

Report on Pillar 2 Thematic Visits

Introduction

1. The Pillar 2 team met twelve firms in October and November 2004 to gain an understanding of their awareness of, and preparations for, Pillar 2. The meetings were informal and therefore a forum for open discussion, structured round a listing of 'areas for general discussion' as reflected at Section C below.
2. With the exception of one medium-sized firm, all firms visited were large and complex financial institutions. The sample of firms was not intended to be representative of the entirety of firms impacted by Pillar 2. The position of smaller/medium sized firms/less complex firms could be different – as the responses to the Basel Roll-out Plan Letters and the Cost Benefit Analysis undertaken by LECG for CP 05/3 are now confirming. Notably, smaller firms seem less familiar with expectations of the Pillar 2 framework.
3. In accordance with the terms of reference of the exercise, individual feedback was not provided to firms but this note gives a general account of the findings.
4. This report is structured in the following way:
 - Key findings
 - Areas of general discussion
 - Questions raised by firms
 - Conclusion.
5. In reading this report it should be noted that this was a purely fact-finding exercise, and the outcomes will not be representative of the regulatory population as the sample was skewed to larger firms.

Key findings

6. Most of the firms have or are planning to use economic capital models. However there are considerable differences in both:
 - the state of development: several firms have had a fully embedded economic capital model for several years; others are quite advanced in moving towards the full use of such models; some have moved to partial use, preferring to adopt a more selective approach to roll-out until they are more confident about the results; while others are still at quite an early stage; and
 - the way in which they are used:

The papers and meetings of the group are intended to encourage useful discussion of the issues rather than to present a comprehensive account of the matters concerned or a set of agreed conclusions. The minutes of the meetings report the discussions of the group, but neither the papers or minutes nor any reported remarks by anyone present at one of those meetings should be read as representing formal positions of the institutions represented or of the FSA. The FSA's Handbook proposals will be subject to consultation in the normal way.

- the wholesale investment firms tended to use several measures for allocating internal capital rather than a single methodology.
 - one major high street firm is developing an approach for internal capital allocation based on a combination of a regulatory capital number plus an economic capital add-on.
 - a number of firms which employ economic capital models within business units do not intend basing their internal capital assessments solely on a economic capital methodology, preferring instead to use a combination of measures (both quantitative and qualitative).
7. All firms indicated that they would be able to explain the differences between their internal processes and regulatory outcomes (though not by way of a detailed reconciliation) and, with the exception of one firm, were comfortable with providing this explanation by using a ‘building block’ approach.
 8. Some firms’ models showed adjustments for “diversification benefits” – some in aggregate across risk buckets and others within risk buckets – but even where this was the case many were cautious about their ability to distribute the benefits across business units in a meaningful way.

Areas of general discussion

How developed were firms' Internal Capital Adequacy Assessment Processes ('ICAAPs'), and if not well developed what preparations were firms beginning to make?

9. All firms were already using, developing or intending to develop economic capital models ('ECMs'). A few already had several years of experience of using fully embedded economic capital models to manage their business; some were quite advanced in implementing economic capital models across all business units; others were going more for a partial roll-out approach until the results were more proven; and a few were still at the developmental stage.
10. Where firms were in the course of developing their economic capital processes these appeared to be being undertaken in the context of well-developed project frameworks. Indeed, compared to discussions on the same subject some 18 months earlier, all firms had now incorporated Pillar 2 fully into their wider Basel Projects. The wholesale investment firms had seasoned approaches to internal/economic capital, in part driven by the home country authorities having for some while placed more emphasis on economic capital.
11. Nearly all firms observed that as their economic capital models utilised the same base data as used for Pillar 1 calculations, it ought to be possible in broad terms to explain the relationship between Pillar 1 calculations and the outcome of the economic capital model for Pillar 2 purposes. That said, any requirement for an exact reconciliation would be more problematic, though this was considered to be unnecessary for the purposes of the exercise, and indeed we do not expect a £ for £ reconciliation.

How embedded was the ICAAP in the day to day businesses processes of firms?

12. The responses varied. For those firms that were developing their approach, the expectation was that they would be able to use the ICAAP for a variety of purposes, including budgeting, business and performance management, pricing for risk, forward capital planning, but that this would take time.
13. Some firms could see the models as having greater relevance for some business divisions as opposed to others e.g. there was a general acceptance of their value/use in wholesale businesses compared with retail units.
14. Most also expected internal resistance which they would have to overcome before they could successfully embed the processes in the business. This was attributed to:
 - the need to persuade businesses/front offices that the benefit of the new methodologies, in terms of better business and risk management, would outweigh the associated costs of roll-out;

- senior management scepticism about the reliability of economic capital models as a main tool for running the business; and
- the sensitivity of risk management to developing a tool which produces a number which the business finds difficult to relate – in certain cases firms said they would be prepared to consider applying a different confidence interval at business unit level if the confidence interval used at Group level for credit rating purposes was so far off prevailing market practice as to put the business unit at a competitive disadvantage.

How integrated was the ICAAP in the day to day risk management of firms?

15. The degree of integration was closely correlated with the extent to which firms had developed ECMS. For those with long-standing ECMS, the ICAAP was well-embedded into risk management and business units. Those firms in the course of developing ECMS spoke of a much closer working relationship forming between risk management functions and finance, with most projects being co-sponsored/managed; they believed that this relationship would only strengthen as the methodologies become more embedded. Some firms referred to the developments of joint finance and risk systems as indicative of this new relationship.

What nature of high level governance existed for firms' ICAAP's?

16. For those firms where economic capital models were already in use, it was clear that the governance was well established. In those cases the capital management processes were either overseen by the Board who were involved in the final decision- making or at senior executive management committee level.
17. Where firms were developing their processes, these appeared to be subject to close scrutiny/oversight by Boards and/or senior management and would require eventual sign-off.
18. One firm was unsure about what the term 'senior management' would mean in the context of its own organisation and how resolution of that might impact its delegation of key responsibilities for the capital assessment process. Another firm considered whether divisions would have to change their management structures to reflect their different risk profiles. (The answer to the first point is quite straightforward in terms of the FSA's definition of senior management responsibility i.e. ultimate responsibility was vested in the Board and executive management team. The second point reflected the perennial issue of how to strike the right balance between relatively large individual business units and Group management functions.)
19. The challenge of ensuring that the governance process around the ICAAP was documented was a consistent observation of the majority of the firms.

How did firms use stress tests, scenario analysis and confidence intervals in their ICAAP?

20. All firms agreed that the use of some stress tests was important to enable them to understand the effects on capital in worst-case scenarios. The general concern of those firms using stress tests was their subjective nature and need for refinement. Even in those firms still developing their approaches, some form of stress testing was already carried out, but again it was agreed that this was an area for refinement. Some firms had developed stress-testing methodologies which they applied on a frequent basis to assess whether they were holding sufficient capital.
21. Developing stress tests for operational risk was cited by firms consistently as an area of difficulty. One firm supported the non-prescriptive nature of the draft directive and considered that a discussion on the matter with the FSA would be essential.
22. Firms were evenly divided about the value of the FSA setting confidence intervals for the stress tests, as in the insurance framework, with broadly the same number of firms in favour as against. However there was no consistent approach to the setting of confidence intervals between firms; even within firms there were inconsistencies.

How were less quantifiable risks reflected in the ICAAP?

23. Strategic and reputational risks were cited by firms as the most difficult to quantify. Those firms that considered reputational risk tended to view it as an event/outcome of business risk which was better mitigated by controls rather than capital. Only two investment firms said they explicitly set capital aside for reputational risk based on empirical evidence. The same firms held capital against short-term variations in income against fixed costs over the same timeframe. The larger firms tended not to do so as they judged that annual profits were sufficient to cover any loss arising from any foreseeable stress test.

Did the ICAAP take into account correlation or diversification benefits?

24. Some firms felt that Basel 2 was not calibrated to a large well-diversified bank and therefore had difficulty in understanding the FSA's reluctance to take account of firms' adjustments for diversification benefits. While a number said they calculated diversification benefits in their models, some of these firms indicated they were doubtful about how to allocate that benefit in a meaningful way and therefore might not sub-allocate to business unit level. The firms that did take account of diversification benefits tended to use stressed correlations in recognition of the fact that correlations increase in periods of stress because there is a greater connection between events and/or risk drivers than in normal conditions.
25. Firms expressed the following views:
- there have been no sensible industry or regulatory discussions on diversification benefits to date and therefore it is difficult to form a reasonable approach;
 - it is possible to manipulate the level of diversification benefits by lowering or raising the confidence intervals used or by modifying the level of granularity; and
 - a few firms said that they would not pursue diversification benefits either because it was too difficult to allocate them in a meaningful way between business units/solo levels or because consideration of diversification benefits was not appropriate in the context of their current risk allocation methodologies.

Could the outcome of the ICAAP be explained to the FSA in a dialogue structured using a 'building block' approach?

26. Most of the firms said that they would be able to explain the outcome of their internal capital process to the FSA, specifically using a building block approach.
27. On the other hand, a small number argued that attempting to reconcile firms' economic capital models to a regulatory requirement was not worthwhile primarily because economic capital models reflected firm-specific considerations and not regulatory concerns. Such firms believed that they should not be asked by the FSA to reconfigure models with different assumptions (nor was this what we were proposing) for regulatory purposes. They argued that rather than trying to reconcile the two processes the FSA should indicate to the firms which risks it had concerns about so that the firm could in turn explain how it had measured those risks and what measures it had taken to mitigate them. (While we would not require the model to be reconfigured, if the results led to an inadequate capital number we would reserve the right to impose a higher capital amount.) The one medium-sized firm participating in the themed visits stated that the FSA should not develop regulatory models to second-guess the outcome of firms' models.

Did firms agree that providing the FSA with Pillar 2 data for peer group comparison or benchmarking was a positive development; if so, were firms in a position to provide the data?

28. The responses were generally positive; however some firms considered that to provide standardised data to the FSA would be too costly in relation to the benefit, especially given other competing priorities generated either by Basel or Sarbanes-Oxley. One firm felt that benchmarking/peer group comparisons could be made by horizontal or themed FSA visits.

Questions raised by firms

29. During the meetings, firms raised some questions relating to aspects of policy still being developed. We have recorded these questions and where we have not already done so will address them in due course.

- Will ICG be the mechanism by which additional capital requirements are expressed; and will it be the mechanism by which additional capital requirements are introduced by the ‘back door’? e.g. procyclicality
- What does the implementation on 1 January 2007 of ICAAP/SREP mean for a firm; furthermore what does it mean for a firm which will use Retail IRB from 1 January 2007 and other advanced approaches from 1 January 2008?
- Do the FSA intend to set confidence intervals?
- Is the FSA considering defining the terms stress testing and scenario analysis – which firms feel are used interchangeably? Additionally will the FSA provide examples of scenario analysis or stress tests that firms, particularly smaller firms, should undertake?
- For groups, to which firm in the group will the FSA deliver the ICG; how many ICAAPs will be performed for a group?
- Does the FSA intend to issue any clarification regarding how firms should treat procyclicality? (A number of firms felt that it was not clear whether, during an economic downturn, they would be entitled to utilise, or required to add to, the capital buffers calculated for this purpose.)

Conclusions

30. Although some firms were quite advanced, others were clearly at an earlier stage of development.
31. It is clear that in both developing an approach and embedding Pillar 2 into a firm’s business processes are lengthy and time-consuming. For example, two of the firms participating in the visit began developing their approaches in the early 1990s and yet both were still refining and redefining important components. This will need to be borne in mind when FSA assesses the “use test”, the models’ robustness and the integrity of their outputs.
32. The FSA has always appreciated that a ‘one size fits all’ SREP approach was not an option given the range and complexity of the firms supervised; however it is now clear that in developing the SREP FSA will need to consider not only the number of different approaches being adopted by firms, but also the different stages of integration.
33. It is clear that there remains ambiguity about the nature and scope of stress-testing and scenario analysis and the kinds of tests that firms are required to carry out. In addition, FSA is aware that where firms did conduct stress-tests the confidence intervals used differed not only between firms but within them. FSA believes this is an area where it, in conjunction with CEBS, need to provide greater clarity for firms. The January CP marks a useful step in that direction.
34. Finally, firms are looking for more clarity on the treatment of diversification benefits. FSA has provided some clarification on this in the January CP and, informed by the work of the recently-instituted Standing Group on Pillar 2, we aim to do that in the second implementation CP.