Basel II Pillar II Practice Study
The World Bank

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Outline

1. Basel II Framework
2. Basel II Pillar II
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4. Main Findings Jurisdictions
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1. Basel II Framework

- The 1988 Accord (Basel I) was the first standard agreed on to establish common capital requirements for internationally active banks.

- The Basel II Framework emerged within the context of the international regulatory landscape in 2004.
2. Basel II Pillar II

Pillar II

1. Banks: assess internal capital adequacy
2. Supervisors: evaluate banks’ assessments & risk system
3. Capital above the minima
4. Early intervention and remedial action
3. WB Basel II Pillar II Practice Study

- The WB study of Pillar II practices:
  - collect information on how supervisors approached the ICAAP;
  - understand how supervisors respond to banks’ ICAAP
- 10 countries responded to the survey.
### 3. WB Basel II Pillar II Practice Study

<table>
<thead>
<tr>
<th></th>
<th>Countries</th>
<th>World Bank classification</th>
<th>Basel Committee members</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Argentina</td>
<td>Latin America and the Caribbean</td>
<td>x</td>
</tr>
<tr>
<td>2</td>
<td>Colombia</td>
<td></td>
<td></td>
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<tr>
<td>3</td>
<td>Peru</td>
<td></td>
<td></td>
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<tr>
<td>4</td>
<td>Croatia</td>
<td>Europe and Central Asia</td>
<td>x</td>
</tr>
<tr>
<td>5</td>
<td>Turkey</td>
<td></td>
<td></td>
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<tr>
<td>6</td>
<td>Poland</td>
<td></td>
<td></td>
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<tr>
<td>7</td>
<td>Korea</td>
<td>East Asia and Pacific</td>
<td>x</td>
</tr>
<tr>
<td>8</td>
<td>Thailand</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Morocco</td>
<td>Middle East and North Africa</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Nigeria</td>
<td>Sub-Saharan Africa</td>
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</tbody>
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4. Main Findings in Surveyed Jurisdictions
Internal Capital Adequacy Assessment Process (ICAAP)
Most countries have issued ICAAP requirements

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Number of Jurisdictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Responded to the survey</td>
<td>10</td>
</tr>
<tr>
<td>Require ICAAPs</td>
<td>9</td>
</tr>
<tr>
<td>Require ICAAP reports to be sent to the supervisor</td>
<td>8</td>
</tr>
<tr>
<td>Common/suggested template for the report</td>
<td>8</td>
</tr>
</tbody>
</table>
Common **templates** to report the ICAAP are useful balancing standardization and flexibility

<table>
<thead>
<tr>
<th>Summary</th>
<th>General information, scope of application, key components of the ICAAP, summary of stress testing, capital planning.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk governance framework</td>
<td>Board and senior management responsibilities. Role of committees. Role of internal audit.</td>
</tr>
<tr>
<td>Risk assessment and internal capital requirements</td>
<td>Identification and measurement (or assessment) of significant risks and related capital needs. Relationship with risk profile, risk appetite, and capacity.</td>
</tr>
<tr>
<td>Capital planning and stress testing</td>
<td>Needs and sources of capital. Capital plan for current and next years. Description of stress testing.</td>
</tr>
<tr>
<td>Aggregation or consolidation of risks</td>
<td>Aggregation of internal capital needs for all risks. Guidance on the treatment of diversification effects.</td>
</tr>
<tr>
<td>Conclusions</td>
<td>Tables or explanations summarizing total internal capital needs and capital sources.</td>
</tr>
</tbody>
</table>
The scope of ICAAP should allow to appropriately reflect the risk in a financial group

- Basel II should be applied on a consolidated basis for internationally active banks (BCBS 2006).
- There are different approaches on requirements of consolidated vis a vis stand-alone reports
- Assessment of capital adequacy for branches should not be different from that of local banks
- ICAAP guidelines: clear responsibilities regarding the role of local institutions that are subsidiaries or branches
For all of the respondents: proportionality is embedded in ICAAPs. Reports / methodologies vary with banks.

Seven of nine respondent supervisors do not offer standardized methodologies.

ICAAP implementation should be bank-driven.
Board and senior management oversight are key to an effective ICAAP

- The ICAAP is a process, not just a quantitative measure of capital
- The ICAAP includes board and senior management oversight:
  - The board should approve the ICAAP and—with senior management—formulate strategic plans and set risk appetite and risk tolerance
- Most jurisdictions require some level of internal review for the ICAAP / outcomes / reports.
- Seven of nine respondents require the ICAAP to be reviewed by the internal audit
The Supervisory Review and Evaluation Process (SREP)
SREP in Pillar II: Risk Assessment

- Supervisors are expected to regularly review the process whereby a bank assesses its capital adequacy, risk position, resulting capital levels, and quality of capital held.
- Supervisors should evaluate to what extent a bank has a sound internal process in place to assess capital adequacy.

The SREP – Number of Jurisdictions

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<tr>
<td>Require ICAAPs</td>
<td>9</td>
</tr>
<tr>
<td>Have a SREP</td>
<td>8</td>
</tr>
<tr>
<td>Have a separate, specific process</td>
<td>5</td>
</tr>
<tr>
<td>Have SREP as part of full examinations</td>
<td>3</td>
</tr>
</tbody>
</table>
SREP: strong culture of risk-based supervision

- Most jurisdictions do not assign a specific rating to supervised institutions
- Proportionality is a key characteristic of the SREP
- Supervisors do not use strict quantitative indicators or benchmarks to evaluate capital for each risk category
- External factors affecting banks’ internal capital assessment are considered
- The SREP is conducted annually

<table>
<thead>
<tr>
<th></th>
<th>Jurisdictions Requiring/Total Respondents*</th>
</tr>
</thead>
<tbody>
<tr>
<td>A supervisory rating is an outcome of the SREP</td>
<td>3/8</td>
</tr>
<tr>
<td>Supervisory categorization of financial institutions</td>
<td>4/8</td>
</tr>
<tr>
<td>Annual SREP</td>
<td>8/8</td>
</tr>
</tbody>
</table>
Supervisors should take action if not satisfied

- Supervisors: require or encourage banks to operate with a buffer over and above Pillar I
- Banking laws and regulations give supervisors explicit powers to set individual capital expectations
- Two-stage process:
  1. Banks determine Pillar II capital needs (ICAAP)
  2. Supervisors can require additional capital
- The range of Pillar II add-ons resulting from the supervisory review is wide
Supervisors need tools to deal with less-than-satisfactory ICAAP results

- Tools: intensifying monitoring, restricting payment of dividends, capital adequacy restoration plan, additional capital, etc.
- All jurisdictions requiring ICAAPs have tools available to deal with less-than-satisfactory ICAAP results
- In most respondents: banks can appeal the supervisory decision to raise Pillar II capital
Corrective actions in surveyed jurisdictions:

**Tools—Available**
- Raise additional capital: 10
- Intensify monitoring: 10
- Improve risk management: 10
- Restrict dividends: 9
- Start capital restoration plan: 9
- Prohibit new activities or acquisitions: 7
- Restrict current activities: 7
- Reduce risk exposure: 7

**Tools—Used in the past 2 years**
- Improve risk management: 7
- Start capital restoration plan: 2
- Raise additional capital: 1
- Restrict dividends: 1
- Restrict current activities: 1
- Intensify monitoring: 1
- Prohibit new activities or acquisitions: 1
- Reduce risk exposure: 0
5. Conclusions and Lessons
ICAAP: main lessons

- Clear supervisory guidelines is important for both supervisors and banks
- The common templates for institutions is useful
- The home-host issue should be addressed correctly
- Proportionality must be embedded in ICAAPs
- A forward looking capital plan is a key component of a sound ICAAP
- Supervisors should be aware of the challenges and limitations faced by parties such as the board and the internal audit
SREP: main lessons

- A strong culture of risk-based supervision is needed
- Integrate the outcomes into the overall supervisory assessment
- Proportionality is important
- Regular supervisory interaction with different levels of the institutions is key to an effective risk governance framework
- Supervisors should have a range of tools to deal with less-than-satisfactory ICAAP results
THANK YOU!