

Building Supervisory Pillar 2 under GRAPE using Simplicity, Comparability and Risk Sensitivity Principles

Otar Nadaraia*

Deputy Governor of the National Bank of Georgia

Basel Consultative Group meeting
Abu Dhabi, January 2016

Special thanks to Otar Gorgodze and Teona Kontridze for drafting this presentation and Clive Briault for his useful comments and suggestions

Outline

- Overview of the process of integrating supervisory stress tests with Pillar 2 framework
- NBG approach
 - Pillar 2 under GRAPE
 - Supervisory stress tests
 - Benefits of integrating supervisory stress tests with Pillar 2 framework
 - An example of concentration add-on in Pillar 2
 - Simplicity, Comparability and Risk Sensitivity principles under Pillar 2
 - Post-stress capital requirements
 - Addressing capital planning uncertainty for the industry during the transition period
 - Current status and action plan

Supervisory stress tests and SREP framework under Pillar 2

- Traditional supervisory frameworks always contain reference to the systemic risks. In practice, it is difficult to implement
 - E.g. CAMEL includes assessment of economic environment
- US approach - annual stress tests and supervisory scenarios are conducted by Federal Reserve to determine additional capital charges
- EU approach - a comprehensive review of the ICAAP/ILAAP is performed as part of the SREP. Throughout the SSM supervisory stress tests are used to require additional capital buffer
- UK approach - The SREP consists of Individual Capital Guidance (ICG) and the PRA buffer, taking into account all relevant stress tests and sensitivity analysis
- In some cases it is divided between Micro and macro Pillar 2, Pillar A and Pillar B
- Integration of the outcomes of stress tests and SREP still remains a challenge for many NCAs (national competent authorities)
- More explicit approach incorporating Simplicity, Comparability and Risk Sensitivity principles to determine capital charges under pillar 2 would be beneficial

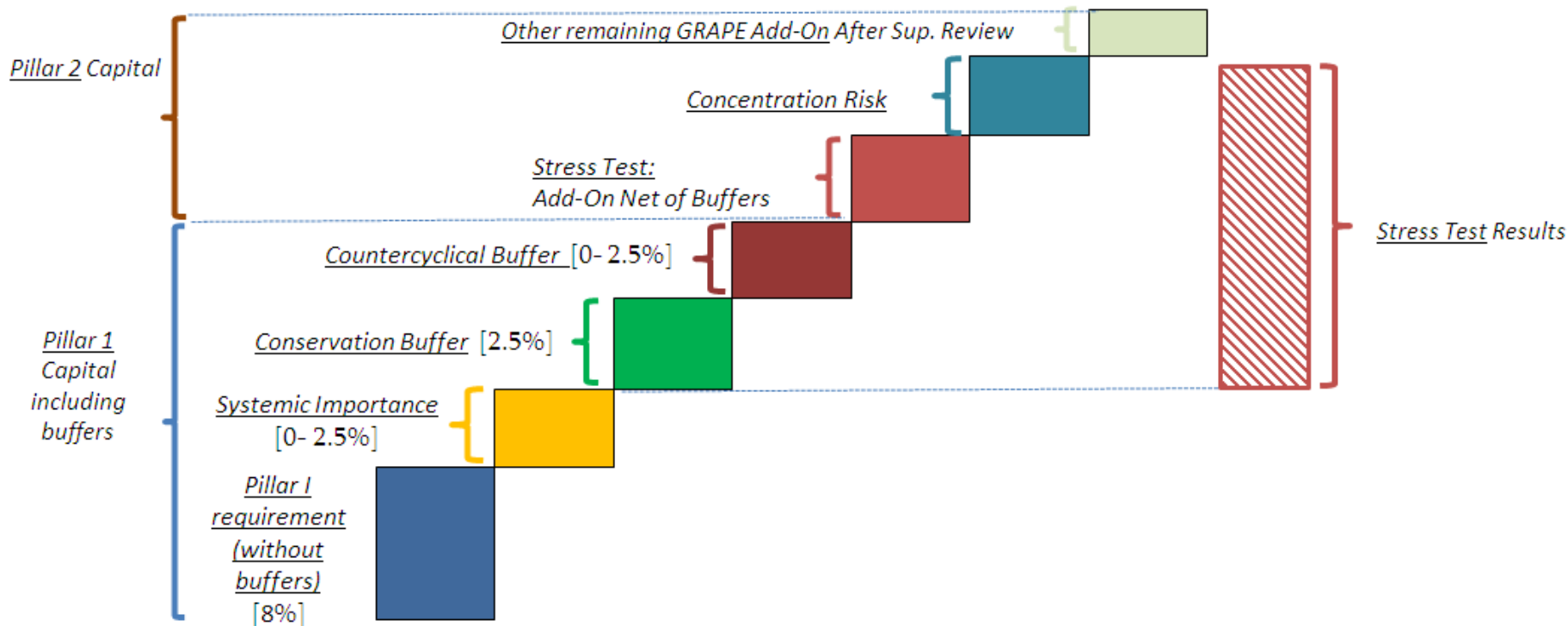
NBG approach - Detailed break down of Pillar 2 under GRAPE

Pillars of Pillar 2:

- Concentration buffer
- Stress-test buffer
- Countercyclical buffer (non-duplicative)
- Other remaining add-ons from GRAPE (General Risk Assessment Program) e.g. corporate governance

Integration stress tests with Pillar 2 framework – an illustrative example*

5



It should be mentioned, that NCAs have different approaches on how Pillar 2 capital add-ons interact with buffers under the Pillar 1 framework

**In this illustrative example FX risk weights are not added. Due to this and other reasons existing Basel I and Basel II/III Pillar 1 requirements are much higher and therefore, Pillar 2 add-ons will not necessarily result in higher capital requirements.*

NBG approach – Regulatory enterprise-wide stress tests

6

- NBG macroprudential risk team designs and regularly updates countercyclical time varying scenarios, taking into account
 - stages of credit cycle (like credit/GDP gap)
 - other systemic risk developments or sector specific imbalances
 - E.g. if oversupply in hotel industry is expected, higher sales drop in hospitality industry is assumed during the scenario design)
- Additional idiosyncratic scenarios might be added by a bank supervisor in case the bank has exposure to additional significant risk factors
 - E.g. downgrade of the rating of a parent bank or concentration on a specific segment
- Enterprise-wide stress tests are micro-based, do not require high quality historical data, and are focused on debt capacity ratios:
 - For large corporates stress is performed on an individual level
 - For granular portfolio statistical sampling methods are used

NBG approach - Integration of supervisory stress tests with Pillar 2

- Stress tests are designed to be used for pillar 2 add-ons
- Add-on is effective if it is greater than Countercyclical + Conservation buffer of Basel III
- In many regards this approach avoids confusion between Micro and Macro Pillar 2 add-ons
- The double requirement of capital for similar risks is also avoided
- Macro scenario is important as bank resolution is always more difficult during systemic imbalances
- Proactive regulatory approach in terms of understanding systemic as well as bank specific inherent risk is also required

NBG Pillar 2 Approach – example of determining capital charges for credit concentration risk

- Name concentration buffer
 - Quantitative risk assessment – HHI
 - Qualitative risk assessment
- Sectoral concentration buffer
 - Quantitative risk assessment – HHI
 - Qualitative risk assessment
- The double requirement of capital must be avoided
 - If a specific factor is already adequately addressed in stress-tests, the buffer, determined within the concentration framework, is no longer required for it. E.g. concentration on cyclical sector is already part of stress tests
 - Banks with sound credit management and ICAAP models have an opportunity to affect pillar 2 add-ons

Simplicity, Comparability and Risk Sensitivity principles under Pillar 2

- **Simplicity**

- Many add-ons have simple calculation rules
- Stress test uses straightforward framework which employs standard financial analysis techniques (with more emphasis on financial ratios for credit risk), which are relatively easily understandable for ordinary supervisors
- Statistical toolkit uses only fundamental tools like stratifying sampling, which is more robust towards model risk

- **Comparability**

- Regulatory stress tests are highly prescriptive and all banks have to use the same models

- **Risk Sensitivity**

- Comprehensive coverage of the risks under enterprise-wide stress test
- Countercyclical scenario
- Use of debt capacity ratios in the stress-tests makes Pillar 2 add-on more risk sensitive and forward looking
- Idiosyncratic scenarios can be added to reflect some specific material risk-exposures of the bank
- Banks have incentives to develop sound risk management and ICAAP models to affect pillar 2 add-ons

What should be post-stress capital requirements?

10

- Normally, severity of the stress scenario and resulting capital requirements are expected to be reduced
- However, it largely depends on the severity of the realized stress and economic environment. E.g. constrains on access to capital should be taken into account (this should have at least some weight)

Addressing capital planning uncertainty for the industry during the transition period

11

- Current capital requirement in Georgia is largely conservative
- During transition period, part of this buffer will be transferred to Pillar 2
 - Overall, capital requirements should not be substantially increased for the industry
 - However, its reallocation will be more risk sensitive
 - There is already practice of using countercyclical and risk-based requirements under existing framework
- To further ease capital planning during transition period these changes are actively discussed with banks in advance

Current status and action plan

12

- What we have done
 - Pillar 2 instruction discussed with banks
 - Calibration process of regulatory micro-based stress tests
 - The Instruction on Determining Capital Buffer for Credit Concentration Risk has been approved
 - Developed Guidelines on Domestic Systemically Important Banks (D-SIB)
- Action plan
 - Continue on-going QISs and calibration of Pillar 2
 - Implementation of D-SIB
 - Develop guidelines on the rest of GRAPE
 - Conduct stock-taking exercise according to GRAPE
 - Full Implementation of Pillar 2

**Thank you
for your attention!**

Otar.Nadaraia@nbg.gov.ge