

Ri\$k Minds 2008

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# ICAAP – the story so far\*

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# Introduction

## The survey

- No names basis – late November 2008
- Senior people responsible for ICAAP/SREP
- Nine questions plus interviews
  - Three regulators (all advanced in Pillar 2)
  - Five major (mostly international) banks; one global asset manager
- Context: PwC Pillar 2 advisory experience
  - Training of regulators on Pillar 2
  - Numerous in-depth ICAAP reviews/development support
  - Global risk-based capital management network

## Pillar 2 - the plan

### 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” [ICAAP]

### 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 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. [SREP] Supervisors should take supervisory action if they are not satisfied with the result of this process”


### Principle 4

**“Supervisors should seek to 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”

## Pillar 2 - is this how it has turned out?


### 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 [CAAP]”



### Principle 2

“Supervisors should review and evaluate banks’ internal capital adequacy assessments and strategies as well as the ability to monitor and ensure their compliance with regulatory capital ratios [REF]. Supervisors should take supervisory action if they are not satisfied with the result of this process”



### Principle 3

“Supervisors should expect banks to operate above the minimum regulatory capital ratios. Supervisors should have the ability to require banks to hold capital in excess of the minimum”



### Principle 4

“Supervisors should seek to 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”

## Important to be clear on purpose/context of Pillar 2



Regulatory tick box – “jumping a low hurdle”

“We are OK in terms of how we manage risk and capital”

“Great opportunity!” - organisational change and impact on decision-making

## Questions asked

1. What benefits of SREP/ICAAP have (i) you and (ii) others gained?
2. With hindsight what would you have done differently?
3. Where have banks/supervisors exceeded expectations?
4. Where do banks/supervisors have further work to do?
5. What reliance did the supervisor place on internal models?
6. What improvements are needed in stress testing/capital planning?
7. What are the implications of the credit crunch for (i) Pillar 2 and (ii) internal models?



## The bankers' story

## 1(i). What benefits have you gained from the ICAAP?

- Stimulus from developing an integrated view of group risk profile, capital adequacy, risk mitigation and engaging with senior team
- Massive steps forward in stress testing capability
- Strengthened capital discipline
- Moved risk up the senior management agenda
- Dynamic view linking strategy, risk appetite and capital
- Good work in understanding diversification effects
- Better appreciation of what is needed for Board to embrace principles of Pillar 2 and to better integrate risk and capital

## 2. With hindsight what would you have done differently?

- Start earlier
- Recognise scale of resources needed
- Involve senior management sooner and more effectively
- Communicate complexities more clearly
- Make it more forward looking – risk of an “as is” style
- Develop credit concentration risk methodology earlier

### 3. Where have supervisors exceeded bank expectations?

- Effort that regulator put into the SREP
  - Number of times they came to visit us!
  - 100 questions over a few months
- Understanding of risk and capital issues
  - Better than rating agencies
  - Good dialogue and insight into the business
- Avoidance of knee jerk reaction to liquidity crisis (informed discussion)
- Probed some material areas well e.g. pension risk
- Length of time that they took to respond to our submission!
- In second SREP round – better focus on key issues

## 4. Where do supervisors have further work to do?

- Move from tick box mentality to “move industry forward” mindset
- Place less emphasis on theory and models; emphasise decision-making
- Join up Pillar 1 and Pillar 2 processes better
- Integrate policy more effectively with supervisory practice
  
- Avoid tendency to use backward-looking judgement linked to Basel I
- Provide time and resources to engage in proper debate
  - Strengthen operational risk modelling capability
- Be more transparent over benchmarks
- Define stress testing requirements more clearly

## 5. To what extent did the supervisor rely on the bank's internal models?

- Increasing reliance (with challenge and examination)
- Relied on our model:
  - Regulator view of capital required was not very different
  - Credit given for areas of conservatism in arriving at total capital
- Differences between EC and Basel II important
- Very little reliance (apart from stress testing and IRRBB)
- We decided to adopt a Pillar 1 plus approach so little reliance

## 6. What future challenges need to be addressed in capital planning and stress testing?

Banks	Regulators
<ul style="list-style-type: none"><li>• Very important to have view on position in cycle</li><li>• Link capital and funding better</li><li>• Integrated stress testing with feedback loop</li><li>• Increasing model complexity needs to be managed</li><li>• What is sensible assumption for lack of access to capital and funding?</li></ul>	<ul style="list-style-type: none"><li>• Procyclicality – need regulatory view on position in cycle</li><li>• Differentiate cycle curves in different countries</li><li>• Address policy creep in prescriptive stress testing</li><li>• Clarity on assumptions</li><li>• Transparency of benchmarks used</li><li>• Be clearer on how risk review and capital assessment link</li></ul>

## 7. What are the implications of the credit crunch for (i) Pillar 2 (ii) internal models?

- Arrived before Pillar 2 embedded (even in leading countries)
- Potential breaking of link of capital guidance with Pillar 1 minimum
- Increased market expectations for capital ratios: reflect and manage
- Risks will behave differently
  - Exceptional risk behaviour not picked up in models
  - Emerging moral hazard in customer behaviour
  - Show humility in recognising model limitations
- Despite the noise: keep Pillar 2 principles in mind
- Link one-off regulatory initiatives with business as usual activities
- Determine how to avoid framework tightening in a downturn



## The regulators' story

## 1(i). What benefits have you gained from the SREP?

- Much deeper understanding of how banks assess risks:
  - Ranking and control of risks
  - Earlier flagging of risk issues
  - Focus areas become clearer after first run
- More explicit link created between risk management and capital
- Better link between our risk assessment and capital assessment
- Allows us to keep up better with banks
- Learning from other regulators
- Dialogue with industry and other stakeholders
- Makes my job a lot more interesting!

## 2. With hindsight what would you have done differently?

- Quite happy with how it went: no change (one regulator)
- Allow more time for:
  - Developing approach (for banks/at regulator)
  - Developing our people
- Clearer drafting of stress test requirements\*:
  - Calibration confusion on stress tests outside capital plan
- Spend more time on smaller banks (main focus was on larger ones)

\*FSA Consultation Paper expected soon

### 3. Where have banks exceeded supervisory expectations?

- Regulator 1: Rarely. Very few first round ICAAPs have met our expectations
- Regulator 2: Nothing noted
- Regulator 3: Expectations generally met
  - Exceeded in:
    - Amount of work banks have undertaken
    - Level of resources devoted by larger banks

## 4. Where do banks have further work to do?

- Improve quality and coherence of documentation
- Capital planning and stress testing
- Clarity of legal entity capital distribution
- Use test/drill down to business units
- Risk appetite
  
- Risk types (IRRBB, operational, residual/other)
- Make convincing case for inter-risk diversification
- Address key man risk associated with risk/capital specialists
- Demonstrate progress from year to year
- Use appropriately skilled consultants

## 5. To what extent have you relied on banks' internal models?

- Regulator 1:
  - Combination of top down and bottom up (based on EC for larger banks)
  - Internal top down target is starting point for assessment
- Regulator 2:
  - Pillar 1 plus approach
  - Greater of EC or Pillar 1 for each Pillar 1 risk; plus Pillar 2 risks
- Regulator 3
  - Pillar 1 plus buffer plus Pillar 2 risks
  - Plus “soft” buffer proposed by bank
- All three regulators
  - Comparisons between EC and Basel II very important
  - Use of EC an important input to use test evidence

## 6. What future challenges need to be addressed in capital planning and stress testing?

Banks	Regulators
<ul style="list-style-type: none"><li>• Senior management involvement</li><li>• Better articulated, holistic scenarios</li><li>• Sufficiently severe</li><li>• Reverse stress testing</li><li>• Focus on key econometric drivers</li><li>• Better linkages between stress test and capital plan</li><li>• Process more important than results</li></ul>	<ul style="list-style-type: none"><li>• Skill sets need to be enhanced<ul style="list-style-type: none"><li>• Econometric input</li><li>• Guidance on interpretation</li><li>• Role of quality of capital</li></ul></li><li>• Challenge process to be better specified<ul style="list-style-type: none"><li>• Coordination of multi-skill inputs</li></ul></li><li>• More senior level training</li><li>• Adapt process post credit crunch</li></ul>

7. What are the implications of the credit crunch for (i) Pillar 2 (ii) internal models?
- No going back: committed to risk sensitive approach to capital assessment
  - No change to Pillar 2 approach
  - For a few banks, capital guidance may be subordinate to government targets
  - Stress testing even higher on the agenda
  - Leverage ratio not seen as a good idea
  - Greater focus on quality of capital



## Conclusion

## Bringing it all together: the yin and yang of ICAAP

Quantitative

Bottom up

Capital

Theoretical rigour

Group

Risk

Present (static)



Qualitative

Top down

Risk management

Practical use

Business unit

Finance

Future (dynamic)

**Not a document but hearts and minds**

## The way forward

- Clarify ICAAP and SREP purpose: tick box or strengthen the industry mindset? Decision needed
- Capital rewards for banks with good risk and capital management need to be seen
- Supervisors have been encouraging and supportive. Banks, beware - the bar will rise
- Focus on linking executive reward to risk will raise profile of Pillar 2 and the risk function
- International playing field requires levelling work
- Constant feedback essential for an evolving process

## The advisor's story.....

- Champagne roundtable this evening
- Share experiences with colleagues



# Thank you!

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