Solvency II: Lessons from Basel II and the Banking Sector Experience

FINANCIAL REGULATOR
Rialtóir Airgeadais

Presenter:
Andrew Mawdsley

Key Themes

1. Basel II – A Short History
2. Solvency II vs. Basel II
3. Lessons for Policy Development
4. Lessons for Implementation

Basel 2: Why the Need for Change?

- Other than market risk amendment, the Basel I framework was unchanged for 18 years…
- Underlying simplicity increasingly a source of weakness:
  - Lack of risk sensitivity
  - Fostered regulatory arbitrage and gaming
  - ‘One-size fits all’
  - No explicit charge for risks other than market and credit risk
  - A bank’s risk asset ratio has become a less reliable barometer of its capital adequacy

Basel 2: Aims and Ambitions

- The two stated aims are:
  - Increased risk sensitivity
  - To provide incentives for better risk management

- The aim is not:
  - To reduce capital but to keep capital in the system more or less the same

Overview of the new proposals

Pillar 1 – Minimum Capital Requirements

- Menu approach
- Increase scope
- Minimal changes to capital definition

Pillar 2 – Supervisory Review

- ICAAP
- SREP
- Capital add-on
- Not just about capital though – risk management/governance

Pillar 3 – Disclosure & Market Discipline

The Process of Change

Basel Committee

- Review began in 1998
- ‘Final’ Accord in June 2004
- Subsequent review of trading book rules

EU

- Implement in line with Basel Committee
- Draft Directive text in July 2004
- Phased implementation 2007/2008

Process of Change – Consultation

EU Commission

- 3 Consultation Papers
- QIS (later exercises done by CEBS)

CEBS

- 15 Consultation Papers
- 14 Guidance Papers

Irish Participation

- Irish banks both individually and through the IBF commented on the consultation papers
- Extensive participation in QIS

From the Directive to Implementation

- Transposition into national law
- Over 100 national discretions in the Directive and calls on these have been made
- Processes have had to be built to deal with the more advanced Pillar 1 approaches and Pillar 2 (ICAAP)
- So, left unfettered, there is potential for significant divergence in implementation

…But we are not implementing in a vacuum

The Committee of European Banking Supervisors (CEBS)

- Established November 2003
- The key push is for convergent implementation, in terms of both policy and process

Our Approach to Implementation

- Starting point is the Directive.
- We have adopted a ‘copy-out’ approach to transposition
- We have adopted the guidance of CEBS
- Beyond that, we will be principles-based
- Emphasis on firms to satisfy themselves that they meet the minimum requirements
- Self-certification is a key part of Pillar 1 and Pillar 2 (ICAAP) approval process

Our approach to implementation

- CRD Implementation Forum established in July 2005
- Four sub-groups established to progress key issues:
  - Pillar 1 Model Validation
  - Pillar 2 (ICAAP)
  - Supervisory Reporting
  - Technology Group

Model Validation and Authorisation

- Process set down by Financial Regulator
- Formal Application Pack
- Firm carries out validation that is scrutinised by the Financial Regulator
- Authorisation based on examination of:
  - Risk management
  - Use test
  - Experience test
  - Model Development and Internal Validation Process
  - Use of Conservatism
  - Self assessment

SREP

- Detailed process
- ICAAP Submission Portal
- Covers all risks
- Review draws together a wide range of information sources
- Outcome is supervisory programme and/or measures

ICAAP and SREP

- Supervisory Review Process
  - Capital adequacy assessment
  - Supervisory review/evaluation of internal capital adequacy assessments and strategies
  - Expectation that firms operate above minimum capital and capital add-ons
  - Early, pre-emptive supervisory action
- Internal Governance
- ICAAP – Company responsibility
- SREP – Challenge process

Implementation Challenges for Firms

Technical

- Validation
- Data integrity
- Project management
- Developing capital assessment framework

Organisational

- Senior management buy-in/governance
- Demonstrable use
- Converting Basel from a Risk Project to Enterprise-wide business as usual
- Skills and resources

Regulatory

- Convincing the Regulator that any reduction in regulatory capital is warranted

Key Challenges for Regulators

- Skills and resources
- Dealing with the spike in applications
- For some, significant business process re-engineering
- Increased scrutiny from firms and other regulators in terms of supervisory approach
- Overall capital

Lessons for Policy Development

- Do not underestimate the complexity of the project
- Industry engagement is vital for effective policy development
- Influence can only be exercised if industry views are expressed clearly in response to consultations and in expression of the industry position to the Financial Regulator and the Department of Finance
- QIS is crucial to the proper calibration of the new framework – wider participation gives more representative results
- The Financial Regulator needs to be clear with industry on its position – this is a key element of our consultative approach

Lessons for Implementation

- This is a large, long-term project that must be carefully managed
- Synergies can be captured but care has to be taken not to be overambitious
- Any new system needs to be robustly challenged and have the input of practitioners – user buy-in
- Early commencement of project is required to achieve early move to the new framework
- Understand the Use/Experience Tests – this is not just about capital
- Data can be a real problem

Thank you

FINANCIAL REGULATOR
Rialtóir Airgeadais