

Economic Capital: Some Difficult Issues

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The views expressed here
are the presenter's and not
necessarily the bank's.

Speaker Background

- Wachovia: Fourth largest U.S. bank
 - Commercial / retail banking (East/West)
 - Large Corporate / International
 - Securities
- Economic Capital system since 1990s
 - Management use since 2000



Responsible for credit risk
economic capital since 1993



Today's Topics

- Strategies for dealing with difficult issues
- Economic view of risk and capital compared to the market view
- Required Return on Risk – Which Risk?
- Risks with different time horizons
- New products; new businesses

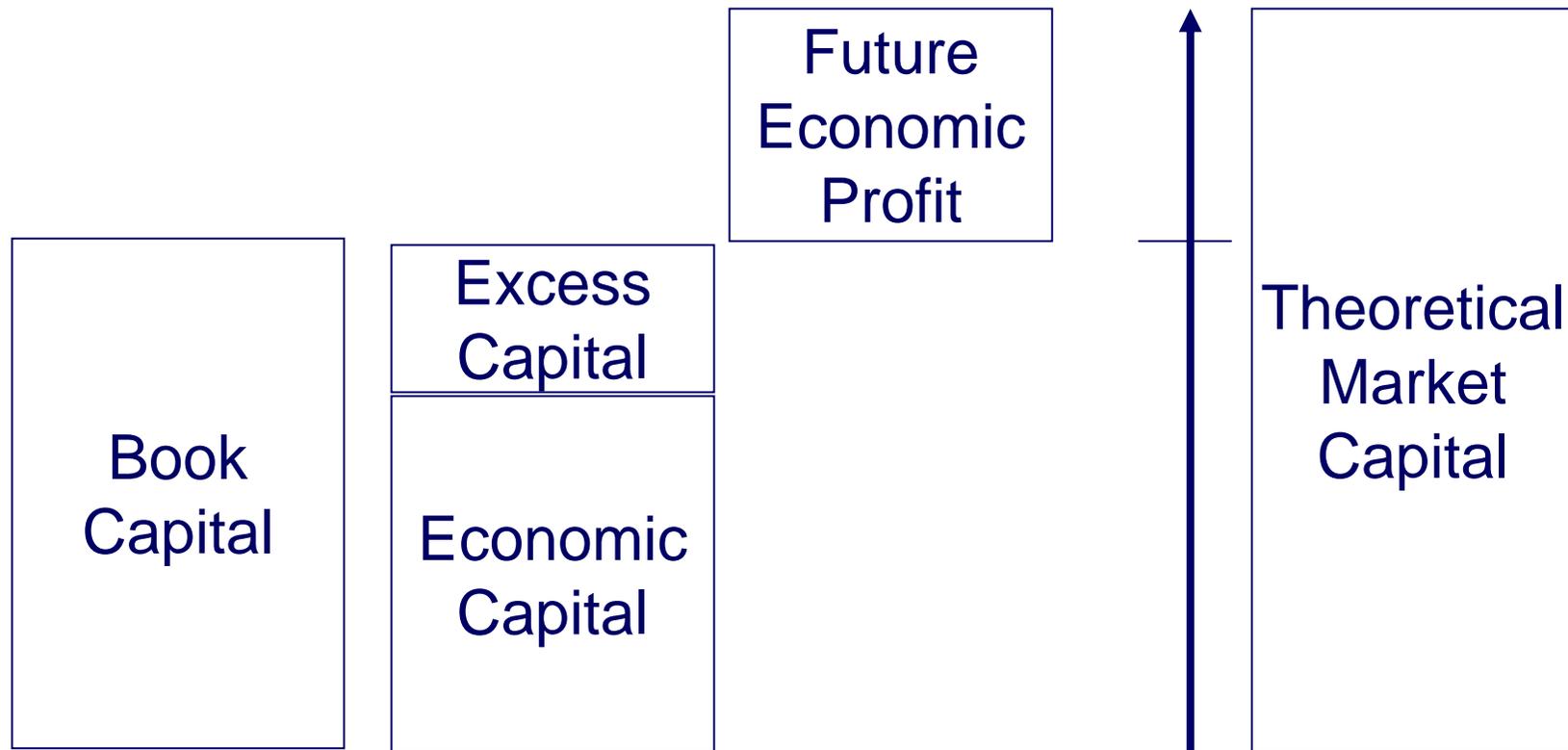


Two choices for difficult issues

- Multiple metrics
 - Less emphasis on Economic Capital where it may not be the right analysis
 - Benefit: Use “best” tool for each purpose
 - Problem: Mixed message; less confidence in overall Economic capital system
- Single system
 - Benefit: Clear priorities
 - Problem: Are you sure you are right?



Views of Capital and Risk



What is at risk?

Capital

- Credit losses
- Market / trading losses
- Losses from operational events
- Realizing future losses by selling or marking

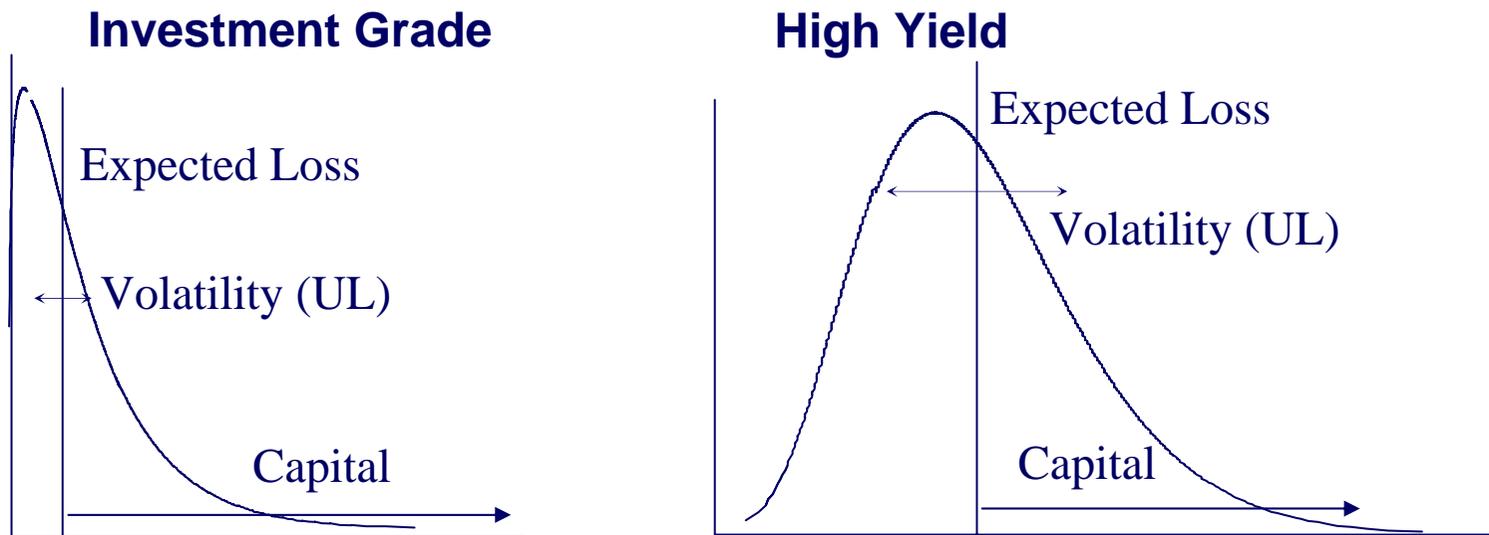
Future Economic Profit

- Compressed margins
- Increased competition
- Customer attrition
- Strategic errors

How do you measure performance against risks that do not require economic capital?

Required Return on Which Risk?

Risks have different uncertainties



How do you allocate the total capital requirement to cause desired behavior?

Required Return on Which Risk?

- What does bond investor want?
 - Concerned about extreme event
- What does stock investor want?
 - Concerned about year-to-year events
- Recommended: **Economic Capital: A Practitioner Guide** Edited by Ashish Dev
- **Alternate approach: Differentiated hurdle rates**



Risks with Different Time Horizons

- Horizon
 - Time to eliminate the risk
 - Time to recapitalize
 - Ease of computation
- Dealing with mismatches
 - Assumptions on reinvesting capital / risk profile for remaining period
 - Eliminate; replicate; other?

New Products and Businesses

One should recognize the risk of having a bad estimate for an input parameter to the capital model.

For individual credits, this is diversified away.

For new products or businesses, it is not.

Possible solutions

Use conservative estimates.

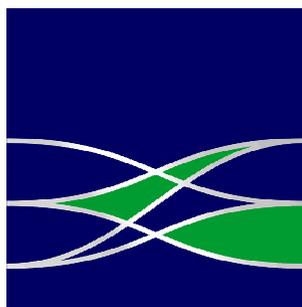
Significantly increase correlations.

Hold “new product” capital until stable.



Questions





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