Proportionality under Pillar 2 of the Basel framework[1]

Executive summary

In 2006, the Basel Committee on Banking Supervision (BCBS) published Basel II, a three pillar approach to the oversight of internationally active banks. Pillar 1 prescribed risk-based capital (RBC) rules, which were subject to supervisory review under Pillar 2 and disclosure requirements in Pillar 3.

Following the Great Financial Crisis (GFC), the BCBS introduced the Basel III reforms, which significantly strengthened the minimum Pillar 1 regulatory requirements. These changes focused on strengthening existing RBC rules. In addition, it also introduced new requirements on leverage, liquidity and capital buffers for systemically important banks as well as for the macro-financial environment.

Although the Pillar 2 rules text was unaffected by Basel III and remains unchanged, its practical interpretation by supervisors has changed over time. Pillar 2 contains four principles that guide the responsibilities of banks and supervisors to ensure, among other objectives, that minimum Pillar 1 requirements are aligned with a bank's overall profile.

Pillar 2 is a principles-based standard that is premised on sound judgment. Principle 1 of Pillar 2 requires banks to assess their own risk profile; this is influenced by the cumulative set of risk management requirements imposed on banks, which typically varies with a bank's size, complexity and risk profile. The remaining principles are supervisory responsibilities, with an indirect effect on banks, and are driven by their implementation of risk-based supervision (RBS). The collective implementation of all four principles necessitates a proportionate approach and is reliant on supervisory judgment.

This paper surveys 16 jurisdictions (both BCBS and non-BCBS members) on their Pillar 2 implementation approaches, including their application of proportionality. A key aim of our study is to determine *whether* and, if so, *how* supervisory authorities apply proportionality in tailoring risk management expectations and supervisory practices according to the size, complexity and risk profile of regulated entities. We also review the construct and evolution of bank rating systems since the advent of Basel II, given its fundamental role in shaping supervisory assessments and outcomes under Pillar 2.

While all surveyed jurisdictions have a process that incorporates the four principles of Pillar 2, their application varies. For example, some jurisdictions require all banks to submit a self-assessment of their own risk profile and internal capital adequacy assessments, while other jurisdictions impose such requirements on only a subset of banks. In addition, there is limited consensus on what Pillar 2 capital add-ons, if imposed, should cover, including how these capital add-ons interact with the new Basel III buffer requirements. Finally, the process used to determine Pillar 2 capital add-ons, if warranted, also differs.

Another insight is that authorities apply proportionality in supervision through one (or a combination) of two methods. The first approach, which we label *"principles-based proportionality that hinges on supervisory judgment"*, entails the development of high-level principles that are subject to tailoring through the judgments of supervisory teams. The second method, which we classify as *"guided discretion"*, imposes a more prescriptive guidance that is supplemented with supervisory judgment.

The proportionality approaches used in supervision involve trade-offs. The principles-based proportionality methods allow supervisory teams flexibility in tailoring supervisory assessments to

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institution-specific circumstances. This approach relies on the judgment of supervisory teams. This has the potential to raise some level-playing-field concerns within a jurisdiction, as the decisions made could be difficult to objectively compare across a range of similar banks. The guided discretion approaches eliminate some of the judgment required from supervisory teams by hard-wiring certain proportionality elements into applicable guidance. Under this approach, an open question is whether the hard-wired guidance serves as a good proxy for the decisions that would otherwise be made by supervisors.

Most surveyed jurisdictions impose supervisory requirements on banks to facilitate the implementation of principle 1 of Pillar 2. Nearly all jurisdictions surveyed require at least a subset of banks to develop an ICAAP and to perform stress tests. While not a formal Pillar 2 requirement, recovery plans have also been introduced in most surveyed jurisdictions. Authorities apply proportionality by either exempting some banks from the requirements or tailoring rules when they are imposed.

When ICAAP, stress testing and recovery plans are required, most authorities tailor applicable rules using either principles-based or guided discretion methods. While principles-based proportionality approaches tend to be used for ICAAP and stress-testing requirements, most authorities apply guided discretion methods to facilitate a proportionate application of recovery plans.

In regard to supervisory responsibilities under Pillar 2, a mix of principles-based and guided discretion approaches is used to tailor supervisory intensity and supervisory risk assessments to a firm's size, risk profile and complexity. Guided discretion approaches are prevalent in the supervisory review of capital adequacy and in setting the supervisory intensity of a firm, with the latter typically combining a bank's systemic importance with its overall supervisory rating. With respect to the assessment of the "firm-wide governance/management" rating, nearly all authorities embed principles-based proportionality in supervisory expectations ("risk management must be commensurate with size, complexity and risk") but rely on supervisors to arrive at a proportionate risk assessment.

The design of bank rating systems, which influences supervisory risk assessments and the supervisory intensity applied to firms, has evolved post-GFC. Many jurisdictions now place more weight on "liquidity risk", "firm-wide governance" and "business model analysis" in their rating system architecture. At least one authority incorporates a bank's resolvability into its rating process; others consider ICAAP and recovery plans when rating a bank's "firm-wide governance". Lastly, a four-point rating scale is a common trend, perhaps to prompt supervisors to distinguish between "good" and "bad" banks, rather than defaulting to the "middle of the road" option under the five-point rating scale.

The appropriate balance between "rules versus discretion" in supervision is context-driven. Nevertheless, there are advantages in adopting guided discretion approaches with respect to tailoring ICAAP, stress-testing and recovery plan requirements imposed on banks; in determining the supervisory intensity of a firm; and in assessing capital adequacy. The primary benefits of this approach are to reduce level-playing-field concerns and to provide supervisors with structure and consistency in the Pillar 2 implementation process, while allowing room for judgment. A principles-based approach to proportionality seems well suited to the supervisory assessment of "firm-wide governance" given the difficulties in prescribing hard-wired risk management standards for small versus large banks.

With the post-crisis regulatory reforms now complete, there is value for the supervisory community to pay even more attention to Pillar 2. The expansion of Pillar 1 requirements under Basel III, including new global liquidity rules and the introduction of various capital buffers, has expanded the supervisory review process and its interactions with Pillar 1. In addition, new sources of risk such as cyber and climate-related risk, together with a greater focus on a firm's conduct and culture, pose fresh challenges for banks and supervisors. In this context, continued collaboration between jurisdictions, through the ongoing exchange of experience on the various methods used to implement Pillar 2, can facilitate a robust implementation of the post-crisis reforms while taking into account the evolution of bank risk management and supervisory practices.