



# IMPLEMENTATION OF PILLAR 2 OF BASEL II – THE NEXT CHALLENGE TO THE BANKS AND SUPERVISORS

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## **1. Introduction**

The Basel Committee on Banking Supervision (BCBS) (“Basel Committee”), the international standard-setter in the field of banking supervision issued a revised framework on capital standards for banks in June 2004 titled “International Convergence of Capital Measurement and Capital Standards – a Revised Framework”. Popularly known as Basel II, the revised framework is intended to replace the existing capital framework for banks (now known as Basel I), which revealed several drawbacks. The new framework is a landmark regulatory framework offering a newer and comprehensive approach and methodology for financial sector regulatory capital calculation, which recognises the advancements and innovations in banks’ businesses, policies and structures and the accompanying financial engineering and innovations. Due to the comprehensiveness and complexity of Basel II, it has taken several years of consultation and quantitative impact studies before finalization.

Under Pillar 1 of Basel II, the computation of the capital ratio has been substantially revised, but what is of greater significance, perhaps is the introduction of two new dimensions in the form of Pillar 2 and Pillar 3. The three pillars complement each other and are mutually reinforcing.

Since the publication of Basel II, banks and regulators over the world have been pre-occupied with various aspects relating to Basel II. Whilst issues such as when to adopt Basel II, which approach/method to use for capital allocation under Pillar 1 have been mostly sorted out, an area that is still under discussion is the application of Pillar 2 of Basel II, the supervisory review process. Being an integral part of Basel II, Pillar 2 poses challenges to the banking industry and the regulators. This article attempts to review the requirements under Pillar 2 of Basel II, and how best the banks and regulators could face the challenges posed under Pillar 2.

## **2. The Basel Capital Adequacy Framework**

Capital is a key component of any prudential supervisory regime to measure the soundness of banks. Banks need to hold capital as a buffer against risk. Capital provides a cushion to absorb losses and acts as a buffer against risk, thus ensuring the safety and soundness of a bank. It also



provides a foundation for future growth and is used as a benchmark against which the financial condition of banks can be measured. However, maintaining an optimum level of capital against a prudent level of risk – return is the challenge for the banks.

The 1988 Basel Capital Accord (Basel I), was a milestone in the risk-based approach to regulation and provided a yardstick for the comparison of banking institutions across the world. Though largely accepted and adopted by more than 100 countries, the simple, “broad brush approach” of Basel I made it ineffective in capturing the actual risk of banks and created opportunities for regulatory arbitrage. Its very simplicity rendered Basel I obsolete since it did not factor in the vast strides made by the internationally active banks in the area of risk management. Basel II is the response of the BCBS with regard to lengthy consultation in this regard.

### **3. Brief Overview of Basel II**

As it is commonly known, Basel II comprises of three mutually reinforcing pillars, namely Pillar 1: minimum capital requirements, Pillar 2: supervisory review process and market discipline as Pillar 3.

#### *Pillar 1 – Minimum Capital Requirement:*

Pillar 1 relates to the computation of the capital ratio and is the direct replacement of the existing Capital Accord, Basel I. The capital ratio includes an explicit capital charge for credit, market and operational risk. A menu of approaches is available for the computation of the capital charge for each risk.

#### *Pillar 2 – Supervisory Review Process:*

Under the second pillar, banks should have their own internal capital assessment processes to capture risks that remained uncovered under the first pillar and thus maintain capital in line with the bank’s risk profile and risk management environment. The supervisors are expected to validate the internal capital adequacy assessment process of the banks to ensure that banks have captured all the risks in their business. Where the supervisor assesses that the bank’s capital assessment process does not capture all its risks, the supervisor is expected to intervene and recommend early corrective action.

Pillar 2 is also expected to encourage banks to develop and use better risk management techniques including the setting up of a separate risk management function in banks for the prudent management of all material risks.

#### *Pillar 3 – Market Discipline:*

The third pillar seeks to enhance disclosure and transparency by strengthening banks’ financial



reporting system and by encouraging market discipline and allowing the key stakeholders to assess key pieces of information on the scope of application, risk exposures, risk assessment processes and capital adequacy of the institution. Pillar 3 complements and reinforces the first two pillars and infuses market pressures to bring in better risk management techniques and to maintain adequate levels of capital in the banks and enables them to take prudent and more informed decisions in banking.

Blended together, Basel II is not only a risk-based capital framework, but also an entire risk-based supervisory framework, which allows banks to operate in a more prudent manner, leading to the stability of the financial system.

#### **4. The Second Pillar of Basel II**

Under Basel II, a bank's *total* capital requirements are ultimately subject not just to Pillar 1, but also to regulatory review under Pillar 2. Risks that are not easily quantifiable under Pillar 1 are addressed in Pillar 2, which seeks to promulgate a comprehensive set of good banking and risk management standards. Further, the effective implementation of Pillar 1 requires the support of Pillar 2. Therefore, greater focus and priority should be placed on Pillar 2 with regard to Basel II implementation.

##### **4.1 The Rationale for Pillar 2**

The starting point and the emphasis of Pillar 2 is the bank's internal capital adequacy assessment. Pillar 2 is intended to;

- a. Encourage banks to utilize better risk management techniques – the level of risks a bank is exposed to, and the control environment will determine the level of capital required to be maintained by banks
- b. Encourage supervisors to enhance risk-based supervision – in order to assess the capital adequacy relative to risks, the supervisor has to enhance the risk-based supervision of banks. Given the nature of supervision adopted by most regulators, which has become increasingly risk-centric, the Pillar 2 process will be an extension and a refinement of the existing supervisory process, rather than a radical change.
- c. Focus on internal, not regulatory capital – the supervisor will be evaluating the bank's internal capital adequacy assessment process (ICAAP) that determines the level of capital to be maintained. Thus, all banks are expected to have such an assessment process or ICAAP in place.
- d. Ensure that banks have adequate capital to support *all* risks – the bank's internal capital assessment should take into account all the risks facing the banks including those risks not captured under Pillar1 and where the capital is not adequate, supervisor is expected



to intervene early to restore capital to the required level. This will foster an active dialogue between the banks and the supervisors regarding the assessment of capital adequacy and risk management standards.

- e. Accommodate differences between banks – the level of risks inherent in the bank’s operations will determine the level of capital required to be maintained, which will depend on the bank’s risk management systems. Thus, the better the risk management systems, the lower the required level of capital.

In describing the second pillar, the Basel Committee proposal states that: “the supervisory review process should not be viewed as a discretionary pillar but, rather, as a critical complement to both the minimum regulatory capital requirement and market discipline.” However, other than to prescribe the broad principles for the application of Pillar 2, Basel II does not contain a prescriptive approach to be followed. Thus, it is up to each regulator and the industry to determine, how the requirements under Pillar 2 will be applied.

In order to achieve the objectives under Pillar 2, the Basel Committee has laid down four key principles:

- **Principle 1:** Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels (i.e. an internal capital adequacy assessment process or ICAAP).
- **Principle 2:** Supervisors should review and evaluate banks’ internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the results of this process.
- **Principle 3:** Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
- **Principle 4:** Supervisors should intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Accordingly, going forward, the supervisor has a key role to play in validating and reviewing internal capital adequacy assessments of banks whilst intervening at early stages to prevent the deterioration of prudent capital requirements.

#### **4.2 Principle 1: Banks’ Own Assessment of Risk and Capital Adequacy**

Since Pillar 2 focuses on the bank’s internal capital assessment process, the primary



responsibility for ensuring that the bank has adequate capital to support all its risks rests with the individual banks. In contrast to Pillar 1, which stipulates how the capital ratio has to be calculated, Pillar 2 focuses on banks' internal process for such an estimation of capital. Accordingly, the level and sophistication of the ICAAP should be tailored to the bank's activities and the risks involved in these activities. The Basel Committee has not recommended a "best practice" with regard to the design and implementation of such a process and is therefore not a "one size fits all" approach. However, some key features that should be included in every bank's capital assessment process have been specified. They are:

- i. Board and Senior Management oversight** – the primary responsibility for establishing a sound capital assessment process lies with the Board and the Senior Management of the bank. They should design policies and procedures to ensure that the bank identifies, measures, monitors and controls all material risks the bank is exposed to. The policies and procedures in this regard should be formerly established through appropriate documentation. It is important that this should be integrated into the management process and decision-making.
- ii. Sound capital assessment** - The ICAAP should also be a systematic and disciplined process that relates capital to the level of risk undertaken by the bank and states capital adequacy goals vis-à-vis risk, considering the bank's strategic focus and business plan. It should also take into account the bank's risk tolerance limits, which should be set by the Board. The ICAAP should be a comprehensive assessment of risks – all material risks faced by the bank should be addressed in the ICAAP. While it may not be possible to measure all risks accurately, a process should be developed to estimate risks.
- iii. Monitoring and reporting** - The ICAAP should be reviewed regularly to take into account the changes in the risk profile and how it affects the capital requirements.
- iv. Internal control review** – As part of the internal control process, the ICAAP should be reviewed and audited by internal and/or external auditors to ensure the integrity of the overall risk management process.

#### **4.3 Principle 2: Supervisory Review Process**

The review process by the supervisors would include review and evaluation of the adequacy and reliability of a bank's ICAAP, risk exposure, capital levels and the quality of capital held. The review process emphasizes on bank's risk management and encourages interaction between banks and supervisor to understand the bank's risk management and controls. The outcome of the supervisory review process should not be confined to a capital figure, since capital cannot replace, but only complement good risk management. The review process could involve a combination of the following:



- On-site examinations
- Off-site surveillance
- Discussions with bank management
- Periodic reporting
- Review of work of internal and external auditors

In addition to these traditional methods, both banks and regulators could use forward-looking stress tests to identify possible events or changes in the market conditions that could adversely impact the capital adequacy.

#### **4.4 Principle 3: Capital Above Regulatory Minimum Ratios**

Supervisors will typically expect banks to operate above the regulatory minimum level of capital in order to provide a buffer to meet other risks and uncertainties since it may be costly to raise capital when market conditions are unfavourable and to meet fluctuations in the capital ratio occurring in the normal course of business. This buffer is expected to meet uncertainties that affect the banking industry as a whole. Bank-specific uncertainties are to be treated under Pillar 2, which reinforces Pillar 1 by taking into account the risks that are not captured under Pillar 1. However, this process is not intended to lead to automatic capital add-ons, although this could be one of the outcomes of the supervisory review process.

In order to assess that the individual banks are operating with adequate levels of capital, the Basel Committee recommends, among other methods, that supervisors may set “trigger” and “target” ratios or define categories above minimum ratios (e.g.: well capitalised and adequately capitalised banks) for identifying the level of capitalisation of a bank. Higher capital ratios may be required for outliers.

#### **4.5 Principle 4: Supervisory Intervention**

Here, the objective is to identify, as early as possible, *the potential* for serious erosion of the bank’s capital position in order to limit risk to depositors and the financial system. This principle involves the use of early warning systems such as trigger ratios as well as preventive and remedial actions. Intervening actions by the supervisor may include a range of options:

- Moral suasion to encourage banks to improve their capital positions
- Intensifying monitoring of the bank
- Improving the bank’s ICAAP, risk management, systems and controls
- Requiring the bank to submit a capital restoration plan
- Restrictions on the payment of dividends
- Placing restrictions on bank activities, acquisitions, investments etc.
- Requiring the replacement of senior management and/or the Board of Directors



## 5. Scope of Pillar 2 Risks

Risks not covered under Pillar 1 are to be catered for under Pillar 2 (figure 1). Three risks, in particular, need to be captured under this pillar, i.e.:

- risks which were not fully captured under Pillar 1 (e.g.: credit concentration risk)
- factors not taken into account by Pillar 1 (e.g.: interest rate risk in the banking book, business and strategic risk); and
- factors external to the bank (e.g.: business cycle effects).

**Figure 1**  
**Banking Risks Addressed under Pillar 1 and Pillar 2**

Banking Risks	Pillar 1 Risks	Pillar 2 Risks
Credit risk	<ul style="list-style-type: none"> <li>• Counterparty default risk</li> <li>• Transaction risk (e.g.: through recognition of CRM)</li> </ul>	<ul style="list-style-type: none"> <li>• Credit concentration risk</li> <li>• Portfolio risk (aggressive expansion/deterioration in asset quality etc)</li> <li>• Residual risk (from use of CRM/securitisation etc.)</li> </ul>
Market risk	Trading risk arising from adverse movements in interest rates, FX security and commodity prices	Residual risk (e.g.: vulnerability under stress and scenario tests)
Interest rate risk	Interest rate risk in the trading book	Interest rate risk in the banking book
Liquidity risk		<ul style="list-style-type: none"> <li>• Funding (cash) liquidity risk</li> <li>• Asset (market) liquidity risk</li> </ul>
Operational risk (including legal risk)	Risk of loss resulting from inadequate or failed internal processes, people and systems/from external events	Residual operational risk (e.g.: risk of loss resulting from low-frequency, high impact events)
Strategic risk		Risk due to: <ul style="list-style-type: none"> <li>• bad/imprudent or improperly implemented business decisions or strategies</li> <li>• lack of response to external changes (industry, economic or IT)</li> </ul>
Reputation risk		Risk due to contagion, negative publicity or susceptibility to market rumours



## **6. The Internal Capital Adequacy Assessment Process (ICAAP) in Banks**

The ICAAP is a comprehensive process that a bank should put in place for identifying and measuring the risks in its business and for assessing how much capital is needed to support such risks. The fundamental elements of a sound ICAAP are discussed in subsection 4.1

The ICAAP should capture all material risks of the bank. While Basel II does not detail the composition of a ICAAP, each bank is expected to establish the ICAAP to fit its own circumstances and needs, based on the risk profile and level of sophistication of its operations. The ICAAP should be a risk-based process and should form an integral part of the management process and decision making culture of a bank. It should be subject to sensitivity analysis and stress testing with regard to the key assumptions on which the ICAAP is based. Stress testing is discussed in detail under section 8.

## **7. Specific Risks to be Addressed Under Pillar 2**

### **7.1 Credit Concentration Risk**

A risk concentration is any single exposure or group of exposures with the potential to produce losses large enough (relative to a bank's capital, total assets or overall risk level) to threaten a bank's health or ability to maintain and sustain its core operations due to an erosion of capital and customer confidence. Risk concentrations are arguably the single most important cause of major problems in banks. Such concentrations are not addressed in Pillar 1.

Credit Risk concentrations include:

- Large exposures
- Credit exposures to parties connected to the bank
- Credit exposures to counterparties in the same economic sector or geographic region
- Credit exposures to counterparties whose financial performance is dependent on the same activity ('group' borrowers)
- Indirect credit exposures arising from a bank's credit risk mitigation activities (e.g.: exposure to a single collateral type)

Banks should have internal systems/policies and controls to identify, measure, monitor and control concentrations, including stress tests in its ICAAP.

### **7.2 Interest Rate Risk in the Banking Book**

While interest rate risk in the trading book is covered under market risk in Pillar 1, interest rate risk in the banking book is a risk explicitly covered under Pillar 2. Interest rate risk is the



exposure of a bank's financial condition to adverse movements in interest rates. Although interest rate risk is part of the business of banking, excessive interest rate risk can pose a significant threat to the bank's earnings and capital. To facilitate supervisors' monitoring of interest rate risk exposure, banks will have to provide the results of their internal measurement systems, expressed in terms of a standardized interest rate shock. If supervisors determine that a bank is not holding capital commensurate with the level of interest rate risk, they should require the bank to reduce its risk, to hold a specific additional amount of capital, or a combination of the two remedies.

In an environment where banks are faced with deposit raising challenges, some having shifted to money market borrowing to fund their asset base, the interest rate risk exposure of the banks has become significant. Another aspect of interest rate risk is the maturity mismatch that the banks are typically exposed to in their deposit and lending portfolios. Whilst current accounts are considered on-demand deposits, savings and fixed deposits have certain accepted maturity terms. On the other hand, most of the asset book of a commercial bank is typically short term (less than one year, mostly maturing in less than 3 months). Managing these maturity mismatches in a volatile environment with low long-term rate curves as compared to high short-term interest curve is another challenge. Some banks have moved to behavioralising<sup>1</sup> of their loan and deposit portfolio to better manage this risk.

### 7.3 Operational Risk

Gross income, used in the Basic Indicator and Standardised Approaches for operational risk, is only a proxy for the scale of operational risk exposure of a bank and can, in some cases (e.g.: for banks with low profitability) underestimate the need for capital for operational risk. Supervisors are expected to consider whether the capital requirement generated by the Pillar 1 calculation gives a consistent picture of a bank's operational risk based on the guidelines issued by the Basel Committee<sup>2</sup>.

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- 1 Certain assets and liabilities behave in a different way from that which their contractual maturity would suggest. These products require behaviouralisation to ensure that the risk inherent in the product is correctly recorded. Behaviouralisation may be defined as the method for measuring interest rate risk for products where this risk is different from that indicated by the product's maturity or re-pricing. The proper capture of the interest rate risk run should enable it to be managed more efficiently.
  - 2 Sound Practices for the Management and Supervision of Operational Risk, BCBS, February 2003



## 8. Stress-testing under the Supervisory Review Process

Stress testing plays a key role in the assessment of capital adequacy under Pillar 2. Stress testing is a generic term for the various techniques (quantitative and/or qualitative) used by banks to gauge their vulnerability to exceptional but plausible events. As defined by the Bank for International Settlements (BIS)<sup>3</sup>, stress testing is a risk management technique used to evaluate the potential effects on an institution's financial condition of a specific event and/or movement in a set of financial variables. The level of complexity of stress testing is expected to vary with the size and level of sophistication of institutions. It is important for institutions to embed stress testing into their risk management framework. In that respect, stress testing should form part of the bank's risk management and the assessment of capital adequacy.

### 8.1 Types of Stress Testing

There are a number of categorisations and concepts currently used by the market or the supervisors. In the context of the ICAAP, stress testing could generally fall within the two following categories: scenario tests and sensitivity analyses.

Sensitivity analyses are generally less complex to carry out since they assess the impact on an institution's financial condition of a move in one particular risk driver, the source of the shock not being identified, whereas scenario tests tend to consider the impact of simultaneous moves in a number of risk drivers, the stress event being well defined. For instance, a typical sensitivity analysis would be to assess the impact on an institution's profitability, should interest rates fall sharply in one day. In contrast, a scenario test would consider the impact of, for instance, a 'Black Monday' like event on an institution's profit and loss account. Such a scenario takes into account a combination of changes in different risk drivers being affected by the stress event chosen by the institution.

### 8.2 Uses of Stress Testing

In practice, stress testing is a valuable risk management technique whose potential applications are quite varied within each individual institution. In the context of internal capital assessment under Pillar 2, institutions should consider stress testing for the following purposes:

- As a diagnostic tool to improve the understanding of the institution's risk profile.
- As a forward looking tool within the ICAAP:
- Earnings are a part of an institution's overall capital planning and are the first line of defense to absorb losses. Therefore, institutions should consider, in the context of their ICAAP, assessing how their earnings are affected by stress situations.

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3 Committee of the global financial system, January 2005: Stress testing by large financial institutions: survey results and practice



- Stress testing may be used to assess the adequacy of internal capital. For example, this can be relevant for smaller institutions that may want to tackle their ICAAP through a series of very simple relevant stress tests to inform their view of the adequacy of their internal capital,
- For institutions using internal capital models, stress testing could be used to supplement statistical methodologies (such as VaR). Stress testing helps form an alternative view where paucity of historical data limits the predictive power of such models.
- Institutions should use stress testing as one tool to assess the risks in a forward-looking manner. It will then be possible for institutions to compare the outcome of those stress tests against their business plan and take the necessary measures in the light of these results.

Some examples of scenarios for stress testing are:

- How an economic downturn would affect the bank's capital and earnings
- The effect of a global recession, occurring once in a 25 year period
- Country failure where the bank has a major presence or exposure
- How changes in the credit quality of a major counterparty would affect the capital and earnings
- The impact of a liquidity crisis on profits
- The effect of a health hazard such as Pandemic Avian influenza, bird flu
- A financial crisis in the region (eg: Asian financial crisis)
- Crisis in a particular industry (e.g.: garment industry, tourism sector etc.)

Stress testing enables a bank to build up a medium/long term capital plan, including mitigating actions approved by the bank's Board and senior management. This would be a key input in analysing the appropriate levels of capital required and provides a buffer in excess of the minimum regulatory capital requirements.

## 9. Regulatory Capital vs. Economic Capital

The focus on the internal capital assessment of banks under Pillar 2 has highlighted the distinction between economic capital and regulatory capital.

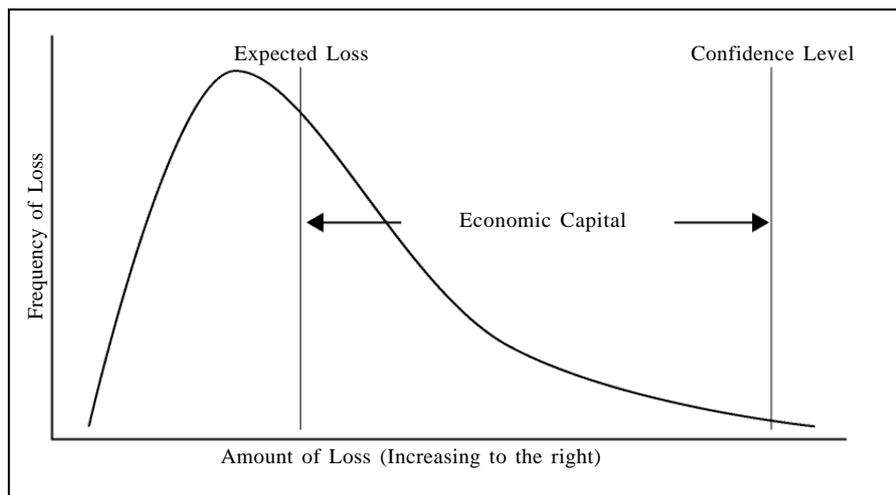
The regulatory capital refers to specific categories of equity (and other capital elements permitted by the regulator) used to meet capital regulations.

Economic capital, on the other hand, could be defined as the amount of risk capital. It is a single measure, which captures *unexpected* losses or reduction in value or income from a portfolio of business in a financial institution. The risk arises from the unexpected nature of the losses as distinct from the *expected* losses which are considered part of doing business and are covered by reserves and income. Economic capital covers all unexpected events except for catastrophic ones



for which it is impossible to hold capital. Typically this is calculated by determining the amount of capital that the firm needs to ensure that its realistic balance sheet stays solvent, over a certain time period, with a pre-specified probability (generally between 99.96 and 99.98 percent) equivalent to the insolvency rate expected for a AA rating.

The concept of economic capital differs from regulatory capital in the sense that regulatory capital is the mandatory capital the regulators require to be maintained while economic capital is the best estimate of required capital that financial institutions use internally to manage their own risk and to allocate the cost of maintaining regulatory capital among different units within the organization. Large international banks have been using economic capital models for over 10 years for assessing their internal capital needs. Model results are expressed as a level of capital expressed in monetary units, necessary to support specific risks assumed. Since economic capital is based on a probabilistic assessment of potential future losses it is a potentially more forward-looking measure of capital adequacy than traditional accounting measures.



It is expected from the Financial Institutions that they hold risk capital of an amount equal to at least the economic capital, which can be above the minimum stipulated regulatory capital requirements.

## 10. Challenges in Implementing Pillar 2

Given the vast scope of Pillar 2, the challenges posed to the banks and the regulators in its effective implementation are enormous. The primary responsibility under Basel II for developing a comprehensive ICAAP that captures all material risks rests with the banks, which would be assessed by the supervisor. Even under the existing Capital Accord, Basel I, banks are expected to operate above the minimum regulatory capital. Under Pillar 2 of Basel II, this becomes a formal



requirement. In adopting the advanced capital estimation methods under the advanced approaches for Pillar 1, the criteria under Pillar 2 become a factor for supervisory validation of the internal measurement methods. The main issues that would arise with regard to implementation from a bank's perspective are;

### **10.1 Challenges from a Bank's Perspective**

- Supervisory guidance for ICAAP - Many banks currently do not have formal and well-developed ICAAPs for assessing capital adequacy. They need clear and comprehensive guidance from supervisors on how to formulate and implement a "sound" ICAAP that would meet supervisory requirements whilst suiting their own operational areas.
- Taking into account the comprehensiveness the ICAAP has to guarantee, and its planning function, it is obvious that the requirements will be best met by implementing an economic capital model. Such a mathematical model relates the capital of a bank to the risks it takes within its business activities taking into account diversification effects between risk types. Only very large, International Banks will have the resources to establish such an advanced system for the allocation of capital. As such, it is envisaged that most banks in Sri Lanka will need more time to develop their capital planning and assessment capabilities, though they may not be complex as large international banks with diverse business operations in different geographical areas.
- Quantification of certain specific risks such as reputation risk and strategic risk – there are no standards set by the industry or Basel Committee currently available for the measurement of such risk. The Basel Committee expects the industry to develop measurement methods. Until such time, banks will have to use estimates.
- The state of readiness of the bank's risk management systems. The establishment of a central risk management function would facilitate prudent risk management.
- Banks also need to consider how to make ICAAP an integral part of their management process and decision-making culture, and not view it as another regulatory tool.
- Supervisory transparency and accountability – Banks would generally expect sufficient transparency in the way the supervisors exercise their discretion under Pillar 2. Further, Pillar 2 will inevitably increase supervisory scrutiny over banks. Concerns with regard to whether the supervisory review process will translate into interference with the way a bank conducts its business could also arise.



## 10.2 Challenges in Implementing Pillar 2 – Supervisor’s Perspective

- Considering the expanded role of the supervisor with regard to Pillar 2 implementation, and the absence of an established framework, the major challenge for the supervisor would be with regard to supervisory resources. Specifically, issues such as standards for a sound ICAAP, which could be applied to banks of different sizes and risk, profile, the extent of reliance placed on such ICAAPs to measure capital requirements pose tremendous challenges. Of particular significance is the building up of industry support for the supervisory review process. Thus, the development of objective assessment criteria for application of Pillar 2 becomes imperative.
- Given that banks will not be making use of sophisticated models for risk management and capital assessment while using the standardised (simple) approaches under Pillar 1, the supervisors may have to develop a mechanism such as a template for the identification of elements unlikely to be adequately catered for by the standard models, and requiring review under Pillar 2.
- Supervisory transparency - The supervisor also has to develop criteria that will be used in Pillar 2 assessments, including target and trigger ratios, which should be made publicly available. If capital requirements are set above the minimum for an individual bank, supervisor should explain the risk characteristics specific to the bank as well as remedial action proposed. Particular considerations would be determining the imposition of capital add-ons – whether a supervisory model should be developed and the scope, i.e. all banks or only “outlier” banks.
- Use of stress tests: should supervisors impose industry-wide standard stress test scenarios or permit individual banks to use their own scenarios.
- Building an effective dialogue with the individual banks is a key requirement under Pillar 2. However, blending the Pillar 2 requirements with the existing supervisory framework should not be a major challenge since most supervisors adopt a risk-based approach to supervision.
- Legal and regulatory impediments – the regulators should have the legal powers to exercise supervisory judgment and enforce capital add-ons where it is warranted.
- Cross-border application of Pillar 2; Enhancing the scope of cross-border communication with regard to application of Pillar 2 for international banking groups in order to reduce duplication of supervisory efforts needs to be considered. This requires harmonizing the divergent supervisory approaches of different regulators. A pragmatic approach to mutual recognition under home – host regulatory co-operation would be an important factor here.



## 11. Conclusion

Under the Basel II Capital Adequacy Framework, a bank's ultimate capital requirements are subject not only to the minimum capital requirements under Pillar 1, but also to regulatory discretion under Pillar 2. However, it is not intended to require formal capital add-ons across the board.

The three pillars, together, are intended to achieve a level of capital commensurate with a bank's overall risk profile. Along with the supporting Pillars 1 and 3, Pillar 2 of Basel II provides an impetus for banks to improve their ability to manage all material risks that a bank is exposed to and also provide the incentive for improving the risk management systems. Given the scope and coverage of Pillar 2 requirements, it could be envisaged that Pillar 2 will lead to a gradual evolution of capital management practices among banks. Thus, not only the international banks using economic capital models, but the smaller banks too will have to develop their capability in assessing internal capital requirements.

Pillar 2 will also help the banks to develop their business strategies and better risk-adjust pricing (measuring return on capital). Going forward, Return on Risk Adjusted Capital (RAROC) would be the norm for pricing as compared to Return on Capital (ROC). The use of stress testing under different scenarios will provide a more forward looking estimate of capital requirements and open up senior management thinking to possible risks that banks are exposed to.

The implementation of Pillar 2 will require much effort from the banking industry as well as pose great challenges to the regulators. Since the regulatory approach to supervision adopted by most regulators, including the Central Bank of Sri Lanka is risk-based, it is expected that Pillar 2 would be an extension and a refinement of the existing regulatory approach and not an entirely new endeavour.



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