Feedback on August 2007 consultation on implementing Pillar 2 of Basel II

Introduction

1 We wrote to locally-incorporated banks in August setting out how we proposed to implement Pillar 2 of the Basel II capital adequacy framework, which covers capital for other material risk and overall capital adequacy. There were two key elements to our proposals, which would apply to all New Zealand-incorporated banks. The first was the need for a bank to have internal processes to enable it to ensure that it has adequate capital against all material risks. The second was the requirement for a bank, as part of its total regulatory capital requirement, to hold a self-determined amount of capital against "other material risks", ie those not captured or only partially captured under Pillar 1.

2 In the feedback we received, the main concerns centred around this second element. Other comments largely sought clarification on points of detail of what the Reserve Bank expects of a bank's ICAAP (Internal Capital Adequacy Assessment Process). There were also questions about the way we intend to review banks' ICAAPs. More detail on this feedback and our responses to it are set out below.

Revised approach

3 In the light of the comments received, we have adapted our approach to Pillar 2 as follows.

4 Banks will be required to have in place an ICAAP to ensure that they have adequate capital against all material risks, and as part of that they will be expected to determine the appropriate level of capital to hold against "other material risks", ie those which are not captured by the Pillar 1 regulatory capital requirement. However, capital for other material risks will not be added to the regulatory capital requirement. We will review this approach towards the end of 2008 or early in 2009 in the light of experience with Basel II implementation.

5 The Pillar 2 framework envisages that the supervisor will impose an additional regulatory requirement if not satisfied that a bank's capital determined under Pillar 1 is adequate. The Reserve Bank has decided to impose a standard Pillar 2 capital add-on for credit risk, on banks that are accredited to use their own internal credit risk models. Such banks will be required to hold additional capital equal to 15% of the Pillar 1 capital they have modelled for the credit risk arising from residential mortgage lending. This is to reflect the current state of development of those models, and will also be subject to review. If we decide in the longer run to include a bank's own internal capital allocated to other (non-Pillar 1) material risks within its regulatory capital requirement, that would also form part of the supervisor-imposed Pillar 2 capital add-on.

6 We have consulted on proposed new disclosure requirements to reflect the introduction of Basel II, and are revising those proposals in the light of comments received. Our intention remains that banks will disclose the amount of capital they have allocated to "other material risks", together with a summary of what those risks are. But in a change from the original proposal, this disclosure will be separate from the disclosure of the summary components of the regulatory capital requirement. On the other hand, the latter will include a "supervisory add-on" component where applicable: for banks using internal models, this will include the 15% add-on for

housing, plus any additional capital needed to take the total capital requirement up to the Basel II "floor" of 90% of the Basel I capital requirement.

7 In our original Pillar 2 proposals, the requirements on New Zealand-incorporated banks to have an ICAAP in place and to determine capital for other material risks were included within the appropriate Capital Adequacy Framework document (either Standardised Approach (BS2A), or Internal Models Based Approaches (BS2B)). Consistent with the revised approach, we will now impose these requirements directly via banks' conditions of registration instead.

8 We have finalised the Handbook document "Guidelines on a Bank's Internal Capital Adequacy Assessment Process ('ICAAP')" (BS12). In doing so, we have made no changes to the substance of the guidance, but have changed the introduction to reflect the revised linkages.

Summary of feedback and RBNZ responses

Concerns about the status of Pillar 2 capital

9 As noted above, there were a number of concerns around the proposal to make banks' internal capital allocation for "other material risks" part of the regulatory requirement. These are summarised below. We believe these concerns will be largely addressed by the revised approach.

Divergence of outcomes

10 One commenter noted that the proposed treatment would penalise banks that have committed time and resources to ensure that their internal capital models have comprehensive cover of the full range of risks, and would also penalise those banks that take a more conservative approach to individual risks.

11 Another commenter raised two concerns about public perceptions. First, as banks develop their approaches to estimating capital for other risks, the numbers may be somewhat volatile, which could give a false impression of rapidly changing risk profiles. Secondly, if the Reserve Bank imposes a transitional capital floor on top of the total of Pillar 1 capital plus the capital for other risks, that might be seen as a penalty on banks that have not come up with large enough "other risk" numbers.

12 We believe that switching to a disclosure-only approach to capital for "other material risks" will mean that it no longer penalises banks that take a more conservative view of the risks. Also, the size of any regulatory over-ride will be independent of the bank's "other risk" capital allocation. There is still the likelihood of divergence between banks in the numbers disclosed, and some volatility of the numbers over time, and these will be apparent from the disclosure. But the benefit of this transparency is that it should add to the incentives for banks to improve their approaches.

Harmonisation with other regulators

13 One commenter suggested that the RBNZ should align its Pillar 2 approach more closely with those of other regulators (particularly APRA), because differences will likely result in additional complexity and cost to foreign-owned New Zealand banks.

14 We believe that our revised approach brings us closer to what other regulators are doing, which amounts to a more gradual introduction of the Pillar 2 philosophy. Other regulators are generally expecting banks to improve their ICAAPs over time, but on initial Basel II implementation they are imposing their own regulatory capital add-ons to the Pillar 1 numbers. A bank's own assessments of non-Pillar 1 capital does not translate directly into a regulatory capital number, but is taken account of by the regulator in its review of a bank's overall capital adequacy. At least some regulators have indicated that over time as they become more comfortable with Pillar 1 models and Pillar 2 approaches, they will place increasing reliance on banks' own overall capital assessments.

15 The key remaining difference in our approach is that we are still expecting banks to disclose their non-Pillar 1 capital estimates. This will subject banks' developing Pillar 2 approaches to market discipline, consistent with the particular emphasis we place on that. But our approach should now fit better with how other regulators' approaches are likely to evolve, addressing at least some of the concerns about cost and complexity.

Desire for reassurance about the number

16 On the basis that the "other material risks" figure was to have formal status, respondents suggested various ways to improve the quality and cross-bank consistency of the number. One bank suggested that there should be a requirement on banks to subject their Pillar 2 numbers to independent review, and also sought one-on-one assessments by the Reserve Bank to deal with the problem of short-term variability in the numbers. There were several other requests for greater clarity on specific aspects of ICAAPs, discussed below.

17 We believe that the revised approach by and large addresses these concerns. One pre-condition for our including banks' internal capital estimates for other material risks within regulatory capital will be that both we and the banks have become sufficiently comfortable with banks' ICAAPs and the numbers they deliver. As discussed further below, that will involve continuing dialogue between the Reserve Bank and the banks. We do not think that it is necessary to require independent review of the Pillar 2 numbers for the purpose of disclosure only, but will see in the light of experience whether it is desirable to do so if the numbers eventually become part of regulatory capital.

Only total capital, not Tier 1, for Pillar 2 risks

18 There was a suggestion that the "other material risks" capital should only be included in the total capital ratio test, not in the Tier 1 capital ratio test.

19 We note that under our revised approach, we are not including "other material risks" in either the total or the Tier 1 capital requirement.

20 However, looking ahead to a time when we might do that, the aim of this suggestion appears to be that a bank should in practice be able to meet additional capital requirements that arise from less reliable risk estimates by raising lower quality Tier 2 capital. Our response is that by the time we are comfortable with imposing a regulatory requirement for other material risks, the numbers should be of adequate quality to be given equal status with Pillar 1 requirements: "a risk is a risk", and should be covered by adequate Tier 1 capital as well as adequate total capital.

Requests for further guidance/ clarification

RBNZ review of banks' overall capital adequacy

21 One respondent asked us how we intend to review banks' approaches and outcomes to Pillar 2 overall capital adequacy. The following sets out our initial intentions.

22 We place considerable emphasis on self-discipline in our approach to Pillar 2. A bank has primary responsibility for its own ICAAP, with the RBNZ having a reactive rather than pro-active role. That is, we think that it is important that we do not micro-manage banks' approaches, and will only override the capital numbers coming out of a bank's ICAAP, and/or require improvements in its ICAAP framework, if we have material concerns about either.

23 The information we would receive as a matter of course would be that required by the disclosure – total capital held against "other material risks", what those risks are, and a summary description of the bank's ICAAP. We would also expect to discuss the approach in routine prudential meetings. We would decide on this basis whether we needed further information.

24 However, as noted earlier, we are planning to review our Pillar 2 approach in late 2008 or early 2009, including considering whether internally-assessed elements should be included in binding regulatory capital requirements. That does imply continuing dialogue between the banks and the RBNZ in the interim. We are not planning a formal accreditation process as for Pillar 1, but we will be happy to consider issues that banks raise with us.

Which confidence levels to use

25 Two banks have indicated that they are working to a 99.97% confidence level in developing their internal capital assessment. This compares to the 99.90% confidence level which underlies the Pillar 1 regulatory capital requirements. The question is thus whether a bank in this case can recalibrate its capital for other material risks to a 99.90% confidence level for the purpose of calculating regulatory capital, as it would otherwise be holding capital to a higher confidence level against "other material risks" than against Pillar 1 risks.

26 In the ICAAP guidance we say that banks should use at least the Pillar 1 confidence level in working out their Pillar 2 capital. If banks' own capital estimates become part of regulatory capital in due course, we will consider further whether we should impose any additional conditions at that point.

27 While those capital estimates are only being disclosed, transparency is the key: we are proposing some qualitative disclosure requirements concerning a bank's ICAAP, and within that we would expect a bank to say what confidence level it targets for internal capital purposes. A bank should also say whether its disclosed "material other risks" figure is recalibrated for comparability with the Pillar 1 numbers.

Inter-risk diversification

28 Some banks have indicated that they intend to take inter-risk diversification into account in their ICAAPs.

29 We are not convinced that industry-wide estimates of stressed cross-risk correlations are robust enough yet to be reflected in regulatory capital requirements. We will keep this issue under review, but at the moment, it seems quite unlikely that there will be sufficiently reliable new data to convince us that cross-risk diversification benefits can be allowed for in total regulatory capital, if and when other components of banks' internal capital estimates are included.

30 Under the disclosure-only approach, we encourage banks to take a cautious approach to any diversification offsets they estimate and disclose. As with confidence levels, transparency is key. The nature of any risk diversification offset should be covered in the summary disclosure of risk management; and if the "other material risks" number is net of a diversification benefit, that should be clearly listed as one of the components of the number.

31 We note that a bank may have an issue of presentation to handle, if it discloses capital for other material risks that is net of diversification benefit, and we later decide that those numbers should become part of regulatory capital with no allowance for diversification.

Clarification sought on some aspects of ICAAP

32 One commenter sought greater certainty on the following three aspects of an ICAAP:

(a) Planning horizon: is a 3-year horizon for capital planning long enough to meet the RBNZ's expectations?

(b) Nature of ICAAP documentation: can the RBNZ provide a format for ICAAP documentation?

(c) Parameterisation of stress scenarios: can the RBNZ provide more guidance on the appropriate levels of parameters to feed in to stress scenarios?

33 Other comments focused on the uncertainty surrounding which risks banks should allocate capital to.

34 We have not added any additional guidance on these matters in finalising the BS12 ICAAP guidelines. We note that a key principle in the guidelines is proportionality, which means that what is appropriate varies from bank to bank. However, we will be prepared to consider banks' proposed approaches and give individual feedback, for instance on whether any aspect looks far out of line. We will also keep under review the question of whether any aspects of ICAAP need more detailed guidance, in the light of experience with banks' approaches.

Other comment – Interest Rate Risk in the Banking Book (IRRBB)

35 One commenter felt that it would be better to leave banks to determine their capital allocation for IRRBB internally, rather than specifying the regulatory capital requirement for it within Pillar 1.

36 We note that IRRBB has until now been included in the measure of market risk for disclosure purposes, and that as an interim step we propose to use that same measure to set the market risk capital requirement. We are reviewing the Pillar 1 requirement for market risk over the next year, and within that review we will consider the most suitable treatment of IRRBB.