

# Pillar 2 of Basel II

## Regulatory, Conceptual and Implementation Issues



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Last month, the RBI released guidelines on the Supervisory Review Process under the New Capital Adequacy Framework (Pillar 2 of Basel II). IBA and Finsight organised a half-day briefing session jointly with Aptivaa Consulting and Algorithmics to enable Indian banks to appreciate regulatory, conceptual and implementing issues in Pillar 2 compliance. The briefing was held on April 17, 2008 at Hotel InterContinental, Mumbai.

Welcoming the delegates, Shirish Pathak, president, Finsight underscored the need for internal capital adequacy assessment process (ICAAP) by banks in the light of RBI guidelines on Pillar 2. The keynote address was delivered by Dr D M Nachane, director, Indira Gandhi Institute of Development and Research (IGIDR). Covering the entire gamut of issues that confront Indian banking industry in Basel II implementation, Dr Nachane informed that a request by banks in India to postpone the compliance deadline by another year is under active consideration of the RBI and its decision is expected shortly.

Dr Surendra Barsode, senior principal, Aptivaa Consulting, delivered a talk on 'RBI Guidelines on Pillar II Compliance'. Dr Barsode spoke in detail on how to approach each element of ICAAP, providing a glimpse of the actual ICAAP report that Aptivaa had prepared for a UAE-based bank. He also explained the methodology for assessing capital charge for non-financial risks such as reputation risk and strategic risk. Both Dr Nachane and Dr Barsode agreed that good corporate governance is the foundation for efficient risk management.

Dr Savita Verma, head, economic capital practice,

Algorithmics, who had flown in from Canada especially for this seminar; held the audience spellbound for the next hour during her presentation on 'Portfolio Credit Risk Modelling for Pillar 2'. Outlining the progression from stylised capital model of internal ratings based (IRB) approach under Pillar 1 for credit risk characterised by assumptions of infinitely granular portfolio, single credit driver, 'hardwired' correlations, and default/no-default two-state model; to more realistic economic capital model characterised by migration matrix, name and sector concentrations, actual correlations and multiple credit drivers; she presented a five-step framework leading to unconditional portfolio loss distribution. Answering questions from the audience, she also explained the methodology of aggregating credit, market and operational risks.

A panel consisting of Dr M K Datar, general manager, risk management, IDBI Bank; Benjamin Frank, senior vice president, wholesale credit and market risk, HDFC Bank; and Chandrashekar Shekar, assistant general manager, ICICI Bank; was joined by Dr Verma and Dr Barsode to discuss implementation issues of Pillar 2. Hari Misra, editor-in-chief, Finsight moderated the discussion. The panel unanimously agreed that ICAAP is just a methodology while enterprise resource management (ERM) is a larger concept involving risk-return trade-off. That implementation will not be without accompanying pain, especially because the measurement is data-intensive, was another point of agreement. The timeframe for implementation was estimated to be 3 to 5 years, and everyone agreed upon the need for regulation of the entire financial sector to avoid crisis like subprime. Rema Menon, senior vice president of IBA proposed a vote of thanks.