

Pillar 2: what it really means

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Agenda

- **Pillar 2 overview**
 - ▶ SREP approach
 - ▶ ICAAP
 - ▶ Arrow and Pillar 2
 - ▶ Key new features
 - Stress Testing
 - Capital Planning
- **IRRBB**
- **Liquidity**
- **Implementation**
 - ▶ Timeline
- **Next Steps**



Pillar 2 Overview

Pillar 2 Overview

Firm assessment

Identify and assess material risks

Identify mitigating controls

Identify amount of capital in relation to business plan, strategies, and profile

Produce capital number and assessment

Supervisory assessment

Review and evaluate all risk and control factors

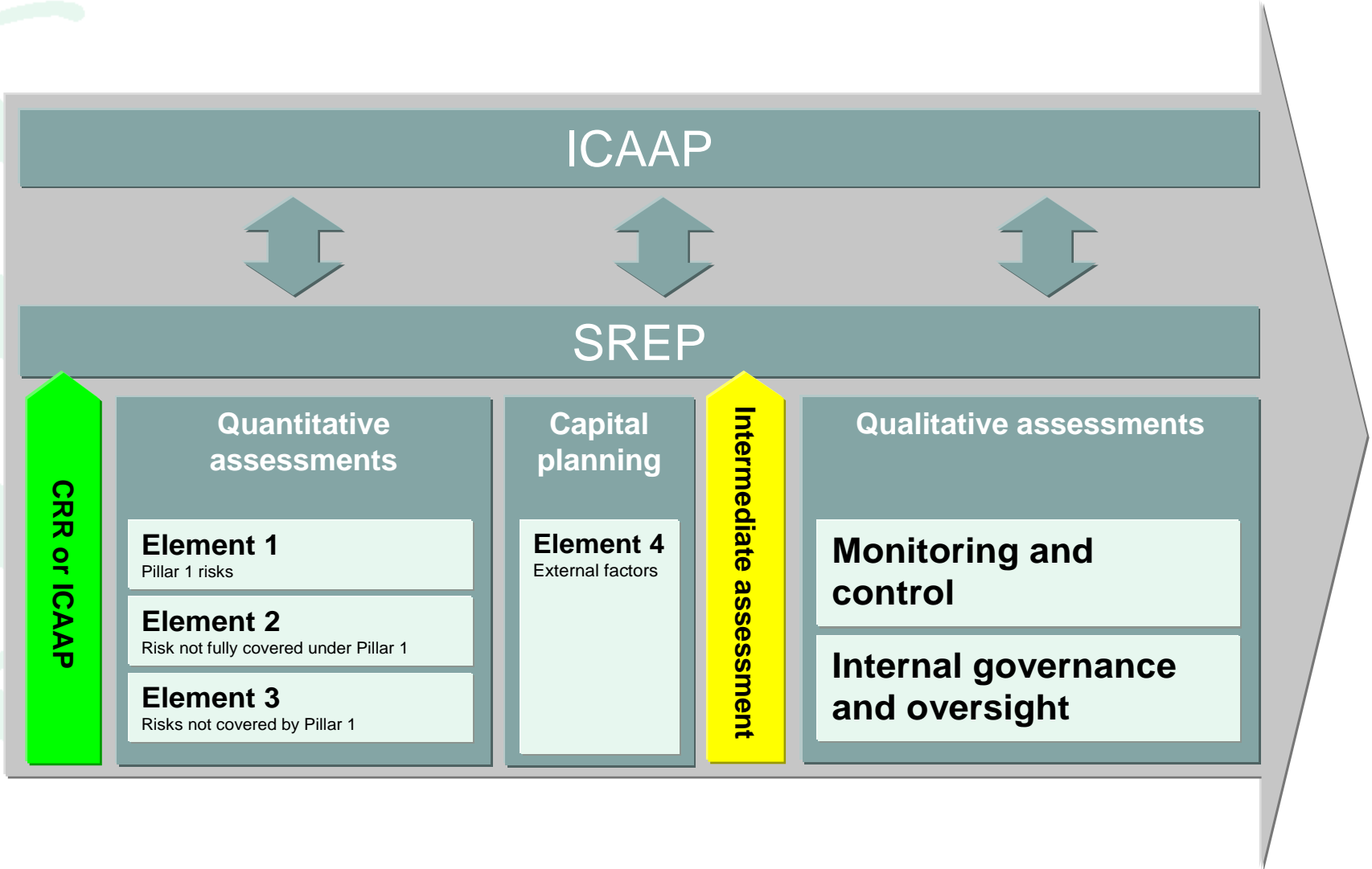
Review and assess the firm's risk assessment

Supervisory conclusion

Dialogue and challenge

Key ICAAP Features

- No automated reporting requirement
- No required format
 - ▶ Although there is a template which might be helpful
 - ▶ Possible structure and suggested content
- Key features to document and explain:
 - ▶ The firm's risk appetite
 - ▶ The key risks and how they are managed
 - ▶ Key drivers and sensitivities
 - ▶ The firm's current and potential capital needs
 - ▶ Pillar 1 compared to Pillar 2
 - ▶ The stress tests undertaken, management actions foreseen, and possible outcomes



Pillar 2 and ARROW



Interim Risk Manager - Version 1.0.11_DEV - Development (AISD) - [Assessment]

File Edit View Insert Format Records Tools Window Help

Finch Hawkins This is the Current Assessment Impact: MH 139 Probability: MH- Save Show sub-sector

Primary sub-sector: Retail banking & mortgage lending Assessment Status: Open for Editing

Search Basics Aggregation Issues **Pillar 2** Impac Groups Log Peer Groups Actions Advanced Migrate Help

Show Elements Show Core Areas

Environmental	Business Model	Controls	Oversight and Governance	Other Mitigants	Net Probability
Environmental Risks	Customers Products Markets Suggestion ML+ Supervisor ML	Customer, Product and Market Controls Suggestion MH Supervisor ML	Control Functions	Management Governance and Culture	Customer Treatment and Market Conduct MH-
	Business Process Suggestion ML Supervisor ML	Financial and Operating Controls Suggestion MH- Supervisor L			Operating ML
	Prudential Suggestion ML+ Supervisor MH	Prudential Risk Controls Suggestion ML+ Supervisor ML			Financial Soundness MH
	Business Risks ML+	Controls ML-			Total Probability MH-

Risk Group	Risk Elements	Sub-sector	Issues	Supervisor	Suggestion	Risk Group Narrative
Management, Governance and Culture	Culture & Management		MH+		MH+	Although the management team is experienced and knowledgeable, FSA supervision has concerns about Finch Hawkins corporate governance. The NED contingent includes Jeremiah Finch, who is related to the bank's previous owners and is a long-term employee, and Jacques Bouffe-Beaucoup who also has little experience outside FH. JBB is also chair of the reward committee. In a separate incident, the strategy
	Corporate Governance		MH+			
	Relationship with Regulators					
	Strategic Planning		MH+			
	Relationship with Rest of Group					
	Quality of ICAAP					

Assessment ID: 10886 Assessment No: 1 Not Close & Continuous Not part of GSA Subject to CRD Supervisor/Owner: Alan Adkins

Current User: Alan Adkins Permission: Administrator Database: Development (AISD) Oracle Status: OK

Form View FLTR

Capital Planning and Stress Testing



Objective:

- That the firm can meet its capital requirements at all times through out a reasonably severe economic recession.

Why capital planning?

- Elements 1 to 3 are static
- Assure the firm will have sufficient capital tomorrow

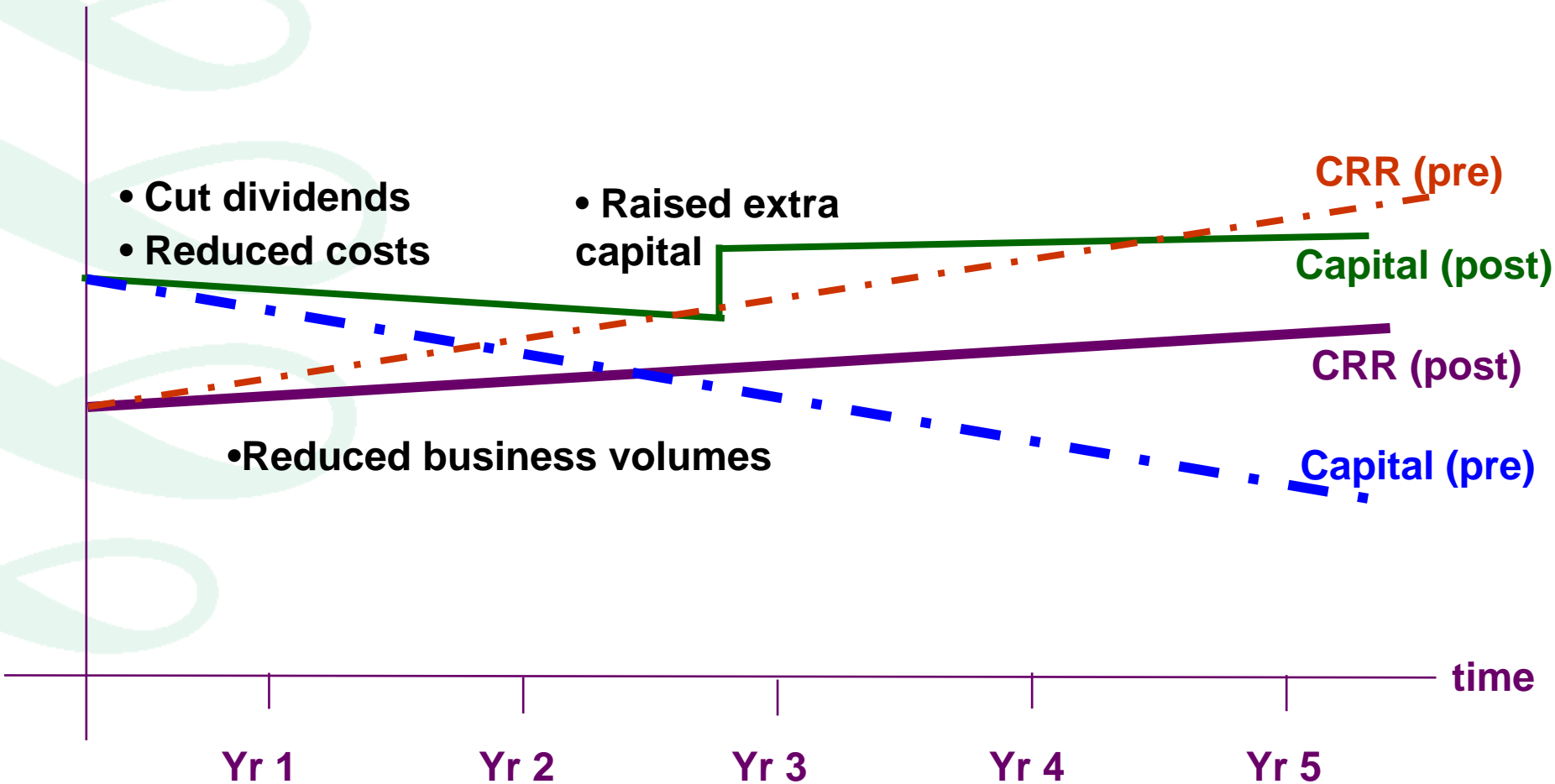
Two aspects:

- Capital planning, and
- Stress testing

Capital Planning and Stress Testing



£ Illustration: pre/post management actions



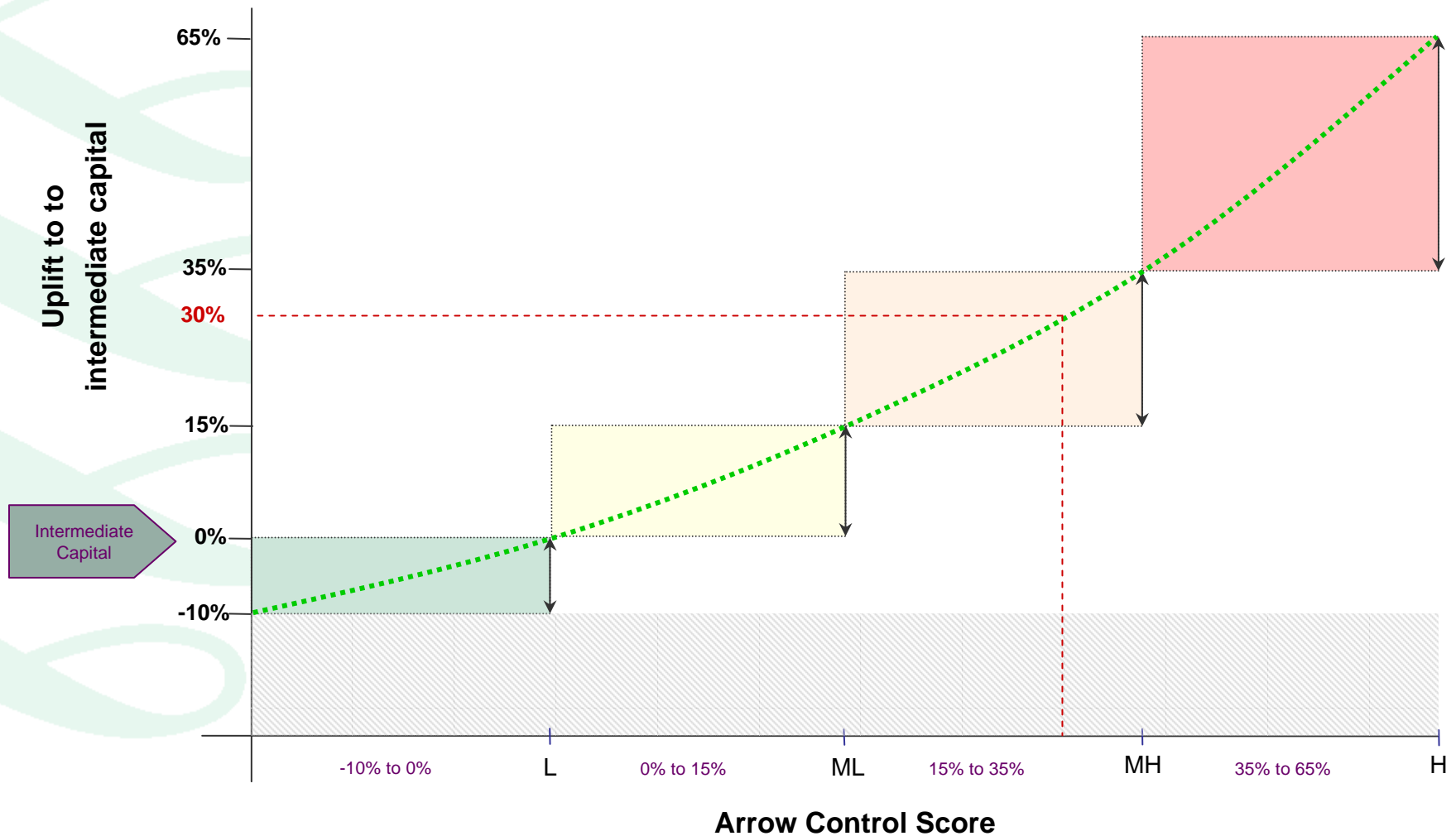
Cyclicality Credit Stress Test

- A subset of Pillar 2 capital planning and stress tests
 - ▶ Scope is narrower than Pillar 2
 - ▶ Static balance sheet
- Same degree of severity (1:25)
- The gross test must be assessed under Pillar 1
- The benefit of management actions and capital impact is considered under Pillar 2

Adjustment for corporate governance and oversight

- Starting point
 - ▶ ARROW 'management, governance and culture' score
- Adjust for
 - ▶ Other qualitative issues relating to the ICAAP not reflected in the ARROW score
 - ▶ Comparison with peers
- Factor can be positive or negative

Scalar adjustment





Pillar 2

Interest rate in the Banking Book (IRRBB)

Rules – a selection (paraphrased)

- **GENPRU 1.2.30R**
 - ▶ Firm must have in place sound, efficient and complete processes, strategies and systems to identify and manage interest rate risk
- **GENPRU 1.2.42**
 - ▶ A firm must carry out stress tests and scenario analyses appropriate to its business based on realistic adverse circumstances, and estimate the financial resources needed
- **BIPRU 2.3.2 G**
 - ▶ IRRBB will normally be a major source of risk for a bank, building society (and investment firm with non-trading book >15% of total).
- **BIPRU 2.3.3G**
 - ▶ Interest rate risk can arise from:
 - Mismatch of repricing periods (yield curve risk)
 - Inaccurate hedging where the hedge reprices on a different basis to the exposure (basis risk)
 - Uncertainties in the timing or occurrence of future transactions (model risk)
 - Early redemption of fixed rate products (embedded optionality risk)
- **BIPRU 2.3.7R & 2.3.12**
 - ▶ Requirement to stress test exposure to interest risk generally (annually) and to a 200bp parallel yield curve shift (at least 1/4ly)

Regulatory approach

- **IRRBB will be one of the top three Pillar 2 risks on which supervisors will focus when reviewing an ICAAP.**
- **The CRD's approach to assessment of risk is based principally on changes to economic value arising from a change in interest rates**
 - ▶ Key test is whether a 200bp parallel yield curve shift in either direction reduces economic value by >20% of capital resources
- **The FSA recognises that firms will normally measure their risks both from an earnings and an economic value perspective**
 - ▶ Relative importance of these measures will vary from firm to firm
 - ▶ Accept that measures to hedge earnings may increase economic value at risk on gone concern basis

Stress testing

- **Sudden 200 bp parallel shift in both directions is at best a crude measure**
- **FSA expects firms to apply stresses more relevant to the composition of their Non-Trading Book**
 - ▶ Effect of earnings hedges may be neutralised in assessing economic value at risk
 - ▶ Allowance may be made for behavioural expectations
- **Need to document key assumptions**
 - ▶ FSA will particularly wish to understand basis for behavioural adjustments

- **IRRBB approach is as for other Pillar 2 risks:**
 - ▶ Firms with relatively non-complex business profiles can apply less sophisticated approaches to capturing and measuring their risks
 - ▶ Larger and/or more complex firms may be expected to adopt more advanced modelling techniques, e.g.
 - Dynamic rather than static balance sheet modelling
 - Simulation modelling to capture non-linear/option risks
 - Behavioural models to determine hedging strategies

Non-prescription

- **FSA has not sought to prescribe how IRRBB should be measured, nor how capital should be attributed.**
 - ▶ Such prescription would in our view be contrary to the principles underlying Pillar 2
 - ▶ A recent thematic review undertaken by the Risk Review Department identified a range of approaches/market practices in this area
 - ▶ However, the objective is still that risk should be measured & mitigated
- **Some overseas regulators are taking a different approach: e.g. APRA**
 - ▶ Has chosen to include IRRBB within Pillar 1
 - ▶ IRRBB models need to meet general and specific requirements before approval is given for their use
 - ▶ Calibration is to 99% over a one year holding period

Regulatory Reporting

- **New interest rate gap return from 1/1/09 (FSA017)**
 - ▶ Similar to existing building society return
 - ▶ Allows for behavioural adjustments
 - ▶ Optional reporting of firm's own model outputs
- **Waiver from completing the return will be available**
 - ▶ FSA agreement will depend upon some assessment of firm's own model
 - ▶ MI to be submitted instead
 - ▶ More detail on application process will be available in Q2 2007
- **Return will inform FSA of firms' IRRBB profile**
 - ▶ But no direct link between 200bp stress number and ICG number

IRRBB Summary

- **IRRBB will be a key risk for banks and building societies.**
 - ▶ IRRBB should accordingly be given due weight in your ICAAPs.
- **In our SREP/ICAAP dialogue, we will be looking to understand:**
 - ▶ the methodology and key assumptions used to calculate IRRBB
 - ▶ the impact on economic value (and earnings, where relevant) of stress scenarios
 - ▶ the effect, where relevant, of applying different confidence intervals and holding periods; and
 - ▶ the impact of allowing for future management actions
 - ▶ how any Pillar 2 capital attribution has been assessed



Liquidity

- **The BIPRU requirement that firms should maintain adequate financial resources embraces both capital and liquidity.**
- **The introduction of the Pillar 2 framework has served as a reminder of this, if one were needed! But distinction between P1 and P2 is not relevant in the liquidity context.**
- **We will expect to see liquidity risk:**
 - ▶ in 'business as usual' supervision, i.e. Arrow;
 - ▶ covered in ICAAP submission; and
 - ▶ considered as part of the Pillar 2 review.
- **No immediate changes in our approach to liquidity supervision are envisaged, though we do want to ensure that the current arrangements are effectively applied and observed.**

- ***North sea fish stocks threatened by over-trawling!***
- **At last year's conference, Paul Sharma mentioned various international initiatives looking at liquidity, and importance of getting sequencing right:**
 - ▶ The Joint Forum – reported in 2006;
 - ▶ The Basel Committee, and revised Core Principles;
 - ▶ The European Central Bank.
- **Latterly, the Commission has announced it will issue a call for advice to CEBS on the assessment of current arrangements on liquidity risk issues.**

A sitrep:

- **The Basel committee has established a Working Group, co-chaired by the Bank of England and BaFin:**
 - ▶ met yesterday for the first time, and the meeting continues today, including a session with the IF;
 - ▶ mandated to undertake an ‘intelligent’ stock-take of liquidity regulation, including an analysis of reasons for diversity, the pros and cons of diversity, and an assessment of options for future work; and
 - ▶ final report to the BCBS is due in Dec 07.

- **CEBS has established its own working group to respond to an expected call for advice from the Commission:**
 - ▶ it will await the Commission's call for advice;
 - ▶ the Commission in turn will not formulate its CFA until the Basel Working Group has reported on its first meeting; and
 - ▶ whatever the CFA the CEBS working group will closely coordinate its activities with the Basel Working Group, including joint stock-takes.
- **National objectives**
 - ▶ Germany has just introduced a distinction between internal modelling and standardised approaches.
 - ▶ France considers its current supervisory approach is overdue for overhaul.
 - ▶ UK keeping open mind, but sees the need to improve on the current approach, if possible.



Implementation and Next steps

Implementation



ICAAP required for firms on Basel 2 credit risk approaches

ICAAP required for other firms (except certain commodities firms)

2006

Pilot process

2007

Early firms

Voluntary

Adopt new CR rules

Mandatory

2008

Other firms

Current (ICR) rules expire

Update on Progress



- **IT support for SREP process**
 - ▶ Record details,
 - ▶ Map progress,
 - ▶ Retain Work Product
- **SREP Training completed for 180+ staff**
- **SREP Internal Guidance completed**
 - ▶ Pillar 2 approach and process
 - ▶ Risk Cards and Policy Cards
- **Pilot Reviews**

Next Steps

- **Planning underway for all firms**

- ▶ Contact
- ▶ Request ICAAP
- ▶ Dialogue
- ▶ Review
- ▶ Panel
- ▶ Communicate ICG

- **Pillar 2 benchmarking project**

- ▶ Objectives:
 - ▶ Inventory differences between Pillar 1 and EC models
 - ▶ Measures of Concentration Risk / Diversification

Major challenges

- Pillar 1 and Pillar 2 relationship – pro tem, we are in a Pillar 1+ world.
- The ICAAP informs the “plus” but it does not at present determine the outcome of the regulatory capital requirement under Pillar 2.
- Some scope for allowing ICAAP “unders” and “overs” to be offset, though the burden of proof for any offsets between P1 and P2 will be high.
- In due course, we want to place more reliance on the results of economic capital modelling. But to do so we need to develop an agreed set of principles/standards against which to assess their robustness.
- In the meantime, we are undertaking urgent benchmarking work to provide a range of tools (e.g. KMV portfolio manager) to:
 - ▶ quantify potential adjustments to Pillar 1 (IRRBB, Concentration);
 - ▶ produce inventory of differences between Pillar 1 and EC models; and
 - ▶ benchmark ICAAPs between peers.