Edgar Meister: Pillar 2 in Basel II - supervisory implications and implementation in Germany

Presentation by Mr Edgar Meister, Member of the Executive Board of the Deutsche Bundesbank, at a seminar at the Bank of Russia “The supervisory implications of Basel II”, Moscow, 20 April 2005.

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Ladies and gentlemen,

It is a great pleasure for me to be invited to this seminar and to share with you some thoughts on the challenges of implementing Pillar 2, also called the Supervisory Review Process (SRP) of the new Basel II framework. As Madame Nouy elaborated this morning the framework comprises overall three pillars: Pillar 1 is covering the minimum capital requirements set by supervisors, Pillar 2 is focusing on banks’ internal capital assessment and Pillar 3 is addressing market discipline and disclosure. A significant innovation of Basel II is the greater use of banks’ own, internal methods for calculating regulatory capital requirements. For example, institutions get the possibility to use internal ratings for the measurement of credit risk as inputs to regulatory capital calculations. Of course, in order to ensure the integrity of internal methods banks have to comply with a number of qualitative requirements. Correspondingly, it is the task of each supervisor to develop review procedures for ensuring banks’ compliance with those qualitative requirements to make sure that banks’ systems and controls are adequate.

The challenge for supervisory authorities is how to implement the new standards in their existing supervisory regimes. Before I start presenting to you how the German supervisory authorities cope with this task, which is the second part of my speech, let me first recall the key principles of Pillar 2.

I

As you are all aware of, there are two sources of international requirements to be recognized by all EU member states: The Basel Committee’s framework paper, which constitutes the Supervisory Review Process in its second pillar, on the one hand and the draft EU directive, putting Basel II into force within the EU, on the other hand.

The Basel II document, addressing internationally active banking groups, sets up the supervisory review process by means of four key principles. Whereas Principle 1 contains provisions banks have to comply with, principles 2 to 4 create standards for supervisory authorities. To start with the banking side, Principle 1 states:

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.

In brief this is called the Internal Capital Adequacy Assessment Process (ICAAP). In contrast to Pillar 1, which contains rules how institutions have to calculate regulatory capital, Principle 1 of Pillar 2 focuses on banks’ internal methods and processes. Thus, banks have, apart from some qualitative requirements, which I will address next, significant leeway to design their internal capital adequacy process. Conversely that also means, that there are no standardised methods or specific guidelines for institutions.

The Basel II paper elaborates the main features of a rigorous process, which have to be in place in order to fulfil Principle 1 of Pillar 2. Namely they are

- **Board and senior management oversight.** The ultimate responsibility for the risk management processes and the internal capital adequacy assessment process is with the senior management. It has to set the strategic goals for capital needs, capital levels and so forth.
- **Sound capital assessment.** This is the core feature of the internal process and states the requirement to relate capital to the level of all material risks not only as of today but also for a certain planning horizon.
- **Comprehensive assessment of risks.** Different to Pillar 1 the list of risks under Pillar 2 is not limited but should be adequate to fit the individual needs of every institution. A bank

would have to cover liquidity risk and interest rate risk in the banking book or even further types addition-ally to the well known risks covered under Pillar 1 (credit risk, market risk and operational risk), e.g. reputational and strategic risk.

The remaining two features are “monitoring and reporting” and “internal control review”.

Taking into account the comprehensiveness, the internal process has to guarantee, and its planning function, obviously, the requirements will be best met by implementing an economic capital model. Such a mathematical model relates the capital of an institution to the risks it takes within its business activities taking into account diversification effects between risk types. Only internationally active banks have the resources to set up a system as complex as that.

And indeed, some of the largest German banking groups are using already an economic capital model.

I am turning to the relevant requirements for supervisors in Basel II. While Principles 3 and 4 are related to regulatory capital ratios, the qualitative part of the supervisor’s duty under the supervisory review process is formulated in Principle 2 of Pillar 2. It states:

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 action if they are not satisfied with the result of this process.

In implementing this principle supervisors have, amongst other things, to assess whether a bank has taken, for its internal capital process, the full range of material risks into account. In addition, supervisors will review how the bank is using the measured risks operationally in setting limits, for example. In relation to the economic capital it will be of interest for supervisors to assess its composition. Questions to answer will be whether the bank individual economic capital can substantially cover unexpected losses or whether the bank uses the economic capital to manage its risks.

The single most debated feature of Pillar 2 might be the supervisors’ right to set capital charges exceeding minimum requirements set in Pillar 1, which is 8% of risk weighted assets. The rationale for this specific supervisory method is to ensure that individual banks are operating with adequate levels of capital.

Before introducing the differences between Basel and the EU directive I want to use the opportunity to express my scepticism regarding capital add-ons.

I am not convinced that capital targets above the minimum on a bank-by-bank basis should be a preferred measure. In general, I am in favour of other prudential measures that would require banks to improve their systems and controls. I therefore prefer the principle of prevention. Supervisors should not rely on the fact that losses caused by weaknesses in a bank’s systems and controls can be covered by additional capital.

I am also sceptical how supervisors can be sure not to treat institutions un-equally and as a consequence distort the level playing field. At least the types of risk and the capital concept according to Pillar 2 are different from Pillar1. It seems to be quite a challenge to determine an institutions’ individual capital add-on. Certainly, this can not be done simply by comparing capital amounts resulting from significantly different capital concepts.

To be clear, I am not totally against additional capital charges. In exceptional cases, where all other supervisory measures have been insufficient to improve a banks’ systems and controls they are useful. Institutions should expect capital add-ons as an ultimate supervisory measure. However, by no means there should be an automatism stating the amount of additional capital to hold, if for example Pillar 2 capital exceeds the amount of regulatory capital according to Pillar 1.

I am now turning to the corresponding rules of the draft EU directive. Although the EU document for most aspects poses no additional requirements but mainly translates the Basel II framework paper into EU law, there is an important difference regarding the circles of addressees. The directive once in force will not only oblige the biggest banks but all banks throughout the whole EU to implement internal capital adequacy processes. As I said a few moments ago, the natural way of implementing it, is developing an economic capital model. By no means we can require medium or small sized banks to make this effort.

The key principle of proportionality solves this issue. It states that processes and strategies have to be “proportionate regarding to the nature, size, scale and complexity of the credit institution’s activities.” In practice small institutions are not forced to build highly sophisticated models.

The principle of proportionality is valid for supervisors also. Supervisory activities with regard to an institution should always take into account the specific situation of the institution as described by the characteristics mentioned above – nature, size, scale and complexity. Additionally, systemic importance is a natural dimension to look at for supervisors.

We should have now a good understanding of the principles of Pillar 2 in Basel and Brussels. Before I will present how we have implemented Pillar 2 in Germany, I would like to address some more general implementation issues first.

II

One issue of relevance not only for my country is the cross-border approval process of internal measurement approaches. This issue is important for al-most every banking group with international operations. As Basel II does not change legal responsibility of supervisors a banking group may be required to obtain approval for advanced approaches from several supervisors. These are the relevant host country supervisors on an individual or sub-consolidated basis, as well as the home country supervisor in respect of consolidated supervision. Consequently, big internationally active banks operating in a large number of countries face an even bigger number of supervisory authorities to deal with in terms of approval process. In order to reduce the burden for banks and supervisors the Basel Committee recognized that closer cooperation and coordination of supervisors will be needed. For this reason it published in 2003 six high level principles for the cross-border implementation of the new accord, which have been developed by the Committee’s Accord Implementation Group. Remarkably, the principles do not touch legal responsibilities of national supervisors.

Different from Basel the EU Draft suggests in Article 129 to change legal responsibilities of supervisors for the approval process. The idea is that home and host supervisors shall accomplish the approval work together in full consultation. Further, they shall within no more than six months reach a joint decision on the application. In the absence of a joint decision within six months, the home supervisor shall make its own decision on the application. Although I show respect to the EU Commission for such a proposal, I also see the following problems with that rule:

There is a conflict between the strong position of the home supervisor who obtains the right to make the final decision on credit risk, market risk and operational risk approaches for the whole banking group and all its entities on one hand and the host supervisor being responsible for financial stability in his jurisdiction on the other hand.

The competition argument is another aspect to be considered. Domestic competitors of the subsidiary of a foreign banking group could be disadvantaged because they would have to accomplish different requirements than the subsidiary of the foreign group that received its approval from the home supervisor. An example would be a host supervisor who does not allow his banks the use of advanced approaches.

Further, there is a risk that those host supervisors who are not willing to accept a home country supervisor’s decision could require the subsidiary in its jurisdiction to hold additional capital charges via Pillar 2. This would undermine the idea of a strong home supervisor in the current EU directive.

From the point of view of the largest internationally active EU banks the concept can not be fully satisfying, as there are countries with important financial markets outside the EU not applying it. Of course, those countries could follow in accepting the rule as proposed in Article 129 of the draft directive, which in my view represents a highly improbable scenario. Consequently, the introduction of Article 129 into EU law may jeopardise the international level playing field between EU member countries on one hand and countries outside the EU on the other hand. This outcome is intensified by the fact that some countries outside the EU have decided not to offer the use of all Pillar 1 approaches to the credit institutions in their jurisdiction.

A second issue of general importance is the structure of the German banking sector and its relevance for the implementation of Basel II. The banking sector in Germany is characterised by a high degree of fragmentation with the majority of banks competing to each other. As of December 2004, there were 2.400 credit institutions operating in Germany. The majority of them are universal banks each covering a broad spectrum of banking activities. Compared to other European countries, for example

Netherlands or France where the five largest credit institutions amount to 84% and 47% of total assets in the national market, the German corresponding figure is 25%. At the other end of the spectrum there are more than 2000 German banks covering only 20% of the market. What does this mean with regard to the implementation of Basel II? The main conclusions are twofold:

First, for level playing field reasons Basel II will be made available for all banks, not only for the internationally active ones.

Second, although German banks compete to each other, they differ significantly in size and risk management. In order to allow them appropriate flexibility in implementing Basel II we are going to implement the full set of credit risk and operational risk approaches that is available in Basel II. We do not require the big banks to use either the foundation or the advanced IRB-Approach. It is up to the banks to make their choice. Of course, we think that for those banks the advanced IRB approach would be adequate without having any legal instruments to require certain types of approaches.

A survey amongst all German institutions performed last summer indicated that most of our internationally active banks (Deutsche, Dresdner, HVB, Commerzbank, WestLB, DZ Bank) are preparing for implementing the advanced approach at least on a sub-portfolio level by implementation date. As far as the smaller banks are concerned we expect about 460 of them to use an internal ratings approach right from the beginning of Basel II. You might ask yourself how there can be such a big number of institutions using the internal ratings approach. The answer is that banking associations are providing centrally developed risk measurement methods, IT services, default information etc. to member institutions. This turned out to be a very efficient way for the institutions to avoid development cost and to share information, e.g. default data. This combined effort of the institutions and their associations contributes to en-sure the credit supply all over the country.

Let me compare our case with the situation in the United States where about 20 of the largest US banks will have to use the most advanced approaches to measuring their credit and operational risk. The rest of the US banking system, which are thousands of smaller banks, have to remain under the existing 1988 Accord. Recent developments in the United States show the importance of taking into account the structure of the banking market when implementing Basel II. Many of the smaller US banks fear that they may be left at a competitive disadvantage after the adoption of the Basel II by their larger rivals. In-deed, a recent Federal Reserve Study revealed for some types of small business loans unintended competitive advantages and disadvantages. US regulators therefore signalled their readiness to adjust the Basel I provisions to protect smaller US banks from unintended problems.

I will now focus on the implementation of Pillar 2 in Germany in further detail. How are we implementing the supervisory review of the banks' internal capital adequacy assessment process. For this purpose, please recall the most important facts we have to deal with:

1. Every Institutions, independent of its size, has to set up such a process.
2. Germany has a lot of smaller banks with limited resources.

In Germany, we face the challenge to provide regulation that meets those criteria at a time. We need rules being flexible enough for forcing large banks to set up sophisticated risk management processes and models without strangling all the smaller banks. The experience with minimum requirements for the credit business and trading activities of credit institutions over the past 25 years shows that they are an instrument meeting this necessities.

Given the wide scope of an internal capital adequacy assessment process covering all aspects of risk management, however, the German implementation needs to be holistic as well. This is the reason why the idea of minimum requirements on risk management (MaRisk) was born: a flexible, overarching set of rules implementing the qualitative requirements for the bank internal capital process. In accordance with the holistic approach in Pillar 2 of the Basel II framework paper and the EU directive, the MaRisk require banks to manage all relevant risks. Specifically the MaRisk address credit risk, market risk, interest rate risk, operational risk and liquidity risk.

As can be inferred from the term "minimum requirements", the MaRisk are formulated on a sound practice level. Risk management processes of smaller banks can regularly be regarded as adequate if they are meeting sound practice. Therefore, the sound practice level is in line with the application of the MaRisk at all institutions. Of course, the leading and largest banks should strive for best practice.

In addition to the qualitative requirements, Pillar 2 of Basel II contains some very specific provisions with regard to securitisation or stress-testing in the IRB approach and some quantitative rules for the measurement of interest rate risk. All this is not content of the MaRisk as it either concerns just banks on more advanced approaches or it does not fit the concept of minimum requirements which are qualitative in nature only. Nevertheless, for the majority of German banks complying with the MaRisk would mean to be also compliant with Pillar 2.

BaFin has published a first draft of the MaRisk in February. An expert group comprising supervisors and representatives of banks, associations and external auditors is discussing it with the goal to present a second draft by June this year. The draft should be fit for formal and final consultation in order to publish the MaRisk in December. Institutions can prepare during 2006 for the starting date end 2006 together with the Basel II framework paper.

Turning from requirements for banks to regulation for supervisory authorities, let me first give you some insight in the structure of financial supervision in Germany and mention some more general aspects of implementing Basel II. After that I will present how BaFin and Bundesbank as German supervisors prepare for Pillar 2.

III

Banking supervision in Germany is characterised by a dual system, i.e. there are the two supervisory bodies Bundesbank and BaFin in charge of banking supervision. Let me in brief describe the role of Bundesbank within this framework. Bundesbank, as a rule, shall carry out day-to-day supervision (e.g. collection of information, regular analysis of financial statements, monthly balance sheets, large loan reports etc., on-site examinations as part of the supervisory review process). As a result of this work Bundesbank provides analysis of information and findings to BaFin. Bundesbank further proposes supervisory actions to BaFin being the authority with the sole responsibility for all legal acts (in particular, granting and withdrawing licenses, closing operations of a bank, restricting business of institutions etc.).

Looking at the organisational structures of both institutions the current division of duties between BaFin and Bundesbank makes a lot of sense: Different from BaFin Bundesbank is present all over the country in its nine regional offices. With an increased importance of on-site examinations and a more intense dialogue between institutions and supervisors as a goal of Basel II the presence of Bundesbank in all regions is even more relevant. Consequently the on-site inspections and day-to-day supervision related to the supervisory review process shall, as a rule, be performed by Bundesbank. Another reason, already mentioned, is that Germany still has a non-centralised banking system with important banks in various cities. Therefore it would remain difficult for BaFin, which has no regional offices in the “Länder”, to carry out day-to day- supervision. Nevertheless, in non-standard cases BaFin will also perform its own on-site audits. The emphasis of BaFin´s audits shall be on cases in which the need for serious supervisory measures is anticipated.

A last but important issue for the implementation of Basel II is that the number of supervisory examiners in Germany before Basel II was rather low. In 2001 there were about 100 colleagues in Bundesbank and BaFin performing supervisory examinations. With the introduction of the supervisory review process in the new capital framework we decided to adjust our examiner capacities. This process started in 2002. Because of the restructuring of Bundesbank the majority of the needed personnel could be provided internally. In order to prepare the new staff for their challenging job Bundesbank and BaFin started a joint training program in summer 2002. To give you some figures: from July 2002 to July 2004 about 200 colleagues participated in the program. The program consists of training on the job periods and seminars as well, to which many experts from our banking industry accepted to contribute. More than half of the 150 trainers came from outside banking supervision . The program is a revolving one and is still running. For our “advanced examiners” we developed special courses in English language which have been opened this year for colleagues from all EU central banks.

Even as the manpower of BaFin and Bundesbank has been increased, we will have to concentrate our supervisory activities on banks which are relevant for the stability of the financial system and which operate on an international level. Given the big number of very small banks we are not going to conduct a full scale Supervisory Review Process including on-site examinations for all banks on an annual basis.

From the supervisor’s point of view the supervisory review and evaluation process is not only the review of the implementation of a banks’ internal capital process as described in Principle 1 of Pillar 2, i.e. the MaRisk. Another important aspect for supervisors is to make sure that a bank is compliant with

Pillar 1 on an ongoing basis. Let me cover this second part of the supervisory review and evaluation process first.

During the last year BaFin and Bundesbank prepared for the approval process of internal rating systems. The goal was to be as early as possible in a position to conduct on-site examinations of internal ratings approaches. You may imagine, that given the number of 460 banks planning to use this kind of approach as indicated by last summer's survey a supervisory authority faces a major challenge; especially, since there is a certain risk of coming at the same time. Consequently, at the end of last year we provided institutions with application forms and guidance in order to apply for the use of an internal ratings approach. In the light of the large number of expected applications, it is of major importance to distribute the approval and examination work as evenly as possible during the time remaining until the EU directive gets into force.

Before a rating model is accepted for calculating regulatory capital it is subject to an on-site examination. That means, one examination at an applying bank will suffice only in the case of a smaller savings bank or credit co-operative, which use standard models developed by their associations. In the case of our largest banks, a series of approval examinations will take place at every institution for evaluating the variety of rating models.

Another issue with regard to Pillar 2 is the approval of advanced measurement approaches (AMA) for operational risk. Germany's approach regarding the advanced approach for operational risk is similar to that for internal ratings approaches. As the advanced operational risk approach will be available not be-fore the beginning of 2008, the schedule is not that tight. Currently we are going to be prepared until the end of this year to handle applications.

Turning back to the national implementation of Pillar 2 in Germany, the approval of internal ratings and advanced operational risk systems is comparable to that of market risk models. In Germany, we have experience with this process whereas the second part of the supervisory review and evaluation process – challenging the institution's internal capital allocation assessment process – is new for us. Due to the overarching nature of the internal process it is quite clear, that there is not a single tool to perform the review of it. Quite on the contrary, all supervisory instruments like off-site review of all kinds of reports, meeting with different levels of the management and on-site inspections have to be used in order to get an idea of the quality and adequacy of an internal capital adequacy assessment process regarding the particular institution using it.

Ladies and Gentlemen,

without any doubt: the implementation of Basel II is a significant challenge for both, banks and supervisory authorities. This holds especially true for countries where a high number of banks are planning to use their internal risk measurement methods for supervisory purposes as well.

It was the intention of my speech to deliver three key messages:

1. The second pillar of Basel II is a significant, vital part of the whole framework. Its scope in covering the risks banks are facing is much wider than the concept of minimum capital requirements in Pillar 1.

2. Supervisors need to prepare guidelines for their institutions and manuals for themselves how to act under Pillar 2. I gave you an overview of the package we have prepared in this respect.

3. Both, the Basel II framework and the EU-Directive, are leaving the necessary flexibility to supervisors to conduct the supervisory review process in proportion to the risk contribution of a bank to the financial system. Especially for countries having a large number of small and medium sized banks this is important to promote the acceptance of the new rules.

One common goal finance ministries, central banks and supervisory authorities are sharing is to enhance the stability of the financial system. The implementation of Basel II will bring us one important step further in achieving and maintaining this goal.

Thank you for your attention.