97, 98
 - jump diffusion, 105
 - liquidity risk, 63, 97–100, 111, 133
 - market risk, 68, 70, 93–100
 - operational risk, 100–103
 - overview, 64
 - probability, 66–72, 75, 77–79, 87–89, 93–95, 98
 - probability distribution, 69–72, 94
 - provisioning approaches, 72, 73
 - and risk and reward concepts, 19–21, 66, 67
 - severity, 68, 69, 72, 75, 87–89, 91, 101, 102
 - strategic/business risk, 19
 - stress testing, 34, 35, 82–84, 89, 104
 - target debt rating, 66, 67, 76, 77, 88, 96, 102
 - through-the-cycle modeling, 68, 73, 81, 82, 86
 - unexpected loss. *See* Unexpected loss (UL)
 - validation of models, 84–87, 90
 - value at risk (VAR), 74, 75, 79, 83, 93–96, 98, 101–103
- Metallgesellschaft AG, 25
- Mis-match risks (asset/liability risk), 16, 97, 209
- Modern Portfolio Theory (MPT), 19–21
- Monitoring
- Basel II, 213
 - and Enterprise Risk Management (ERM), 143, 146, 150, 151, 154, 156, 161, 163
 - performance metrics, 34
 - risk appetite, 27, 135–138
 - validation of models, 86
- Monte Carlo simulation, 94, 95, 98, 209
- Mortgage products, 69, 82, 91, 171, 184, 185, 205, 220
- Multi-period calculations
- performance measures, 33, 112–115, 121, 122
 - pricing models, 34, 121, 124, 174–176
- Multi-period economic profit, 112–114
- National Australia Bank (NAB), 47
- Net Income After Cost of Capital (NIACC), 110, 112
- Net present value (NPV), 87, 110, 112–114, 174

- Net Stable Funding Ratio, 225, 226
- Non-bank financial institutions (NBFIs), 232
- Non-traded market risk, 16, 200, 209. *See also* Interest rate risk; Liquidity risk
- Normal distribution, 70, 95, 222
- Northern Rock Bank, 99
- Operational risk
 - Basel II, 200, 202–203, 209–211, 221
 - Basel III, 223, 224, 227
 - basic, standardized, and Advanced Measurement Approach models, 221
 - committee, 53
 - described, 17, 18
 - limits and controls, 32, 33, 57. *See also* Limits and controls
 - measurement, 100–103
 - scenario analysis, 210
 - subcategories of, 17, 18
 - and Use Test, 214. *See also* Use Test
- Optionality risk, 16, 97–99, 209
- Organizational culture
 - and approach to risk management, 30, 31, 43, 44, 141, 142
 - and characteristics of successful organizations, 22
 - continuous improvement, 39
 - employees, 29, 141, 142
 - failure to respond to warning signals, 4
 - and framework for risk management, 41, 48–51
 - risk culture, 6, 10, 27–30, 43, 44, 47–54, 143–152, 156, 158, 159, 163, 165
 - sales-driven, 27, 28
- Origination costs, 178
- “Other risks,” 17, 18, 23, 129, 217
- Oversight, 10, 37, 38, 138, 151, 156, 212
- Parametric VAR, 94–96
- Parent/subsidiary relationships, 56, 163, 219
- Pareto principle (80-20 rule), 165
- Pension risk, 17
- People/organizational risk, 17
- Performance measures
 - about, 108, 109
 - accountability, 33
 - alignment with risk and reward, 33, 34, 122, 123
 - application of, 119–125
 - bottom up implementation, 124, 125
 - capital allocation, 115–119
 - capital attribution, 118, 119
 - comparison of common measures, 110
 - and compensation, 34, 120, 122, 123, 125
 - contribution measures, 108, 109, 112
 - data and systems, importance of, 44
 - discount rates, 113, 115
 - economic profit (EP), 109, 110, 112, 114, 116, 121–123, 148
 - economic value added (EVA), 112, 120
 - monitoring, 34
 - multi-period calculations, 112–115
 - net present value (NPV), 110, 113, 114
 - return measures, 30, 33, 34, 108, 109, 116, 142
 - return on equity (ROE), 110–112

- Performance measures (*Continued*)
- risk-adjusted return on capital (RAROC), 33, 109–111, 120–122, 148
 - and risk appetite, 26
 - and risk/return concepts, 20, 21, 108
 - shareholder value added (SVA), 112, 113
 - top-down implementation, 124, 125
 - use of, 121–124
- Performance metrics. *See* Performance measures
- Pillars of Basel II Accord, 200–204, 211–213, 217, 227
- Policies and processes, framework for risk management, 40–43, 55–58
- Portfolios
- corporate lending, 91, 93
 - and credit risk modeling, 93, 94
 - expected loss. *See* Expected loss (EL)
 - limits and controls, 32, 55–57, 136, 137. *See also* Limits and controls
 - management, 19–21, 36, 132, 133, 186–190
 - market risk modeling, 95–100
 - monitoring, 57, 61, 137
 - mortgage portfolio, 91
 - operational risk modeling, 100–103
 - performance measurement, 33, 34, 108–112. *See also* Performance measures
 - probability distributions, 69–72
 - reporting, 32, 33, 38, 54, 158
 - retail portfolios, 89, 93, 118, 119, 188–190
 - risk appetite, 26, 132, 156
 - risk measurement, 53, 54, 65–76, 91, 92
 - securitized asset portfolio, 32, 93, 94
 - stress testing, 24, 46, 62
 - trading portfolio, 93
 - unexpected loss. *See* Unexpected loss (UL)
 - value at risk. *See* Value at risk (VAR)
- Possibility of loss, 13. *See also* Expected loss (EL)
- Pricing, 6, 21, 34, 58, 111–113, 120, 124, 125, 144, 164, 167, 169, 171–179, 186, 188, 190, 214, 215, 8295
- Pricing-floor model, 215
- Principles of risk management, 22–39
- Probability distribution, 69–72, 94
- Probability of default (PD)
- credit risk, 68, 87–91, 93, 201
 - data requirements, 206
 - Foundation Internal Ratings Approach (FIRB), 201
 - institutional default, 77, 106
 - model validation, 215
 - rating agencies, 77, 106, 227, 228
 - risk quantification, 207
 - securitized assets, 93, 94
- Probability of loss, 13, 66–72, 75, 77–79, 87–89, 93–95, 98
- Process streamlining, 185, 186
- Pro-cyclicality, 73, 74, 124, 208, 226
- Product lifecycle, 166
- Product structuring, 183–185
- Project risk, 18
- Provisioning, 25, 31, 55, 65–67, 72–74, 78, 81–84, 109, 111, 123, 127, 132, 226

- RAROC. *See* Risk-adjusted return on capital (RAROC)
- Rate Shock method (interest rate risk), 98
- Rating agencies, 66, 77, 105, 139, 227, 228, 232
- Rating systems for risk
and Basel II Accord, 201, 206–208
credit risk, 89–91
and risk management, 101, 102, 218
and use test, 214
- Recalibration, 86, 90, 181
- Regulatory arbitrage, 197, 225
- Regulatory capital
and capital allocation, 117
defined, 194
and impact of Basel Accords, 199, 206, 208
and interest rate risk, 98
market risk measurement, 96, 97
and performance measures, 33
and return on equity, 112
and risk-adjusted return on capital (RAROC), 111, 112
stress testing, 216
- Regulatory compliance. *See also* Basel Committee on Banking Supervision (BCBS)
data requirements, 58
“home-host” issues, 198
as minimum standard for risk management, 3
regulator perspective on international regulation, 195–200
risk and compliance management, 152–155
and risk management frameworks, 22, 23
- Remuneration. *See* Compensation
- Reporting
Basel II, 213
content of reports, 157, 158
and decision-making, 158, 159
and Enterprise Risk Management (ERM), 142, 143, 150, 151, 154, 156–159, 162
frequency of reports, 32, 158
lines of, 45, 46
and oversight responsibilities, 38
on risks, 54, 55
size of reports, 54, 55, 157
“top ten” risks, 55
- Repricing risk, 16
- Reputation risk, 17, 18, 26, 27, 46, 50, 210, 213, 217
- Reserves, 14, 26, 34, 37, 55, 68, 77, 78, 143, 151, 161, 163, 208, 214
- Return measures, 30, 33, 34, 108, 109, 116, 142. *See also* Risk and reward
- Return on assets (ROA), 110, 173
- Return on equity (ROE), 110–112, 173
- Risk, defining, 12–14
- Risk-adjusted profitability analysis, 169–172
- Risk-adjusted return on capital (RAROC)
performance measures, 33, 109–112, 116, 120–122, 148
and pricing, 173, 174
- Risk and capital committee, 37, 53, 137, 138
- Risk and reward
alignment of performance and incentives to, 33, 34. *See also* Compensation; Performance measures
Modern Portfolio Theory (MPT), 19–21

- Risk and reward (*Continued*)
 performance measures, 20, 21,
 108–125
 and portfolio management,
 186–190
 responsibility for balancing, 105
 and risk appetite, 27, 106. *See*
also Risk appetite
 and risk measurement, 19–21, 66,
 67
 and strategic decision-making,
 106–108
- Risk appetite
 about, 126
 and annual business plan, 161
 business lines, 131, 132, 136, 137
 and common language for risk
 management, 29
 described, 26, 27
 and governance, 52, 138
 identifying, 126
 and internal capital adequacy
 assessment process (ICAAP),
 127–129
 limits and controls, establishing,
 32, 33, 52, 53, 131–135
 living will concept, 138–140
 monitoring adherence to
 statement, 135–138
 Risk Appetite Framework, 128,
 129
 sample statement, 134, 135
 statement, 25–27, 50, 126, 127,
 129–135, 138, 212
 and stress testing, 129, 131, 137,
 138
 triggers for threshold warnings,
 136–138
 willingness to take risk, 131
- Risk Appetite Framework, 128,
 129
- Risk categories, 15–19
- Risk culture, 6, 10, 27–30, 43, 44,
 47–54, 143–152, 156, 158,
 159, 163, 165
- Risk dashboard, 54, 55, 156, 157
- Risk management
 attitudes toward, 12
 benefits of, 5–7, 164–166
 capabilities and approaches
 appropriate for organization,
 30, 31, 165
 centralized versus decentralized,
 47
 common language for, 29, 141,
 142
 complexity of, 1, 2
 continuum, 50, 51
 downside risks, benefits of
 managing, 5, 6, 165, 179–182
 and financial failure, 4
 implementation issues, 7–10
 importance of, 3, 11, 12
 optimization, 164, 165, 182–190
 organizational failures, reasons
 for, 3, 4
 proactive, 2, 24, 39
 and regulatory minimums, 3
 return, 165
 strategy implementation issues,
 7–10
 upside risks, benefits of
 managing, 6, 7, 167, 169–179
- Risk models, overview
 assumptions, 31
 challenging and stress-testing, 34,
 35. *See also* Stress testing
 complexity of, 30
 framework for risk management,
 40–43
 limitations of, 2, 23–25, 31, 32
 “look through” modeling, 32
- Risk professionals, use of, 36
- Risk quantification, 7, 26, 206–209

- Risks, awareness of, 23–25, 48, 145. *See also* Risk culture
- Rounding issues, 76, 80, 115
- Sales-driven culture, 27, 28
- Scenario analysis, 24, 25, 45, 46, 50, 53, 83, 84, 95, 96, 98, 100–101, 104, 117, 129, 210, 213, 215, 216
- Scorecards, 89–91, 101, 103, 180, 181, 206, 211
- Securitization transactions, 32, 93, 94, 201, 203, 204, 213, 227, 228, 230
- Security risk, 17, 18
- Segmentation
 - customers, 33, 167, 169–172, 176, 178–182
 - portfolios, 33, 54, 83
 - pricing, 176
- Self-assessment, 101, 211
- Senior management
 - active leadership, 35, 36
 - and Basel II Accord, 212, 217–219
 - limits and controls, enforcing, 33, 52, 53
 - responsibilities of, 35, 36, 155, 156, 212, 217–219
 - support, 10
 - tone at the top, 44, 50, 127, 146, 155, 156
- Severity modeling, 68–69, 72, 75, 87–89, 91, 101, 102
- Shareholder equity and capital requirements, 65–67
- Shareholder value added (SVA), 112, 113
- Simulation engines/approaches, 75, 79, 89. *See also* Historical simulation; Monte Carlo simulation
- Skewed distribution, 70–72, 84, 222
- Small businesses, 205, 206
- Solvency II, 58, 64, 195, 228–231
- “Sound practices” guidelines, 39, 204
- Spain, loan loss provisioning
 - method, 73, 74, 82, 208
- Specialization versus integration, systems, 61, 62
- Specific risk (idiosyncratic risk), 14, 19, 101, 146, 153–154
- Stakeholder-management risk, 18
- Standardized method, 201, 202, 209, 211, 219–221, 227, 231, 232
- Statistical provisioning, 72, 73
- Statistical validation of models, 86, 215, 216, 219, 230
- Strategic and business risks, 18, 19, 27, 46, 210, 217
- Strategic partners, vendors, and service providers, 151, 152
- Strategic planning
 - and Enterprise Risk Management (ERM), 150, 159
 - and risk management, 24, 25, 106
 - and risk/reward balance, 106–108
- Stress testing
 - about, 34, 35, 83
 - and Basel II Accord, 204, 216, 217
 - considerations, 83, 84
 - importance of, 34, 53
 - methods, 83
 - pitfalls, 83, 84
 - responsibility for, 46, 54
 - and risk appetite, 129, 131, 137, 138
 - risk measurement, 34, 35, 82–84, 89, 104
 - and strategic planning, 24
 - and systems design, 61, 62

- Successful organizations,
 characteristics of, 22, 23
- Succession planning, 150
- SunTrust Bank, 73
- Systemically Important Financial
 Intermediaries (SIFIs), 139, 140
- Systemic risk (undiversifiable risk),
 14, 19
- Systems and equipment risk, 18
- Systems capabilities, 23, 31–35,
 40–44, 58–63, 116, 129, 143
- Target debt rating
 and CEO responsibilities, 105
 and risk appetite statement, 127,
 130
 risk measurement, 66, 67, 76, 77,
 88, 96, 102
- Technological/obsolescence risk, 18
- Terminology, 13
- Test-and-learn approaches, 181
- Through-the-cycle modeling, 68,
 73, 81, 82, 86. *See also*
 Economic cycles
- Tone at the top, 44, 50, 127, 146,
 155, 156
- “Too big to fail” (TBTF), 99, 191,
 197, 232, 233
- Top-down implementation
 performance compensation, 34,
 124
 performance measures, 124, 125
- Traded-market risk, 16, 70, 92–98,
 200, 209, 223, 227
- Transaction limits, 56–57
- Transparency
 assumptions, 62
 and black box effect, 75, 76, 113
 governance, 44
 and reporting, 54
 and risk management, 9, 20, 23,
 27, 31, 32, 143, 144
 and shareholder returns, 20
 simulation engines, 75, 76
 validation process, 85
- Treadway Commission. *See*
 Committee of Sponsoring
 Organizations (COSO)
- Uncertain outcomes, 13, 14
- Underestimating risk, 26, 103
- Undiversifiable risk (systemic risk),
 14, 19
- Unexpected loss (UL), 14, 65–67,
 71, 74–76, 78, 79, 83, 84,
 87–89, 92, 106, 115, 137, 138,
 154, 161. *See also* Volatility
- Unexpected loss contribution
 (ULC), 92, 115, 190
- Use Test, 57, 58, 199, 214, 215,
 230, 231
- Validation of models, 84–87, 90,
 215–216, 219, 230
- Value at risk (VAR)
 internal and standardized models,
 202, 209
 parametric VAR, 94–96
 risk measurement, 74, 75, 79, 83,
 93–96, 98, 101–103
 and volatility, 14
- Variance-covariance VAR, 94
- Volatility. *See also* Unexpected loss
 (UL); Value at risk (VAR)
 about, 13, 14
 of losses, 14
 of returns (earnings), 3, 5, 14, 19,
 106, 107, 187–189
- War-gaming, 24, 84
- What-if analysis, 24
- “Words for Boards to live by,” 23
- Yield curve risk, 16, 83, 97, 98