

Attachment B

Current sense of the Committee on the implementation of the supervisory review process – Pillar 2

Pillar 2 of the New Basel Accord recognises the important role that supervisors play in the maintenance of adequate bank capitalisation. Given differences in legal and regulatory structures, the Basel Committee is conscious of the need to maintain adequate flexibility in the application of Pillar 2 in different jurisdictions. As such the Committee has resisted providing extensive prescriptive guidance in this area. Instead, the Committee emphasises the need for a combination of information-sharing on supervisory practices between supervisors on the one hand and constructive dialogue between banks and supervisors on the other to help promote consistency in the implementation of Pillar 2. However, members of the Committee continue to receive comments from the industry that appear to reflect misconceptions about what Pillar 2 means, such as the view that Pillar 2 is moving toward a system of automatic capital add-ons driven less by the circumstances of each bank and more by general regulatory requirements. The Committee would like to clarify its current thinking on the following points.

The Committee's view in creating Pillar 2 was to promote and support a more rigorous process at internationally active banks to determine the actual capital held and to make this process subject to a more focused supervisory review than may have been the case. Pillar 2, both in its first principle and in the consideration of several more specific risks, makes it clear that the prime responsibility is on banks to make this assessment, taking account of their circumstances. In many cases where specific risks are identified under Pillar 2, such as interest rate risk or credit concentration risk, CP3 makes clear that the onus is on banks to take account of these risks in their own capital adequacy assessments and provides high-level guidance on aspects that banks should consider. Pillar 2 then puts the onus on supervisors to satisfy themselves as to the appropriateness of banks' approaches and the adequacy of banks' capital and to take various actions in light of any concerns that supervisors may have.

While there are linkages between Pillar 1 and 2, the Committee sees clear differences between the two. The Committee has been well aware of the distinctions in deciding to include several more specific elements in Pillar 2. Pillar 1 has always represented the minimum regulatory requirement. Pillar 2 is deliberately expressed differently. For example, Pillar 2 is not described as, and is not intended to lead to, specific additional formal across-the-board *requirements*. Pillar 2 does not require such an approach. Nor does Pillar 2 require an explicit automatic add-on for each element mentioned in the Accord. On the other hand, Pillar 2 explicitly recognises that banks face risks not included under Pillar 1 and that many banks choose to operate at capital levels well above those implied by Pillar 1 minimums. Pillar 2 thus expresses the Committee's *expectation* that internationally active banks should operate above the Pillar 1 minimum. This principle is very important to the overall Capital Accord, and Pillar 2 provides considerable flexibility as to how that is achieved.

Pillar 2 explicitly recognises that national jurisdictions may have different approaches to meet the principles set out in CP3. In some cases, for example, under the existing situation certain countries do use more formalised approaches or requirements to deal with some of the issues covered by Pillar 2. The Committee expects that this will continue and explicitly recognises that it is always open to a country to impose formal requirements that are higher than the Basel minimum. What matters in meeting Pillar 2 is that information on these different approaches is shared among supervisors in order to promote consistency in application of the Accord, which is the mandate of the AIG. In fact, in this respect, the introduction of Pillar 2 has set in motion a process that will result in a better understanding of those differences. It will also promote greater exchange of information and cooperation among supervisors and more convergence of supervisory practices. But the Committee does not expect there to be perfect uniformity of approaches or results across national jurisdictions.

The Committee also notes that the need for reasonable flexibility in dealing with certain risks was precisely the reason they were included in Pillar 2 and not in Pillar 1. Thus, the Committee does not believe that reintegrating these into other parts of the framework, as some respondents suggest, would be wise at this stage.

On the particular issue of cross-border implementation of Pillar 2, the Committee's high-level principles for the cross-border implementation of the New Accord, published in August 2003, will apply. In general, the implementation of the New Accord is not a reason to change the legal responsibilities of national supervisors for the regulation of their domestic institutions or the arrangements for consolidated supervision already put in place by the Basel Committee. Nevertheless, the cross-border responsibilities for Pillar 2 assessment are a clear example of an area that should be worked out on a bilateral, collaborative basis between home and host supervisors, as the principles indicate.

Finally, there is a range of practical issues regarding how Pillar 2 will operate. The AIG has devoted considerable focus to these issues, and this will continue, particularly as approaches in national implementation become more clearly defined. The Committee will continue to conduct regular reviews of similarities and differences in approaches to identify particular issues that may need to be addressed, and it will welcome further dialogue on these matters with the industry, fellow supervisors and other interested parties.