FINANCIAL STABILITY INSTITUTE

BANK FOR INTERNATIONAL SETTLEMENTS

An Overview of Basel II's Pillar 2

Seminar for Senior Bank Supervisors from Emerging Economies

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Topics to be covered

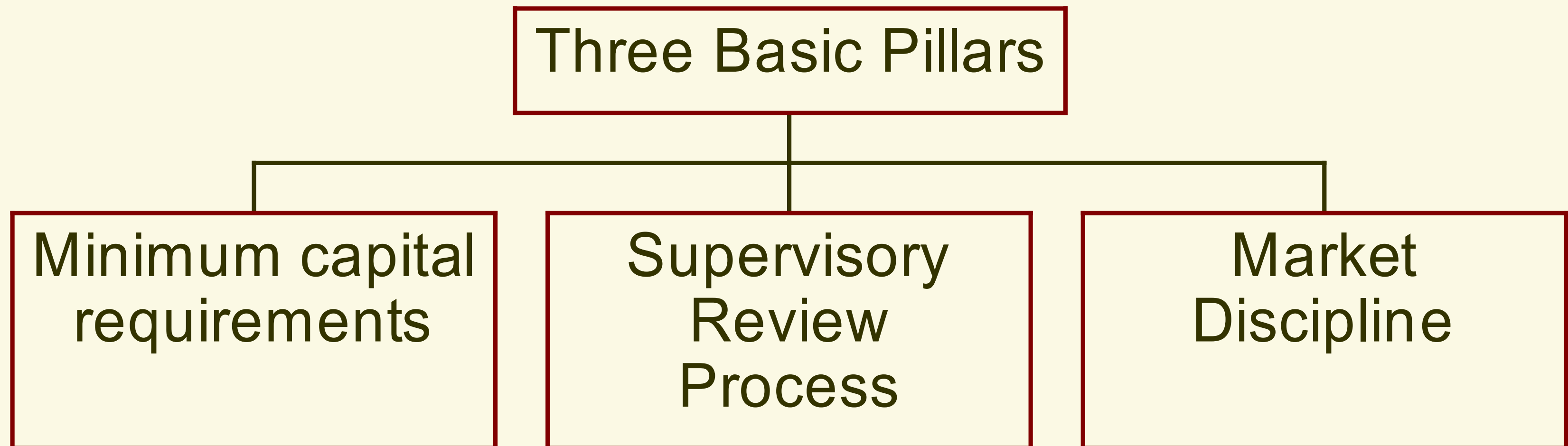
- Why does Pillar 2 exist?
- The four principles of Pillar 2
- Specific aspects and challenges of Pillar 2
- Conclusions

Why does Pillar 2 exist?

Objectives of Basel II

- Continue to promote safety and soundness in the banking system
- Better align regulatory capital to underlying risk
- Encourage banks to improve further their risk management systems
- Focus on internationally active banks but should be suitable for banks of varying levels of complexity and sophistication

The Organisation of the New Accord



Menu of Options for Various Risks

- Credit Risk:
  - Standardised approach
  - Foundation internal ratings-based approach
  - Advanced internal ratings-based approach
- Market Risk:
  - Standardised measurement method
  - Internal models approach
- Operational Risk:
  - Basic Indicator Approach
  - Standardised Approach
  - Advanced Measurement Approaches

What is Pillar 2?

- An overall assessment of risks that includes:
  - quantitative and qualitative factors
- An assessment of capital management and planning
- It should cover all parts of a financial group
- It should include a strategic assessment of the institution
- It should be flexible and proportionate to the risks faced by an individual institution

Pillar 2: Supervisory Review Process

- Supporting Pillar 1
  - Dimensions of risks not considered (e.g. large exposures and credit concentrations)
  - Risks not taken into account (e.g. interest rate risk in the banking book, business and strategic risk)
  - Factors external to the bank (e.g. business cycles)
- Ensuring compliance with Pillar 1 requirements – both quantitative and qualitative
- Fostering improvements in risk management and in supervision

Pillar 2: Supervisory Review Process

- Is Pillar 2 the most important pillar?
- Pillar 1 determines the minimum level of capital, not the optimal level of capital
- Pillar 2 will enable early intervention by supervisors if a bank's capital does not sufficiently buffer the risks inherent in its business
- Pillar 2 provides a positive correlation between the capital required to adequately address a bank's risks and the strength of its risk management processes

The Four Principles of Pillar 2

Pillar 2: The four principles

- Pillar 2 is based on four key principles:

1. Bank's own assessment of capital adequacy
2. Supervisory review process
3. Capital above regulatory minima
4. Supervisory intervention

Foundation = existing supervisory guidance, especially *The Core Principles for Effective Banking Supervision*

Supervisory Review - Principles

- **Principle 1:**

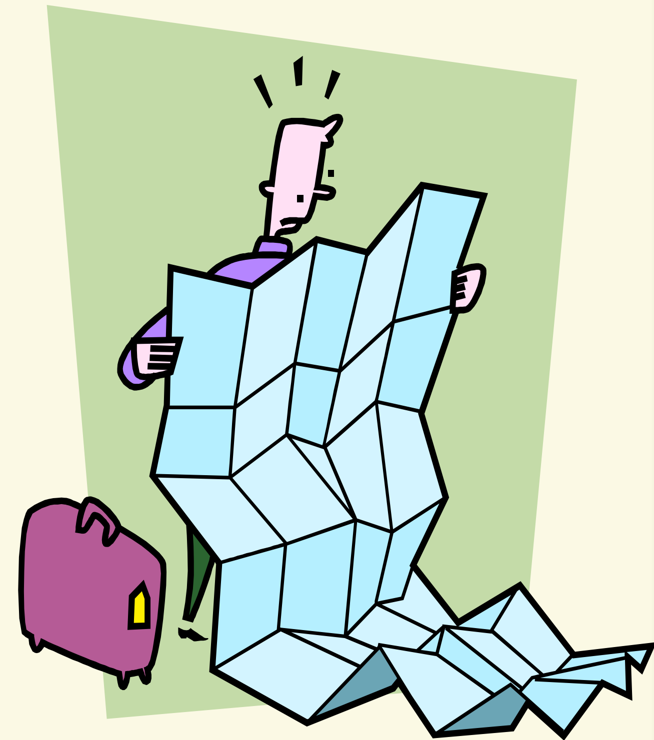
  Bank's should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

  ICAAP = internal capital adequacy assessment process

Capital Adequacy Assessment Process

Strategic Planning

- Helps organisation anticipate and adapt to change
- Allows it to be **proactive** rather than **reactive**
- Should clearly outline
  - desirable capital level
  - external capital sources
  - expected capital requirements and expenditures



Capital Adequacy Assessment Process

- The level and sophistication of the capital adequacy assessment process should be tailored to the bank's activities and the risks involved in these activities
- There is no "best practice" with regard to the design and implementation of such a process (no "one size fits all")
- However, there are some key features that should be included in every bank's ICAAP

Capital Adequacy Assessment Process

- Board and senior management oversight
- Policies and procedures designed to ensure that the bank identifies, measures, monitors and controls all material risks
- A systematic, disciplined <u>process</u> that:
  - relates capital to the level of risk
  - states capital adequacy goals vis-à-vis risk, considering the bank's strategic focus and business plan
  - includes internal controls, reviews, and audit to ensure the integrity of the overall management process
- All material risks incurred by the bank should be factored into the ICAAP

Capital Adequacy Assessment Process

What factors should management consider?

- regulatory ratios and requirements
- peer comparisons
- expectations of counterparties and rating agencies
- concentrations of credit and other risks
- business cycle effects
- forward-looking stress tests
- formal modelling and risk analysis
- other qualitative and subjective factors
- building value for shareholders

Supervisory Review - Principles

- **Principle 2:**

  Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate action if they are not satisfied with the results of this **process**.

Supervisory Review Process

- Traditional methods for monitoring compliance with minimum regulatory capital ratios:
  - on-site examinations
  - off-site surveillance
  - meetings with bank management
  - periodic reporting
  - review of work done by internal and external auditors

Supervisory Review Process

- Supervisors should review the bank's assessment process to determine that:
  - target levels of capital chosen are comprehensive and relevant to the current operating environment
  - these levels are properly monitored and reviewed by senior management
  - the composition of capital is appropriate for the nature and scale of the bank's business

Supervisory Review - Principles

- **Principle 3:**

  Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Capital Above Regulatory Minimum Ratios

Why should banks operate with an additional capital buffer?

- Competitive reasons
- Fluctuations in the overall capital ratio occurring in the normal course of business
- Cost for a bank to raise capital, especially when needed quickly or when market conditions are unfavourable
- Ramifications of falling below minimum regulatory capital requirements
- Bank-specific risks or macroeconomic factors may not be taken into account in Pillar 1

Capital Above Regulatory Minimum Ratios

Means to ensure that banks are operating with adequate capital levels:

- Reliance on a bank's ICAAP
- Establishment of trigger and target ratios (e.g. the former U.K. model)
- Establishment of defined capital categories above minimum ratios (e.g. the U.S. model – "prompt corrective action")
- Higher requirements for outliers

Supervisory Review - Principles

- **Principle 4:**

  Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Supervisory Intervention

Objective

Identify as early as possible the *potential* for serious erosion of the bank's capital position in order to limit risk to depositors and the financial system

Supervisory Intervention

Intervening actions:

- Determined by law, national policies, case-by-case analysis
- Moral suasion to encourage banks to improve their capital positions
- Capital ratios may represent triggers for supervisory action, up to and including the closure of the bank

Supervisory Intervention

Potential supervisory actions:

- Increased monitoring of the bank
- Requiring the bank to improve its ICAAP
- Requiring the bank to submit a capital restoration plan
- Placing restrictions on bank activities, acquisitions, etc.
- Restricting the payment of dividends
- Requiring the replacement of senior management and/or the board of directors

Specific Aspects and Challenges of Pillar 2

Specific Aspects of Pillar 2

Interest rate risk in the banking book

- Significant risk that should be supported by capital
- Apply standardised interest rate shock
- Banks with significant interest rate risk ("outliers") should reduce risk, increase capital, or both

Operational risk

- Is Pillar 1 requirement under Basic Indicator or Standardised Approach sufficient (e.g., for banks with low profitability)?

Specific Aspects of Pillar 2

Credit concentration risk

- Single exposure or group of exposures that have potential to produce losses large enough to threaten bank solvency
- Banks should have internal systems/policies & controls to identify/measure/monitor/control concentrations.
- Bank should include concentrations, including periodic stress tests, in their ICAAPs

Other risks

- IRB stress tests, definition of default, residual risk, securitisation

Specific Aspects of Pillar 2

Supervisory transparency and accountability

- Criteria used in Pillar 2 assessments should be made publicly available
- Factors considered in setting target or trigger ratios above the regulatory minimum should also be publicly available
- If capital requirements are set above minimum for an individual bank, supervisors should explain to the bank:
  - The risk characteristics specific to the bank
  - Any remedial action necessary

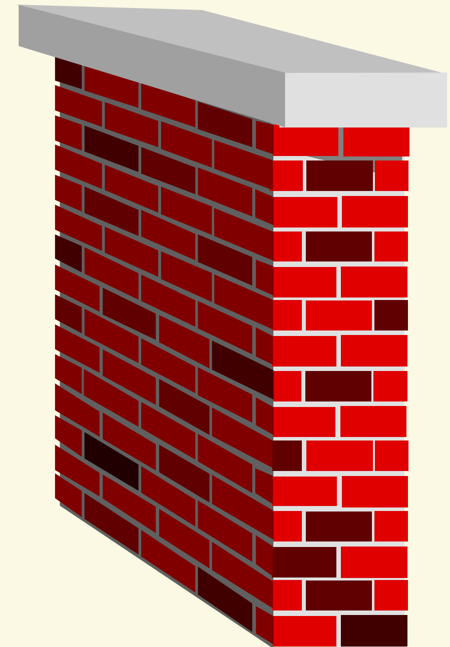
Cross-Border Communication and Cooperation

- Basel II will require enhanced, practical cooperation among supervisors of internationally active banks
- **Legal responsibilities do not change under Basel II!**
- Hopefully, methods and approval processes at the group level can be accepted by host supervisors
- Supervisors should avoid performing redundant and uncoordinated approval and validation work—burdensome for banks and supervisors
- Roles of home and host supervisors should be communicated to banks operating in multiple jurisdictions
- Pragmatic approach of mutual recognition is desirable

Pillar 2 Challenges

Potentially Significant Obstacles

- Legal and regulatory impediments
- Resources (personnel, training, etc) necessary for effective supervisory review
- Level playing field
- Transparency
- Ability to exercise supervisory judgment



Pillar 2 Challenges

- Supervisors will need to put in place a coherent and practical framework that is most suited to the circumstances in their jurisdiction, while aligning with the overall objectives of Pillar 2
- Expertise in reviewing banks' capital assessments and capital adequacy will also need to be developed or strengthened
- Given the wide range of supervisory practices in different jurisdictions, sharing of supervisory approaches will help the process

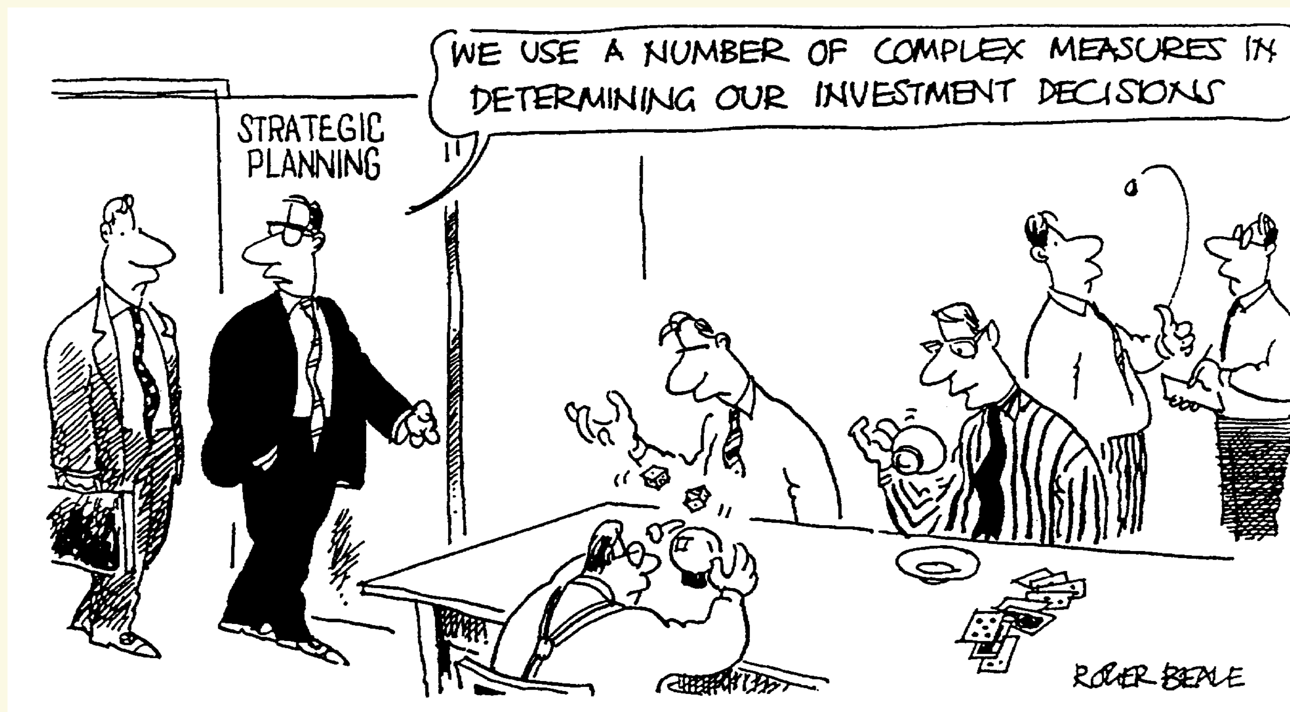
Conclusions

- The three pillars together are intended to achieve a level of capital commensurate with a bank's overall risk profile
- Starting point and emphasis is bank's assessment
- Sophistication of capital assessment should depend on size, complexity, and risk profile of the bank
- Pillar 2 does not require specific, formal, across-the-board capital add-on requirements
- Intention is to drive better bank risk management and more risk-focused (and judgment focused) supervision

Keeping Basel II in Context

- Capital requirements must be viewed in conjunction with other important standards
  - The Core Principles
  - Accounting standards
  - Risk management
- Capital adequacy is only one part of the puzzle
- Capital is NOT a substitute for inadequate control or risk management processes

Keeping Basel II in Context



Questions?

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