

Basel II Pillar II Practice Study

The World Bank

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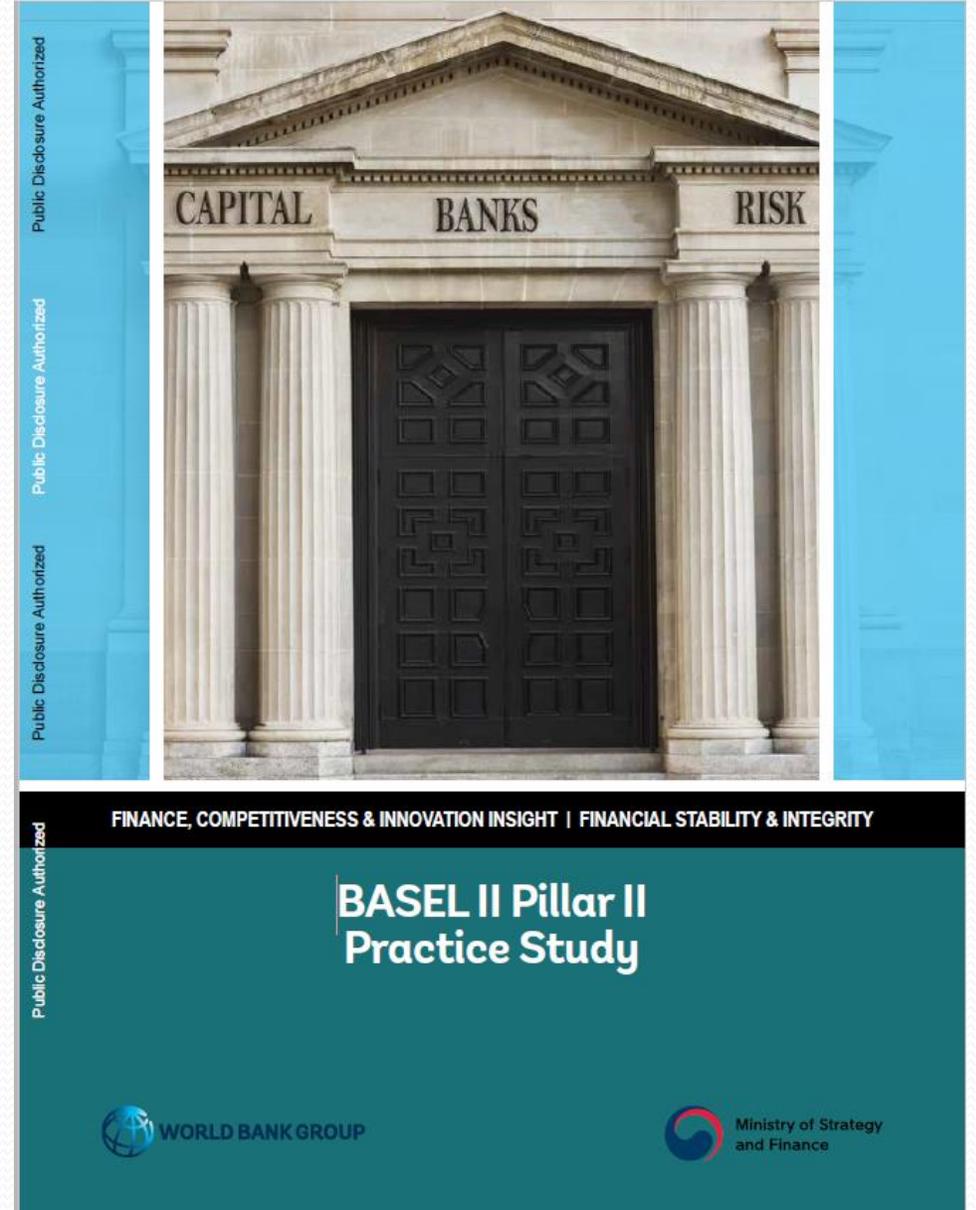
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WORLD BANK GROUP
Finance, Competitiveness & Innovation

Outline

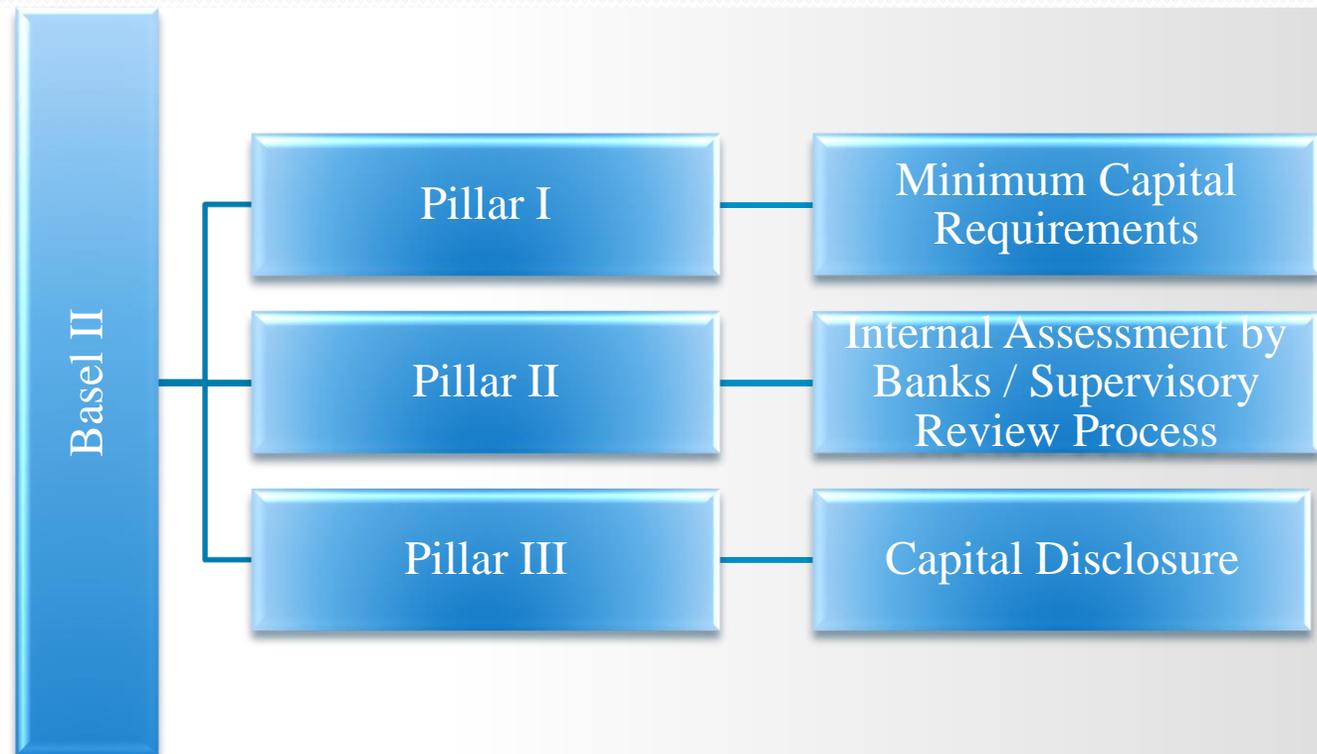
1. Basel II Framework
2. Basel II Pillar II
3. Basel II Pillar II Practice Study
4. Main Findings Jurisdictions
 1. ICAAP
 2. SREP
5. Conclusions and Lessons



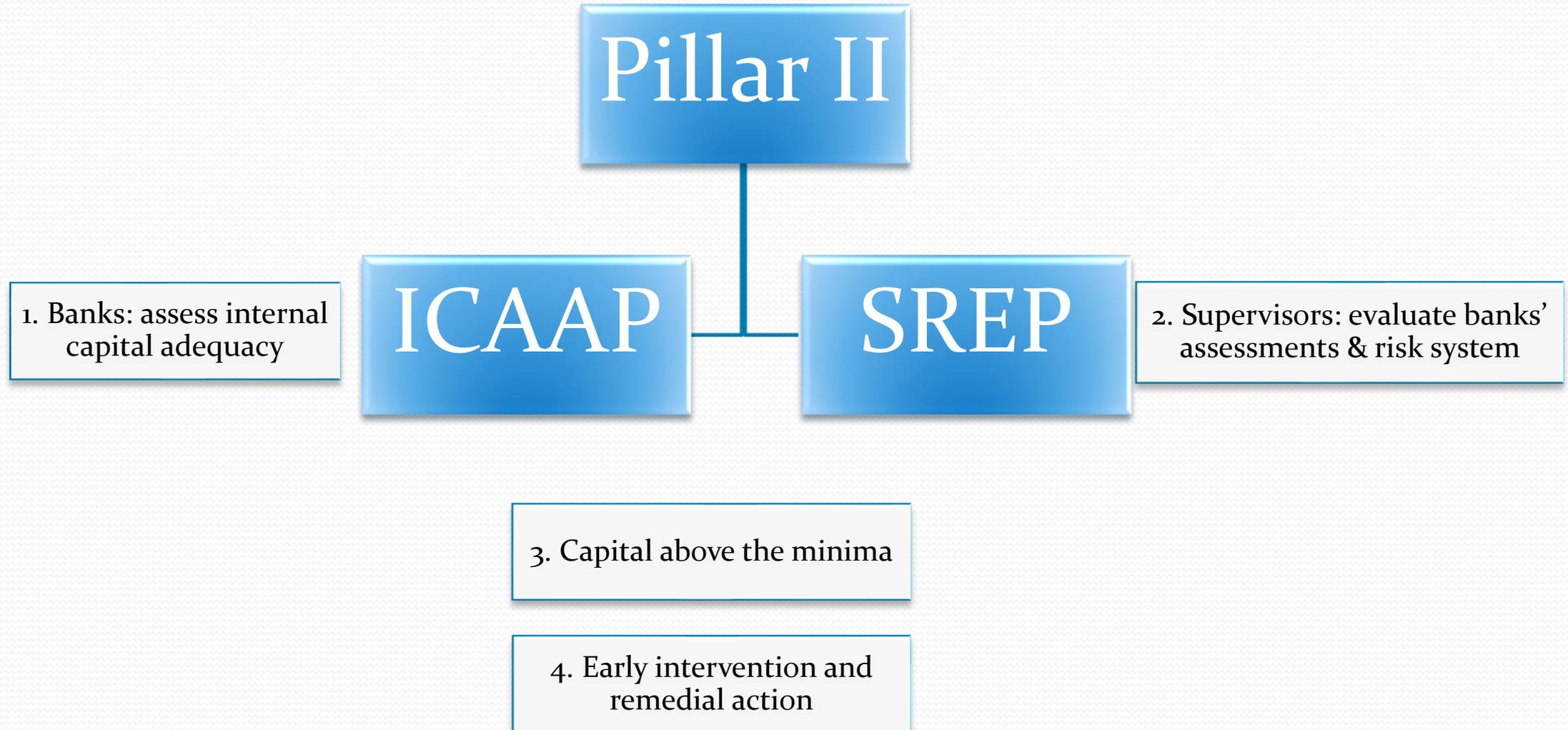
1. Basel II Framework

- 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.

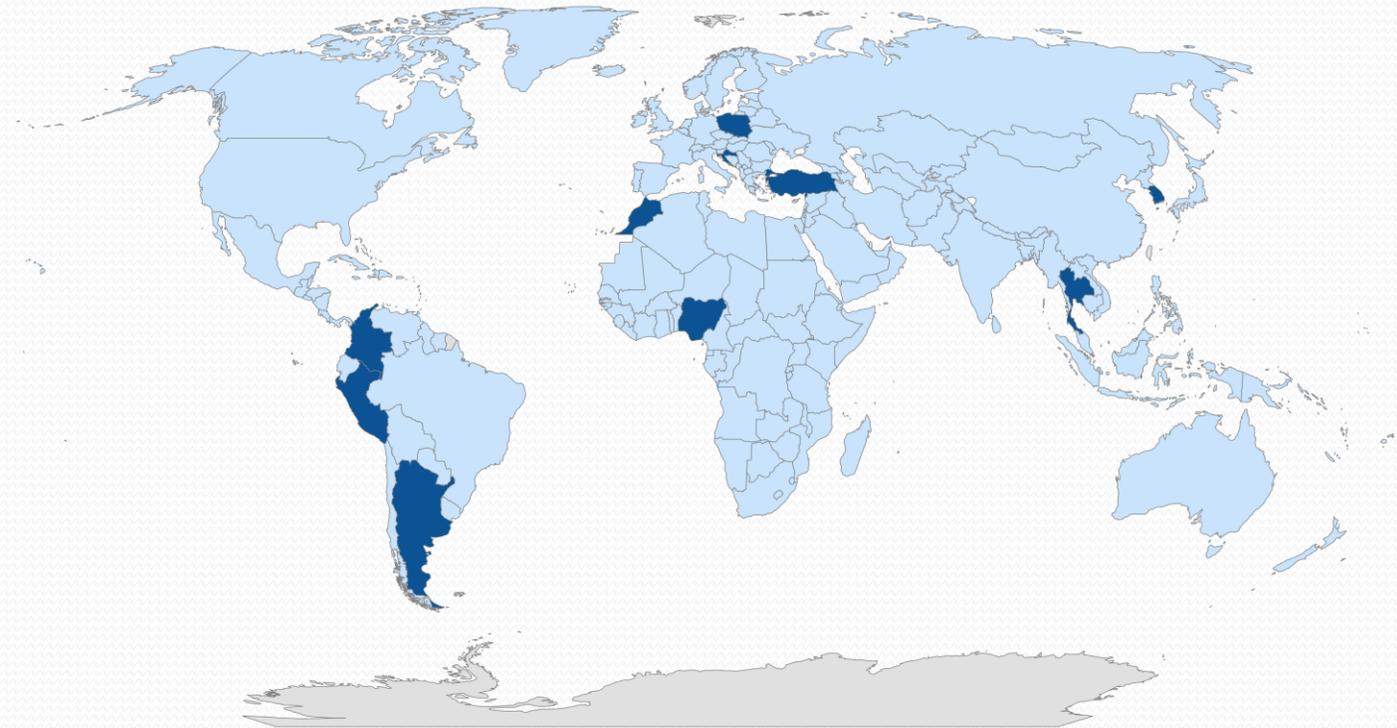


2. Basel II Pillar II



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.



■ Responded countries of the World Bank study

3. WB Basel II Pillar II Practice Study

	Countries	World Bank classification	Basel Committee members
1	Argentina	Latin America and the Caribbean	X
2	Colombia		
3	Peru		
4	Croatia	Europe and Central Asia	
5	Turkey		X
6	Poland		
7	Korea	East Asia and Pacific	X
8	Thailand		
9	Morocco	Middle East and North Africa	
10	Nigeria	Sub-Saharan Africa	

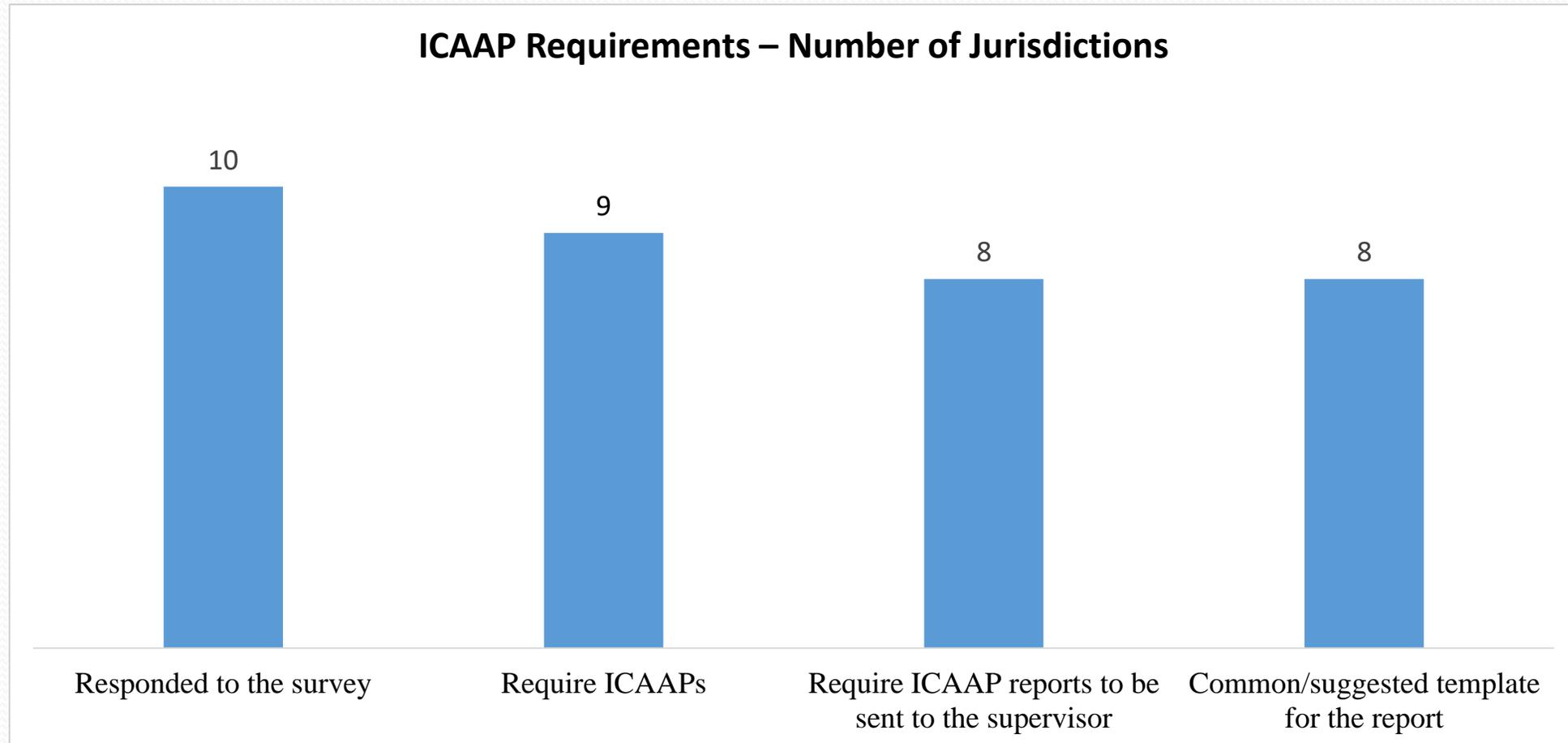
4. Main Findings in Surveyed Jurisdictions





Internal Capital Adequacy Assessment Process (ICAAP)

Most countries have issued ICAAP requirements



Common **templates** to report the ICAAP are useful balancing standardization and flexibility

Summary	General information, scope of application, key components of the ICAAP, summary of stress testing, capital planning.
Risk governance framework	Board and senior management responsibilities. Role of committees. Role of internal audit.
Risk assessment and internal capital requirements	Identification and measurement (or assessment) of significant risks and related capital needs. Relationship with risk profile, risk appetite, and capacity.
Capital planning and stress testing	Needs and sources of capital. Capital plan for current and next years. Description of stress testing.
Aggregation or consolidation of risks	Aggregation of internal capital needs for all risks. Guidance on the treatment of diversification effects.
Conclusions	Tables or explanations summarizing total internal capital needs and capital sources.

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

Proportionality must be embedded in ICAAPs



- 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**



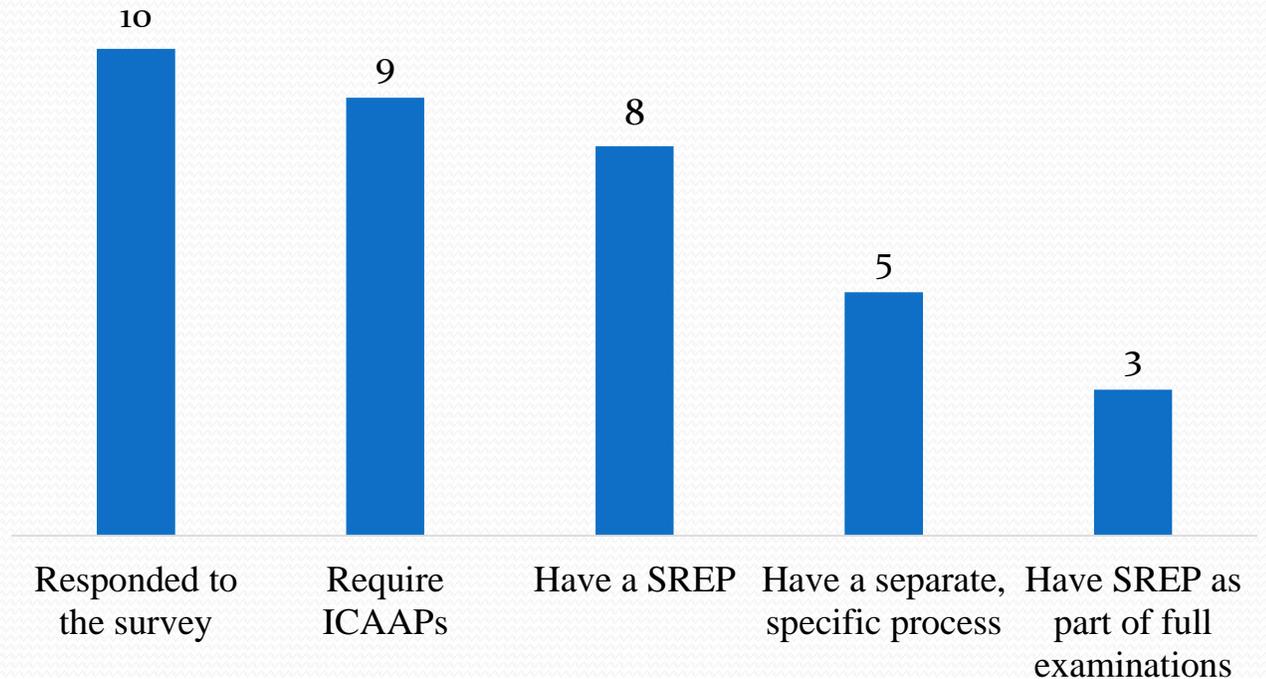


The Supervisory Review and Evaluation Process (SREP)

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



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
- External factors affecting banks' internal capital assessment are considered.
- The SREP is conducted annually

	Jurisdictions Requiring/Total Respondents*
A supervisory rating is an outcome of the SREP	3/8
Supervisory categorization of financial institutions	4/8
Annual SREP	8/8

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

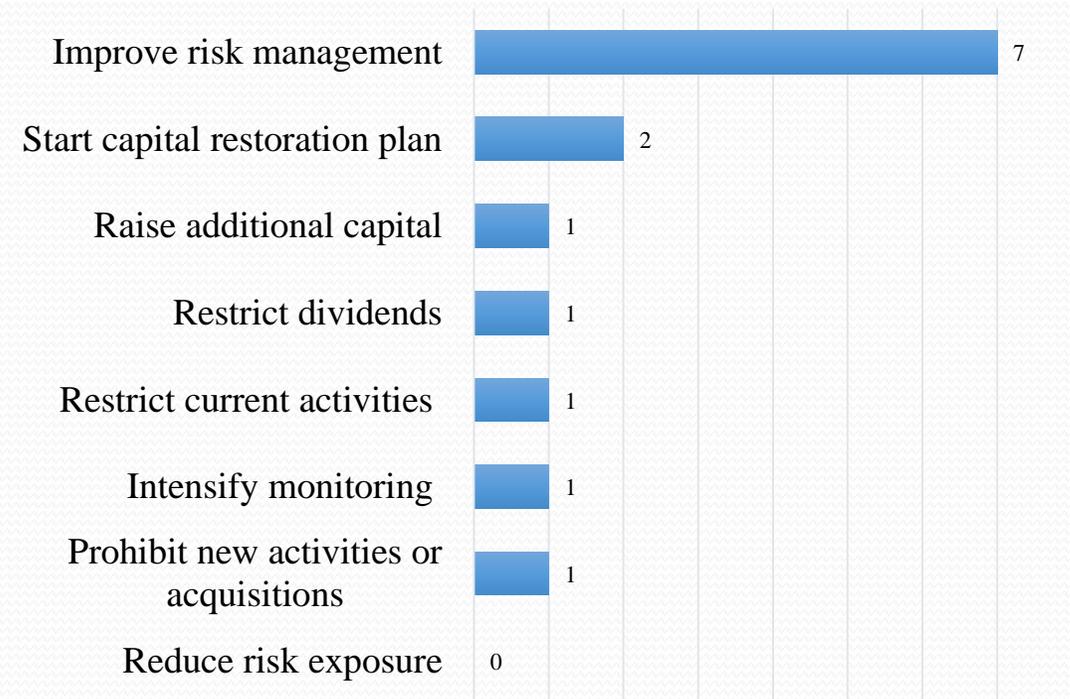


Corrective actions in surveyed jurisdictions:

Tools—Available



Tools—Used in the past 2 years





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!