

# **BASEL II, PILLAR 2: A SOURCE OF COMPETITIVE ADVANTAGE**

TECHNICALNOTE

## **AUTHOR**

Greg Mizon

## **ABSTRACT**

As we approach the milestone of January 1, 2008, a date many regulatory agencies set for the introduction of the New Basel Capital Accord (Basel II), it is apparent that most of the effort has been applied to the Pillar 1 aspects of the Basel Accord. Many banks made significant financial and human resource investments in data capture systems, risk grading tools, portfolio assessment tools, and other necessary elements to meet regulatory expectations. In most cases, the road map for achieving an acceptable standard has been set by the regulator and therefore has been somewhat prescriptive.

We will gain far greater advantages in the next phase, Pillar 2, the Supervisory Review Process (SRP). In this paper, we limit the discussion in relation to credit risk, but we also address important parallels for both market and operational risk.

Copyright© 2007, Moody's KMV Company. All rights reserved. Credit Monitor, CreditEdge, CreditEdge Plus, CreditMark, DealAnalyzer, EDFCalc, Private Firm Model, Portfolio Preprocessor, GCorr, the Moody's KMV logo, Moody's KMV Financial Analyst, Moody's KMV LossCalc, Moody's KMV Portfolio Manager, Moody's KMV Risk Advisor, Moody's KMV RiskCalc, RiskAnalyst, RiskFrontier, Expected Default Frequency, and EDF are trademarks owned by of MIS Quality Management Corp. and used under license by Moody's KMV Company.

Published by:  
Moody's KMV Company

To contact Moody's KMV, visit us online at [www.moodyskmv.com](http://www.moodyskmv.com). You can also contact Moody's KMV through e-mail at [info@mkmv.com](mailto:info@mkmv.com), or call us by using the following phone numbers:

NORTH AND SOUTH AMERICA, NEW ZEALAND, AND AUSTRALIA:  
1 866 321 MKMV (6568) or 415 874 6000

EUROPE, THE MIDDLE EAST, AFRICA, AND INDIA:  
44 20 7280 8300

ASIA-PACIFIC:  
852 3551 3000

JAPAN:  
813 3218 1160

# TABLE OF CONTENTS

---

---

**1 INTRODUCTION ..... 5**

**2 EMBEDDING RISK MANAGEMENT AS A CORE COMPETENCY ..... 5**

**3 CHALLENGES OF PILLAR 2 ..... 5**

**4 PRINCIPLES OF PILLAR 2..... 5**

**5 ABOUT THE REGULATOR’S OBLIGATION ..... 7**

**6 DRIVING THE CULTURE AND IDENTIFYING THE PAYOFF ..... 7**



## 1 INTRODUCTION

As we approach the milestone of January 1, 2008, a date many regulatory agencies set for the introduction of the New Basel Capital Accord (Basel II), it is apparent that most of the effort has been applied to the Pillar 1 aspects of the Accord. Many banks made significant financial and human resource investments in data capture systems, risk grading tools, portfolio assessment tools, and other necessary elements to meet regulatory expectations. In most cases, the road map for achieving an acceptable standard has been set by the regulator and therefore has been somewhat prescriptive.

We will gain far greater advantages in the next phase, Pillar 2, the Supervisory Review Process (SRP). In this paper, we limit the discussion in relation to credit risk, but we also address important parallels for both market and operational risk.

## 2 EMBEDDING RISK MANAGEMENT AS A CORE COMPETENCY

One of the constant complaints from banks is the lack of clear direction from regulators as to what is required. Many regulators produced format guidelines for the Internal Capital Adequacy Assessment Process (ICAAP), most notably and comprehensively by Britain's Financial Services Authority (FSA). But this complaint from bankers demonstrates the real misunderstanding of Pillar 2; it is not about compliance—it is about instilling a risk awareness culture.

It is within Pillar 2 that regulators have the ability and the discretion to reward those institutions that truly embrace risk management as a core competency. This will be rewarded by a lower capital add-on compared to those institutions where the Basel Accord is approached as a compliance task, or where the investment in a risk management culture is insufficient. This lower capital level is a source of real competitive advantage when sourcing customers and risk assets.

## 3 CHALLENGES OF PILLAR 2

First, we need to acknowledge that within Pillar 2 the challenges in assessing regulatory and economic capital are significantly greater than the challenges under Pillar 1. For example, under the Pillar 1 advanced approach for calculating credit capital, no regard is taken of an institution's specific aggregate credit portfolio; rather a stylized risk capital model/curve is applied. This, in essence, ignores the idiosyncrasy of each portfolio, especially in the extremely important risk elements of concentration, correlation, and migration. Pillar 2 explicitly acknowledges this fact and forces institutions to better understand the impact of these risks, and the consequences for their capital requirements.

To do this, a bank needs to adopt an internal capital model (generally regarded as an economic capital model) that explicitly accounts for both concentration and correlation. An institution has two basic alternatives to address this issue: buy a recognized model, or develop its own. There are a number of models available commercially with varying approaches. Of course, at the heart of any model is the data that forms its foundation. It is highly unusual for any one institution to have sufficient depth and diversity of data for building a correlation model with appropriate veracity. But far more importantly from a Pillar 2 perspective is how the institution comprehends the model's limitations, applications, and uses of the outputs.

## 4 PRINCIPLES OF PILLAR 2

Pillar 2 comprises four key principles of supervisory review:

1. Banks should have a process for assessing their overall capital adequacy in relation to their risk profile. The Basel Accord sets out five main features of a rigorous process:
  - Board and senior management oversight
  - Sound capital assessment
  - Comprehensive assessment of risks
  - Monitoring and reporting
  - Internal control review

2. Supervisors should review and evaluate internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure compliance with regulatory capital ratios. Supervisors should take appropriate action if they are not satisfied with the result.
3. Supervisors should expect banks to operate above the minimum regulatory ratios, and should have the ability to require banks to hold capital in excess.
4. Supervisors should seek to intervene at an early stage to prevent capital from falling below minimum acceptable levels.

The last three principles are, in essence, consequences and reactions to the first principle, which seeks to address the highly relevant question of whether a bank instills risk management as a core competency. The process for this assessment follows the guidelines for the ICAAP.

## 4.1 Understanding the Keys to Principle 1

This section covers the first principle and its five main features of a “rigorous process.”

### Board and Senior Management Oversight

A bank’s senior management is responsible for understanding the nature and level of risk taken by the bank, and how these risks relate to adequate capital levels. The board is also responsible for the sophistication of the processes in light of the risks and business plan. The process should start with setting up the strategic business plan which should articulate the bank’s tolerance for risk, as well as identify the capital needs and the sources—actual and contingent—of required capital.

Often the board members are not risk experts, and under Pillar 2, they are faced with yet another view of capital. They are used to book capital, market capitalization, and since Basel I, regulatory capital. They now face a non-accounting or market measure—economic capital. This presents yet more challenges that only a dedicated educational effort by the bank’s senior executive management will overcome.

The background and experience of directors is an important element in a regulator’s assessment of capability. In addition, the formal processes, such as the risk committee agendas and conduct, and the manner in which risk appetite is communicated throughout the institution, should be reviewed.

### Sound Capital Assessment

Regulators expect that a bank has policies and procedures to identify, measure, and report all material risks. Additionally, a bank needs processes that relate capital to risk, tie strategic and business goals to capital, and finally deliver a demonstrable system of checks that ensure the integrity of the assessment.

### Comprehensive Assessment of Risks

All material risks should be assessed. However, when they cannot be assessed with precise accuracy, appropriate processes should be adopted to estimate the risk. This requires banks to assess individual counterparty and aggregate portfolio risks. Individual ratings should relate to a probability of default and ideally differentiate between counterparty and individual facilities. If there are varying structural issues that a risk manager deems relevant between facilities, then this should be expressed through a varying loss given default assumption.

Most importantly, the expectation is that a bank will be in a position to identify any weaknesses at the portfolio level, especially in regards to any concentration risk. In addition, the techniques used to manage concentration and other portfolio risks (both individually and collectively) need to be assessed.

### Monitoring and Reporting

A system needs to be established for monitoring and reporting portfolio risk, as well as for identifying how changes in risk profiles impact capital needs. Bank management, including the board, should expect regular reports on the state of

the risk profile and the capital needs. The aim is for management to be able to assess material risks, challenge the reasonableness of key assumptions in risk and capital assessment, ensure compliance, and assess future capital needs. This implies the adoption of risk planning in conjunction with other business planning. A growth in assets may well imply a growth in risk; indeed, even the regular renewal of existing lending lines often involves a change of risk profile for the bank. These expectations should be explicitly measured in the development of profit and strategic plans.

### **Internal Control Review**

With the emphasis on awareness and culture, the bank's internal control process is critical to the success of the Pillar 2 approach. This includes the independent review of both approaches to risk assessment, and the processes adopted under the Basel Accord, and should include involvement by both internal and external auditors. Again, the ultimate responsibility resides with the board to ensure that management establishes these process checks.

## **5 ABOUT THE REGULATOR'S OBLIGATION**

If the full benefits of the move to a Basel II environment are to be realized, it is also the responsibility of the regulator to avoid a prescriptive approach to Pillar 2, and to be fully prepared to differentiate between institutions when it comes to capital add-ons. Any concerns held by regulators (or even external commentators) about how this would be interfering with the commercial landscape (and therefore somehow inappropriate) need to be banished. At the heart of all regulation is the aim of financial stability and security. By overtly differentiating between proactively risk-managed banks versus others by way of lower capital add-ons, regulators give a strong and clear message. By adopting this approach, a regulator embraces the true meaning of the new Basel Accord and leverages it for maximum advantage.

## **6 DRIVING THE CULTURE AND IDENTIFYING THE PAYOFF**

To fully benefit from the investment made in adopting the Basel Accord, an institution must ensure that a risk management culture permeates the organization. The only way for this to happen is for the most senior management, including the board, to *live* risk management. Educational programs, organizational structures, budget and planning programs, as well as remuneration and bonus payments all need to be highly cognizant of the acceptance of risk management as a key attribute. Working on the principle "what interests my manager, fascinates me" will ignite the cultural change. Opting out is not an option, and must not be rewarded.

Where is the ultimate payoff? Across most developed equity markets the price/earnings ratio for banks is generally some 2–5 points less than the industrial average (e.g., if the industrial average is 18–20 times earning, then banking stocks are in the 13–18 range).

Put another way, why are expected future earnings for banks discounted at a higher rate? Banks continually disappoint investors by having greater volatility in earnings. The source of that volatility is primarily the failure of risk management processes whether they be credit (usually the largest), market, or operational. One only has to note the 2007 third-quarter round of bank reporting where credit-related losses—both direct and trading—have been extremely large and beyond investors expectations, to justify the higher discount rate.

If investment in risk management can, over time, result in lower losses and more consistent earnings, then a re-rating by the equity markets will follow. This will do more for shareholder wealth creation than any alternative quick fix. If the regulators meet their obligation, then a bank can easily link the investment required to inculcate risk management with a payoff of lower capital requirements. Being required to carry less capital per unit of risk because of the adoption of world-class risk management processes will be a strong source of competitive advantage.