



GUERNSEY
FINANCIAL
SERVICES
COMMISSION

Basel II Briefing: Pillar 2 Preparations

Considerations on Pillar 2 for Subsidiary Banks

November 2006

Preamble

Those studying this document should be aware that because of the nature of the technical language used in the Basel II Accord a broad understanding is assumed of the Accord document “International Convergence of Capital Measurement and Capital Standards” and the three Pillar approach which it contains. At the very least readers should be familiar with the information contained on Basel II on the Commission’s website. At the outset it should be noted that “other risks” referred to in this paper does not mean operational, credit or market risks, which are comprehensively addressed under Pillar 1. On current numbers this paper is relevant to the 28 subsidiary banks in Guernsey.

Overview

The purpose of producing this briefing paper is to ensure bankers focus on Pillar 2 in late 2006 and early 2007 so that they will be ready to put in place the building blocks for Basel II in 2007. The Commission is not looking to implement Basel II before the beginning of 2008 but there will be much to do in 2007. (The Commission will endeavour to accommodate earlier implementation where requested if it is considered prudent to do so.) This paper therefore encourages bankers to engage in thinking about how Pillar 2 will affect their bank. Regulators cannot implement Basel II just by putting in place a Pillar 1 framework – Pillar 1 cannot exist in a vacuum. To achieve an effective rollout of Basel II we need to address both Pillar 1 and Pillar 2. [Pillar 3, which is about disclosure and market disciplines, does not apply at the subsidiary level and is only relevant at the consolidated group level.]

Pillar 2 is about capturing the risks not already captured under Pillar 1 and either significantly mitigating those risks or allocating capital against them. Pillar 1 on the straightforward standardised basis that will be widely adopted in Guernsey is essentially a mechanical process capturing credit risk and operational risk. It is clearly the foundation for calculations of capital adequacy but is not sufficient in itself. Pillar 2 is about banks having the capability to make their own capital adequacy calculations by identifying and assessing all the relevant risks. Pillar 2 is also about the exercise known as the supervisory review process which embraces two dimensions: bankers’ assessment of capital required to cover their risks and the supervisory review and evaluation of that assessment. The supervisory dimension is sometimes known as the SREP – the Supervisory Review and Evaluation Process. The banker’s dimension is the ICAAP – the Internal Capital Adequacy Assessment Process. The ICAAP is the responsibility of banks but the novel element is that it involves a dialogue between banks and their supervisors (the SREP) with a view to achieving a consensus on the relevant amounts of capital and other mitigants required to support the risks in particular areas.

The purpose of this paper is also to raise awareness of the scope of Pillar 2 and to alert bankers to the fact that they will need to make good use of the available lead-time in order to be well prepared for Basel II by 2008.

The first reason for bankers to be alert is that they have to stand ready to generate an ICAAP with a goal of aligning the bank's own assessment of its economic capital needs with its regulatory capital needs. Hence the banks should have the capability to perform an ICAAP and to produce overall capital numbers which can be supported and which can be part of a dialogue on risk evaluation between the bank and supervisor.

Pillar 2 Source Material

The Basel Committee of Banking Supervisors has pointed out in May 2006 that it did not intend to issue any further detailed guidance on Pillar 2 because it did not believe that it was possible or helpful to be prescriptive on what supervisors should do with regard to Pillar 2 as this was being left to national regulatory regimes to take forward. That reflects the general feeling that Pillar 2 is not a precise science and needs to reflect the particular combinations of risks in different jurisdictions and in different banks. Regulators have therefore taken the initiative in their own jurisdictions and have begun developing a framework for Pillar 2. For example, the Financial Services Authority in the United Kingdom has engaged in extensive consultation and put out some helpful documents indicating the main areas that need to be addressed including its SREP framework and ICAAP submission suggested format. In its deliberations on Pillar 2 it emphasises that it regards Pillar 2 as a proportionate concept which is intended to be fit for purpose but which also has flexibility. We have seen other comprehensive contributions on Pillar 2, notably by the Hong Kong Monetary Authority ("HKMA"), a member of the Offshore Group of Banking Supervisors, which is both a home supervisor and a host supervisor utilising a 'scorecard' approach.

For general principles on Pillar 2 some of the best source material has been from the Committee of European Banking Supervisors ("CEBS"). Its consultation paper of June 2005 clearly indicated the preferred shape that an acceptable approach to Pillar 2 was likely to take. CEBS embraces the concept of the "structured dialogue" and to underpin that it has produced schematic diagrams showing the elements of the process (for example see Appendix 1 and their Pillar 2 consultative document at the following website address: www.c-ebs.org/Consultation_papers/CP03-second.pdf). It has also listed a summary of guidelines under the various component parts notably – internal governance, guidelines on ICAAP, guidelines on SREP and guidelines on risk assessment systems.

The Commission has included in Appendix 2 to this document some guidance on what an ICAAP might look like and the sort of areas that should be covered. This is not prescriptive and banks may wish to follow models adopted in their group or other acceptable approaches.

Some Unresolved Issues on the Way Forward

There is still an ongoing debate as to whether group allocations of capital for Pillar 2 will be sufficient i.e. there is a feeling amongst some home regulators that a top-down process would suffice. At first sight it might seem attractive that the lead regulator could determine an overall Pillar 2 cushion with the parent and allocate that capital cushion among its subsidiaries. One flaw in that approach is that it presumes that it is not important to match additional capital to identified additional risks – rather to rely upon the portfolio effects of a group as a whole. The Commission considers there to be good arguments for a zero-based locally assessed Pillar 2 capital allocation rather than a top-down approach. The primary reason for this is that capital in legal entities is not fungible across borders. Hence it needs to be allocated on a legal entity basis whether in the parent jurisdiction or in other separate legal jurisdictions. A second reason is that it is the host supervisor who has the statutory responsibility for the subsidiary and understands the additional risks in the local subsidiaries and is in a position to engage in a dialogue with the local bank to determine the specific capital allocations or appropriate risk mitigants for the specific local risks. This approach is more risk sensitive than a top-down approach which relies upon the diversification effects within a portfolio of different business lines. The process of identifying the local risks and generating local ICAAPs and SREPs should provide the starting point for home/host supervisor interaction with a view to giving the most efficient allocation of capital among different entities while at the same time minimising duplication of effort between supervisors and within banking groups.

Realistically, there will have to be some “reasonableness” tests as part of the home/host supervisory dialogue but it is difficult to envisage a prudent outcome other than a requirement of the local supervisors to require sufficient capital to support all the risks in their jurisdiction.

What Other Risks might be Material

To assist banks in determining what Pillar 2 risk they should be considering this paper explores some of the other risks that have been identified as material. The ICAAP should be comprehensive and should cover all Pillar 2 risks including those listed in Appendix 2.

On concentration risk the Commission will be expecting the ICAAP to cover sectoral risks and geographic concentrations in property and money market books. For example, sectoral risk may be relevant in Guernsey to the specialist business which has evolved in providing facilities in the fund of hedge funds sector. In addition, to address concentration risk one of the things we will have to look to is the incidence of large exposures and rank banks in accordance with their clustering of large exposures based on the 800% of capital base limit (contained in the Commission’s large exposure principles) and the numbers of large exposures over 25% of capital base. For mitigation to be effective we would have to recognise significant diversification of those large exposures and the nature of the collateral held.

Not surprisingly European supervisors have specifically identified the risks to banks of having to meet pension fund obligations and the need to address the funding of pension fund shortfalls and the impact that may have on a bank's ability to add to its capital reserves. Subsidiaries in Guernsey with locally funded pension schemes will need to take account of their risks in this area.

In a deposit gathering-led banking centre such as Guernsey reputational risk is clearly a significant risk to be captured as part of the ICAAP and SREP processes. Reputational risk is one of the most important risks in offshore finance centres. That risk is heightened where there are particular blind spots in respect of customer identity and customer due diligence, for example, where, in the past, beneficial owner details were not known or have not been passed on as part of introductory certificates from business introducers or as a result of accepting business contained within inappropriate pooled accounts.

There may be other risks specific to particular banks. In what would be regarded as underestimation of credit risk in Pillar 1, it is possible that the practice of giving indicative credit facilities to funds on an uncommitted basis, when commercially a bank may not realistically be able to walk away from that relationship, needs to be recognised. With such uncommitted facilities it is important to estimate the real exposure to the potential borrower and reflect that as a Pillar 2 risk. This is not uncommon since banks dealing with large clients will take a longer term view to safeguard potential earnings over the life cycle of the relationship. Again in Pillar 1 specifically identified credit risks and operational risks may not have been fully reflected as the simpler approaches may under record the risk.

Supervisory Approach to “Other Risks”

Identifying the risks may be relatively straightforward. A suggested list of other risks is included within Appendix 2. There is widespread acceptance of the point that the particular “other risks” identified may not be responsive to the application of additional amounts of capital: it may be more appropriate to implement safer or more effective control systems which may involve smarter or better-resourced risk management systems. A related issue is the expectation that, as part of the Pillar 2 dialogue, the regime will generate incentives (in effect discounts to capital add-ons) for well established risk mitigants including robust control systems.

Pillar 2 requires the Commission to put in place a regime for the assessment of “other risks” and consequent capital add-ons which is both systematic and transparent. In order to translate these other risks into explicit capital charges a series of matrices will have to be constructed.

As an example of one of the more intangible risks, which is particularly relevant for the specialist private banks, Appendix 3 embodies a matrix which illustrates a practical approach to the assessment of reputational risk. That approach envisages that additional capital is required based on the proportion of high risk customers (including PEPs) in the client list. A high proportion of high risk clients would generate a capital add-on. However, the supervisory approach then sets out how this could be mitigated – under certain conditions to a zero capital add-on. It would seem that robust and clear customer acceptance procedures and implemented processes with

no blind spots (including inappropriate pooled accounts) would be a good starting point. That said, the acceptance solely of group business would not, of itself, be a mitigation based on our observation of risks from that source. A robust customer risk-profiling regime would be a pre-requisite.

In the interests of pragmatic regulation we are keen to keep the process simple and transparent and to avoid introducing extensive detailed risk assessments which require a large number of graded judgements on the quality of the mitigants.

The timing of ICAAPs, Calibration and the Supervisory Programme

It is proposed that boards of subsidiaries should require an ICAAP to be produced once a year. Clearly for static business models the initial ICAAP will involve more effort than subsequent annual assessments. Boards will want to be satisfied that the capital assessment exercise has been diligently undertaken but if there has been no material change in the business lines undertaken and the risk profile of those business lines is unchanged then there should be very little change in the ICAAP.

At this stage there is no definitive mode of calibration of Pillar 2 risks. Our understanding of how the larger regulators are addressing this is that the likely approach will be "Pillar 1 plus". Hence the aggregate capital requirement for Pillar 1 and Pillar 2 risks will be expressed in terms of Pillar 1, for example, where the ICAAP would suggest that capital should equal 105% of Pillar 1, the additional Pillar 2 requirement is 5% of the capital required for Pillar 1. This ratio of Pillar 1 to Pillar 2 would be maintained by the bank until the next year's ICAAP had been agreed.

We envisage no change in our on-site review programmes. These will continue to inform the Commission on areas of mitigation with respect to credit risk and AML/KYC/CFT/fraud risk issues. Similarly there will be no change in our monitoring of corporate governance issues through the s36c Annual Review regime.

After the initial ICAAP which some banks may choose to synchronise with group wide exercises we would propose that banks undertake annual ICAAPs at a time convenient to them during each financial year. That said it will be most helpful if the exercise was completed ahead of our annual prudential meeting so a productive dialogue could be conducted on the ICAAP at that meeting.

Summary

The purpose of this paper has been to raise awareness of Pillar 2 in the minds of the management of local banks. After studying this paper over the coming months we would expect banks' management to become much more focused on four areas:-

- i) To understand what their group is doing with respect to Pillar 1 and Pillar 2 risks and what they are expecting of their Guernsey subsidiary.
- ii) To take steps to plan their internal capability to calculate capital numbers under Pillar 1 in 2007.

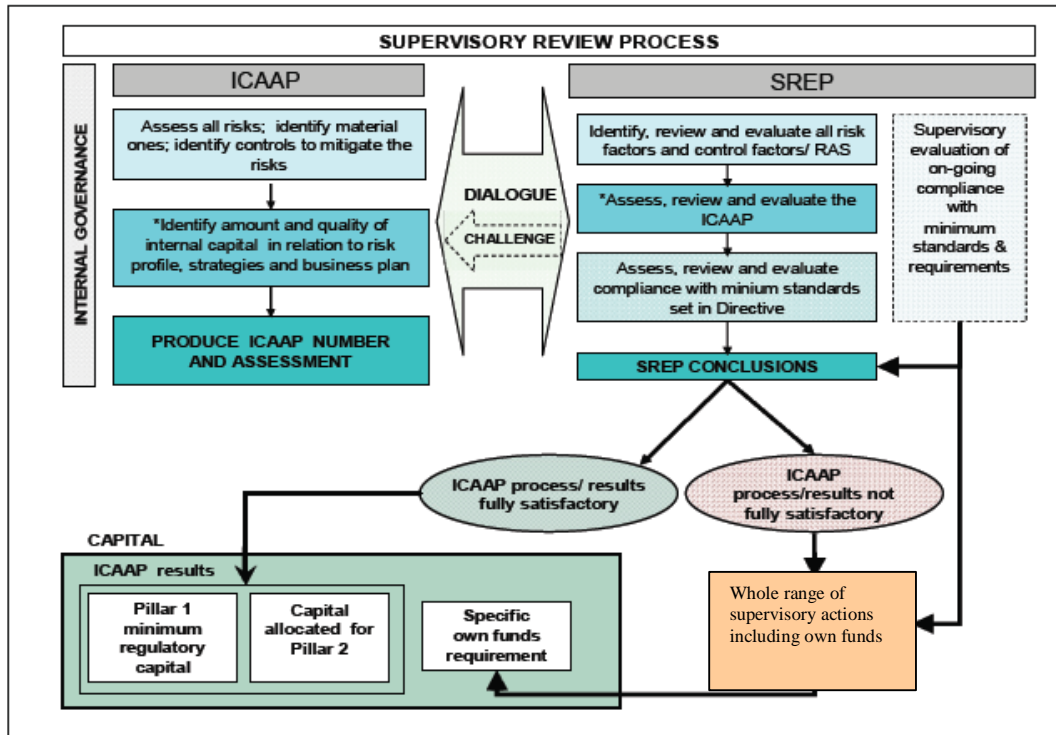
- iii) To identify “other risks” under Pillar 2 relevant to their legal entity and to assess the risk mitigants available to set against those “other risks” under Pillar 2 by end September 2007.
- iv) To take steps to plan their internal capability to calculate capital requirements under Pillar 2 by end December 2007.

Philip Marr
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Appendix 1

A Committee of European Banking Supervisors schematic



Source: Adapted from Committee of European Banking Supervisors. Consultation Paper: Application of the Supervisory Review Process under Pillar 2 (CP03 revised) (http://www.c-eb.org/Consultation_papers/CP03-second.pdf)

Appendix 2

ICAAP submission suggested format

Banks' business and risk profiles differ and the ICAAP should be proportionate to the size, nature and complexity of a bank's business. Adopting this format may be convenient for banks as it covers most of the matters which typically would be reviewed by the Commission under the SREP. However, other formats may be acceptable.

Executive Summary

The purpose of the Executive Summary is to present an overview of the ICAAP methodology and results. This overview would typically include:-

- the purpose of the report and which bank(s) is (are) covered by the ICAAP;
- the main findings of the ICAAP eg:-
 - how much and what composition of internal capital the bank considers it should hold as compared with the Pillar 1 minimum capital requirement; and
 - an assessment of the adequacy of the bank's risk management processes;
- brief descriptions of the capital and dividend plan; how the bank intends to manage capital going forward and for what purposes;
- commentary on your most material risks, why the level of risk is acceptable or, if it is not, what mitigating actions are planned;
- commentary on major issues where further analysis and decisions are required; and
- who has carried out the assessment, how it has been challenged, and who has approved it.

Background

This section would cover the relevant organisational and historical financial data for the bank. e.g. group structure and key data and trends drawn from the bank's quarterly prudential returns.

Capital Adequacy

This section might start with a description of the risk appetite used in the ICAAP. Where economic capital models are used this would include details of the assumptions behind that model. Where scenario analyses or other means are used, then some other description of how the severity of scenario has been chosen would be included.

The section would then include a detailed review of the capital adequacy of your bank including:-

Timing

- the effective date of the ICAAP calculations together with consideration of any events between this date and the date of submission which would materially impact the ICAAP calculation together with their effects; and
- details of, and rationale for, the time period over which capital has been assessed.

Risks analysed

- an identification of the major risks faced in each of the following categories:-
 - credit risk,
 - market risk,
 - operational risk,
 - liquidity risk,
 - reputational risk
 - regulatory risk
 - insurance risk
 - concentration risk
 - residual risk
 - securitisation risk
 - business risk
 - interest rate risk
 - pension obligation risk; and
 - any other risks identified
- for each risk an explanation of how the risk has been assessed and the quantitative results of that assessment;
- a clear articulation of the bank's risk appetite by risk category, for example, strong appetite, modest appetite or conservative appetite; and
- an explanation of any other methods apart from capital used to mitigate the risks e.g. risk management or control structures.

Methodology and assumptions

A description of how assessments for each of the major risks have been approached and the main assumptions made. The description would make clear which risks are covered by which approach.

Where stress tests or scenario analyses have been used to validate, supplement, or probe the results, then this section would provide details.

Capital transferability

Details of any restrictions on the management ability to transfer capital into or out of the bank (for example, contractual, commercial, regulatory or statutory restrictions that apply).

ICAAP comparisons

An analysis of significant movements in available capital and capital required since the latest ICAAP and a comparison of the overall level and quality of capital required under Pillar 1 as compared with the overall capital requirement identified by the ICAAP.

Key Sensitivities and Future Scenarios

This section would detail the sensitivity tests undertaken to key assumptions and factors that have a significant impact on the broader financial condition of the company. Material changes in the financial risks to which the business is exposed would be explained and quantified as far as possible in this section. The analysis would include financial projections forward for, three or five years based on business plans and capital adequacy calculations. These would take account of expected capital requirements over economic and business cycles.

Typical scenarios would include:-

- how an economic downturn would affect the bank's capital resources, capital requirements and its future earnings taking into account the bank's business plan;
- how changes in the credit quality of the bank's credit risk counterparties affect the bank's capital and its credit risk capital requirement (note that this scenario stress test is a requirement for banks with an IRB permission);
- an assessment by the bank of how it would continue to meet its regulatory capital requirements throughout a recession;
- projections of cash inflows and outflows under stressed conditions.

Aggregation

This section would describe how the results of the various separate risk assessments are brought together and an overall view taken on capital adequacy. This requires some sort of methodology to be used to quantify the capital required to support individual risks so that they can be aggregated into a total figure.

As regards the overall assessment, this would describe how the bank has arrived at its overall assessment of the capital it needs taking into account such matters as:-

- the inherent uncertainty in any modelling approach;
- weaknesses in the bank's risk management procedures, systems or controls;
- the differences between regulatory capital and internal capital; and
- the differing purposes that capital serves: shareholder returns, rating objectives for the bank as a whole, avoidance of regulatory intervention (eg on large exposure notifications), customer perception, protection against uncertain events, working capital, capital held for strategic acquisitions etc.

Challenge and Adoption of the ICAAP

This section would describe the extent of challenge and testing of the ICAAP. It would include the testing and control processes applied to the ICAAP calculations, and the senior management or board review and sign off procedures. It would be helpful if a copy were attached of any relevant report to senior management or the board and their response.

Details of the reliance placed on any external suppliers/advisers/consultants would also be detailed here e.g. for generating economic scenarios or for assistance in preparation of the ICAAP. In addition, a copy of any report obtained from an external reviewer or internal audit would also be included.

Use of the ICAAP within the Bank

This would demonstrate the extent to which capital management is embedded within your bank including the extent and use of capital modelling or scenario analysis and stress testing within your bank's capital management policy, e.g. in setting pricing and charges. This would also include a statement of your actual operating philosophy on capital management and how this links to the ICAAP submitted. For instance differences in risk appetite used in the ICAAP as compared to that used for business decisions might be discussed.

Appendix 3

Addressing reputational risk under Pillar 2

Worked example of capital add-on / risk mitigant matrix. Capital add-on expressed as add-on to Pillar 1 capital requirement

% client base designated High Risk clients	Capital add-on	Mitigation required to reduce add-on to zero%
1% - 24%	+1%	Documented robust, fraud prevention, client take-on and KYC regime – positive desktop assessment by GFSC
25% - 49%	+2%	Robust, fraud prevention, client take-on and KYC regime – on-site reviewed and validated by GFSC within last 24 months
50% - 74%	+3%	Robust, fraud prevention, client take-on and KYC regime – on-site reviewed and validated by GFSC within last 12 months
75% - 100%	+4%	Robust, fraud prevention, client take-on and KYC regime – on-site reviewed and validated by GFSC within last 6 months

A client base with no high risk clients would not generate a capital add-on for reputational risk.