

CASE STUDY

Rand Merchant Bank



RiskMetrics Group

Overview - Market Drivers

Rand Merchant Bank, headquartered in Johannesburg, South Africa, decided to take a proactive stance to upcoming risk regulation given the unprecedented turmoil in the financial markets. As such, Rand Merchant Bank was seeking a risk management partner that could advise them on how best to meet the regulatory requirements related to the 'Guidelines for Computing Capital for Incremental Risk in the Trading Book,' as proposed by the Basel Committee on Banking Supervision (2008 and 2009).

These guidelines, which are expected to be formalized during the course of 2009, will require banks to extend the measurement of "specific" market risk in the trading book to include default and migration risks. To meet the potential regulatory demands, Rand Merchant Bank required consultation on building consistent risk frameworks that integrate market and credit risk, allowing them to create a framework for calculating the incremental risk charge.

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Vendor Selection Process

As banks have found themselves in the regulatory spotlight, Rand Merchant Bank undertook a specific risk project in order to better understand, measure and manage "specific" risks associated with debt and equity positions in their trading books. Given that Rand Merchant Bank recently applied for internal model approval for general market risk in the trading book, a natural next step was to develop an internal model for the measurement and management of specific risk.

While Rand Merchant Bank had the in-house expertise to build a credit risk analytics solution, RMB risk staff explained, "We found it would be far simpler and less time consuming to purchase an external set of credit risk analytics." Having considered a wide range of providers and solutions, Rand Merchant Bank selected RiskMetrics Group's CreditManager® solution—the portfolio credit model based on RiskMetrics' CreditMetrics™ methodology. The CreditMetrics methodology, an open source transparent credit risk model, is widely regarded as a proven benchmark standard for credit risk measurement.

Therefore, RiskMetrics advised Rand Merchant Bank on the implementation of CreditManager for the purpose of measuring the incremental risk charge in the Bank's trading book. They also tasked RiskMetrics with advising them on the regulatory requirement put forth by the Basel Committee on Banking Supervision. Summing up CreditManager's advantages over other options, RMB risk staff say: "It is web-based, easy to use and implement, provides a solution for all types of exposures and has many great features in the reporting setup."

Implementation

Following the selection of RiskMetrics' CreditManager, the focus of the consultancy support was on challenges related to choosing appropriate inputs to feed the credit risk model. There are various modeling challenges banks face when implementing the incremental risk charge, and RiskMetrics' senior consultants supported Rand Merchant Bank with the following:

- + The rating assignment to each issuer in the portfolio, as it is not uncommon to find unrated companies in the trading book
- + The measurement of probabilities of default and transition matrices over a short horizon (less than one year)
- + The estimation of the liquidity period for categories of traded products and the following aggregation of single-period simulations over the one-year regulatory horizon
- + The implementation of the regulatory principle of the "constant level of risk"
- + Including equities in the overall credit risk framework.

A further value add provided by RiskMetrics' consultants was advice on how to adjust the model to take into account both available data in the local market and changing economic conditions.

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Conclusion - Results

Following the swift and successful implementation, Rand Merchant Bank plans to combine CreditManager with other internal systems and to use it to run a multitude of scenarios, especially "what if" to see the impact of new trades and structures on Rand Merchant Bank's risk profile. While the current project has successfully concluded, Rand Merchant Bank intends to work closely with RiskMetrics to ensure that their implementation remains compliant with the forthcoming incremental risk charge regulation.

The RMB risk professionals were particularly impressed by the support from RiskMetrics while implementing CreditManager. "RiskMetrics' experts proved extremely knowledgeable and we received excellent service at every stage of the project." In summary, RiskMetrics' advisory support and analytics enabled Rand Merchant Bank to build a robust market and credit risk framework, which equips them with the tools to model and calculate the incremental risk charge.

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