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BASEL II CASE STUDY: UBP

Pillars of strength

As the January 2007 deadline draws nearer, the demands of Basel II compliance are making their presence felt ever stronger. How does a relatively small operation perceive and face up to the challenge? Tom Alford reports

Universal Bank Public (UBP) operates in commercial and private banking for the retail, corporate and the high net-worth markets. It is a listed company on the Cyprus Stock Exchange, and is part of a much larger group of companies headed by Universal Life, one of the largest life insurers in the region, and a major institutional investor with operations extending beyond Cyprus, into Greece. The major shareholders in Universal Life are the two largest banks in Cyprus: the Bank of Cyprus Group and the Cyprus Popular Bank Group.

UBP dates back to 1925, having started life as the Yialousa Savings Bank (YSB). However, its modern history starts in 1990, after a period of enforced inertia, with the opening of a branch in the island's capital, Nicosia. From here it set out to offer simple local currency loan and deposit accounts. Other branches followed in the major towns of Limassol (1995) and Larnaca (1996).

Universal Life acquired its initial 30 per cent stake in the bank in 1996, at which point YSB was renamed Universal Savings Bank. Following the implementation of new legislation regarding Cyprus-listed companies in June 2004, the bank's name changed to Universal Bank Public.

Today, UBP operates 17 branches throughout Cyprus, offering a full range of products including deposits, loans, finance,

bancassurance, credit cards and internet banking.

From its new beginning in 1990, there was an emphasis and strategy in the bank to provide various products through alternative channels, says Philippos Peleties, head of IT projects at UBP. One of the first efforts was to establish a comprehensive ATM network, which has been running for a few years. The next element was to introduce internet banking and related products, something which has been available for three years. 'Our size and the fact that our workforce is fairly young allows us to be flexible, and that is very important,' states Peleties.

This attitude has prevailed where Basel II is concerned. From the outset, UBP cut a straight path through the complexities of compliance, taking its cue from the

deals with the minimum capital requirements a bank must maintain; the second with the supervisory view of the various processes that a bank has in taking risks; and the third introduces market discipline in terms of disclosure of that information.

Breaking these down, Pillar One takes into account three types of risk: credit, market, and operational – the latter is a new feature in Basel II. 'These elements of risk are embedded into the computation of capital adequacy,' explains Peleties. 'Each risk element has a number of calculation approaches.' Pillar Two deals with the assessment by the banks of the capital adequacy that they maintain in terms of the risks that they face. The supervisor is called upon to review these processes and determine whether the bank is supplying

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element of the ruling which introduces the concept of risk to banks, as well as the calculation of the allocation of capital in order to cover the computed risk.

The first Basel Accord, says Peleties, was 'relatively insensitive to any risks'. However, he says, Basel II is more accommodating. It rests on three pillars, the first of which

the minimum capital requirements. If not, then a number of steps and 'corrective actions' may be taken by the authority, so that the bank operates within the limits.

Pillar three deals with the enforcement of market discipline, with the concept of external disclosure, both quantitative and qualitative, with the bank having to explain

the way it measures its risks on a half-yearly or yearly basis, depending on the nature of the information.

It is an involved process that has placed considerable strain on many banks. But all member states of the EU have to implement the requirements of Basel II by 1st January 2007.

In terms of credit risk, there will be three possible approaches. These comprise the Standardised Approach, where group exposures are classified into a series of categories; the Foundation Internal Rating-Based (IRB) Approach where lenders will be able to develop their own models to calculate capital requirements; and the Advanced IRB Approach where lenders with a more sophisticated approach can estimate the concepts of Loss Given Default, Exposure at Default, and the Probability of Default. There will also be three models for calculating operating risk. These are the Basic Indicator, the Standardised Approach, and the Advanced Measurement Approach.

The banks have the discretion to use whichever of these methodologies suits to achieve compliance. If they opt to complete the Foundation Approach for credit risk and the Standardised Approach for operational risk, they will have an additional year to play with.

The Central Bank of Cyprus, acting as the local supervisor, has issued a number of directives in accordance with the European directive for all banks, large and small, to follow. 'The impact of Basel II is going to

their smaller counterparts in terms of the cost of application that Basel II implies, he notes.

Another area of concern for Peleties is the lack of relevant data, and the quality and cleanliness of what is available. 'It's an area that affects the quality of your results,' he notes, 'but it's an area that people do not seem to be taking too many steps towards correcting.'

He is also moved to comment on the lack of understanding by the board and the management within some banks. 'It's an area where significant education is needed.' His final area of consternation is the occasional inability of the supervisor to offer the level of guidance that is required by banks. This is especially true in smaller banks which may not have the resources to be able to take a comprehensive view of Basel II compliance.

Peleties cites an Ernst & Young report on Basel II, which indicates that senior management executives are only just starting to appreciate the long-term business impact of the Accord on their organisations, and the banking industry as a whole. The report anticipates a number of key elements wrapped up in the implementation of Basel II, the most notable for Peleties is the increased use

Approach for credit risk, and the Basic Indicator Approach for operational risk.

The specific areas of UBP's operation that were subject to analysis were the organisational structure and the governance of the bank, the various models

and methodologies used internally, the data and systems, and the people and processes. Based on the 'severity of the gaps' that were identified, a number of projects were created and given a priority status, with the bank implementing those projects according to that status.

An area that looks like having significant impact

on Basel II is that area of data and systems. Indeed, says Peleties, 'it is an area where we felt the bank could get concrete results very fast'. With this in mind, the bank then had to move to bridge the gaps identified at the analysis stage. The first decision was to proceed with a risk management solution.

A team was created to manage the selection process. Its first task was to set the objectives in terms of the solution to be chosen. 'It had to be flexible, easy to operate, fast to implement, and be cost effective,' recalls Peleties. These objectives were turned into a set of corresponding requirements, which in turn produced the RFI document that was sent to a number of vendors. 'Now here's a fact,' states Peleties, 'there's a very wide range of available solutions, both in capabilities and in cost.' The team carried out an evaluation and produced a shortlist, with UK-based vendor, TLC, and its Barracuda product, winning the deal.

TLC became part of Temenos in January 2006, with the Barracuda name being dropped in favour of the more prosaic T-Risk. (TLC had first struck up an alliance with the Swiss vendor in late 2004. In fact, UBP was to be the first joint client of this alliance.)

A mid-project change of ownership did not diminish Peleties' enthusiasm though. 'It provides good analysis and reporting methodologies,' he says. 'It also gives you the possibility of running different scenarios for any class of corrective action needed



Philippos Peleties, UBP

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Philippos Peleties, Universal Bank Public

be significant,' states Peleties. 'It will change the way banks do business, and that impact seems to be greater for smaller banks.'

Both large and small operations are expected to reduce their capital requirements. But the substantial cost of implementation - both in terms of software and hardware, and for external consulting fees - imposed on all institutions is a major concern. 'In our case it is very significant,' states Peleties. But the larger banks are expected to recover much quicker than

of risk-based pricing. But implementation and compliance cannot come at any cost - 'it has to be proportionate to the size of the bank'.

So what is UBP's practical approach to Basel II? At the end of 2005, the bank ran a gap analysis programme, looking into a number of areas. The first port of call was an assessment of the current state of its risk management practices. Analysis of the results produced a plan to 'fill the gaps' and make a decision upon which approach to adopt. It will be taking the Standardised

and was favourably evaluated by a number of important players in the area of risk management.' Another major plus-point was the pre-existence of an interface with UBP's core system, Temenos' Globus. 'This was an indication that the implementation would be fairly fast,' says Peleties.

Although still under the TLC/Barracuda banner at the time of selection and implementation, the working relationship between UBP and Temenos – through Globus – was most favourable. As for cost, not giving too much away, Peleties states that the pricing structure was 'in line with the bank's objectives and expectations'.

Implementation of Barracuda began in October 2005, taking just one month. 'In terms of preparation of hardware and software, the systemic requirements were very light,' recalls Peleties. The product is installed on Intel-based architecture, using Windows 2003, SQL Server and .Net technology – 'something that most IT


departments would be very familiar with'. Peleties describes the process as a 'fast, reliable and issues-free implementation', adding, 'I wish all projects were like this'.

The rapid progress can in part be attributed to the forward planning, and to the implementation team. This consisted of one specialist from TLC; one from Temenos to manage the interface to the core system; and from UBP there were two IT specialists for general set-ups, one Globus developer, and two designated end-users. Peleties acted as the project manager.

He describes the project stages as 'fairly standard': firstly preparing the hardware and software; then preparation of the T-Risk database and configuration and pre-checking of Globus data; then the installation, configuration and calculation testing of T-Risk, then user training; and eventual user acceptance. Go-live was in December 2005.

T-Risk now forms the basis of UBP's

move towards Basel II compliance. 'We use it as a tool to fine-tune the various processes that we have,' says Peleties. 'One area in which it is helping significantly is to show us the quality of our data.' UBP is in the process of cleaning up and enriching its data in an 'interactive and iterative fashion' where it can assess the quality of what it has, then go back and correct it where necessary.

'It is very easy to maintain,' says Peleties. 'That is very important for our IT staff. Being a small bank we don't have too many resources.' And in day-to-day operation he seems pleased with the product too, saying there have been 'very positive' comments from those that have used it so far. With Basel II just around the corner, UBP is now settling into its risk-based approach to compliance, having shown that with forethought and planning it need not be such a collective headache, even for the smaller banks of this world. 



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