

# **Basel II-Pillar 2: Towards Fostering an Enterprise-Wide Risk Management Culture**

## **Abstract**

The current financial crisis has been attributed to multiple causes, the most critical one being laxity in adherence to risk management principles, processes, and practices. Some of the sophisticated risk management practices and framework in banks were more on paper than in practice.

The Basel II Capital Accord lays emphasis on use testing to ensure that all the sophisticated internal models and systems are embedded into Business As Usual (BAU) processes. It is in this context that Pillar 2 has assumed increased significance and relevance. Through Pillar 2 implementation, banks have a strategic opportunity to go beyond the mirage of compliance to establish a robust risk, capital, and performance management setup. Pillar 2 is an essential step towards fostering an enterprise-wide risk management culture in the bank.

This paper highlights the importance of Pillar 2 in the current financial turbulence context and summarizes the possible modifications that the regulators are considering adopting. It also suggests a suitable implementation methodology for banks to embrace Pillar 2 in their journey towards risk sophistication.

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## 1. Introduction

Pillar 2 is the core and essence of Basel II Capital Accord. Pillar 2 gives sufficient flexibility for banks in addressing capital requirements in alignment with the bank's size, profile, portfolio complexity etc.

It introduces the qualitative dimensions of risk management besides the holistic coverage of the underlying risks. It brings a unique opportunity to strengthen risk, capital, and performance management setup across banks. Through a robust Pillar 2 implementation, banks can embed the best of the risk management practices and leverage them for effective business management and strategic decision making.

### 1.1 Background

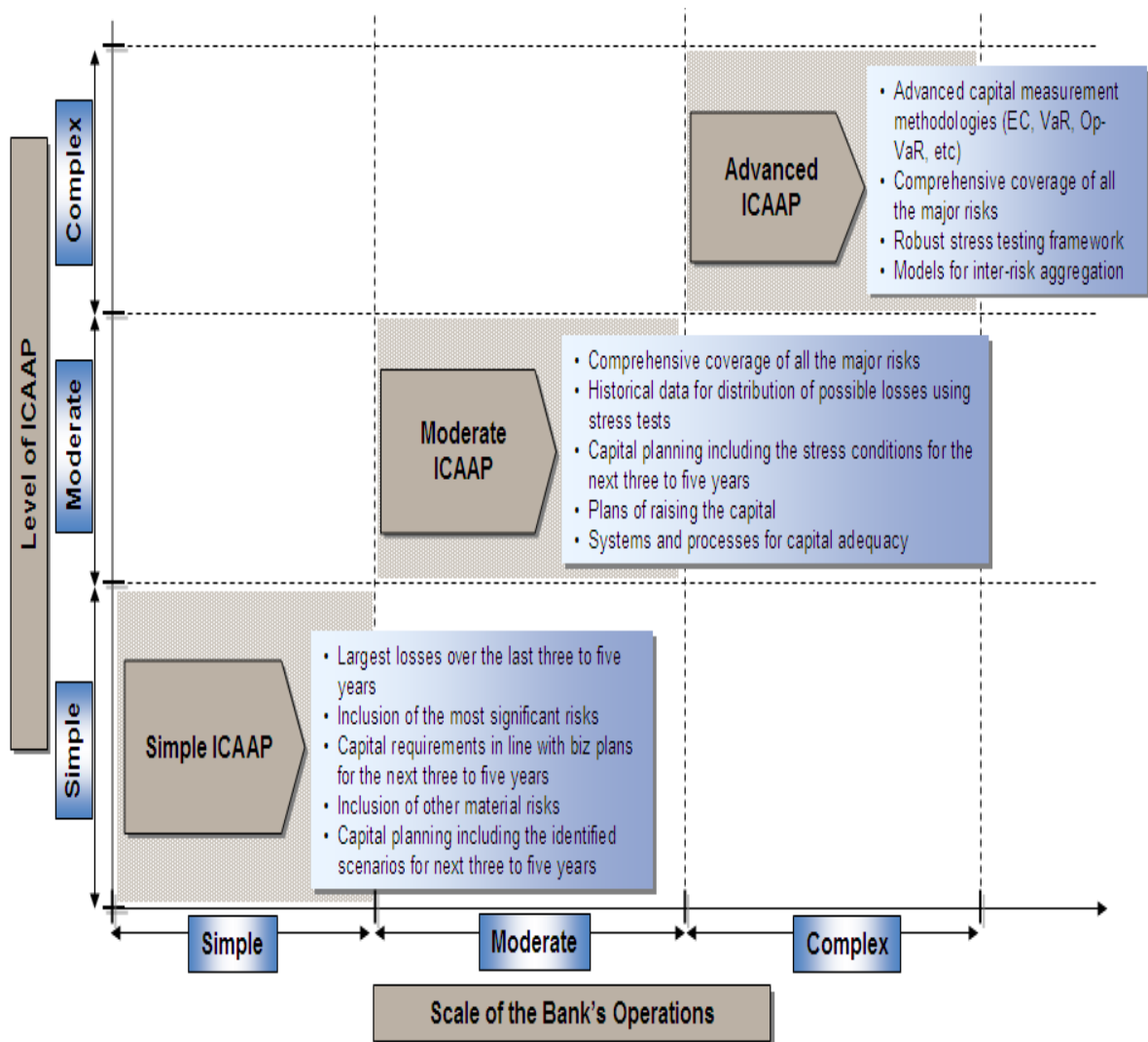
The Basel II Capital Accord, which was introduced in 2004, is based on a three pillar structure:

- Pillar 1 deals with the minimum capital requirements
- Pillar 2 deals with the internal capital requirements and supervisory review process
- Pillar 3 deals with market disclosures and discipline

Pillar 2 has the following components:

- Internal Capital Adequacy Assessment Process (ICAAP)– Guidelines for banks to address the internal capital requirements
- Supervisory Review and Evaluation Process (SREP) – Guidelines for supervisors to review and assess the capital adequacy in banks

Banks globally are in various stages of Pillar 2 implementation. Regulators have customized Pillar 2 adoption primarily based on the banks' scale of operations. The following figure gives a summarized view of ICAAP adoption maturity ladder:



**Figure 1 - ICAAP Maturity Ladder**

Banks in the advanced stage of the maturity ladder look to leverage Pillar 2 framework to further enhance risk management practices and to ensure a strong risk culture across the enterprise.

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## 2. Regulatory Response to Financial Crisis

The credit crisis has highlighted some specific challenges in how organisations identify, measure, report, manage, and control risk.

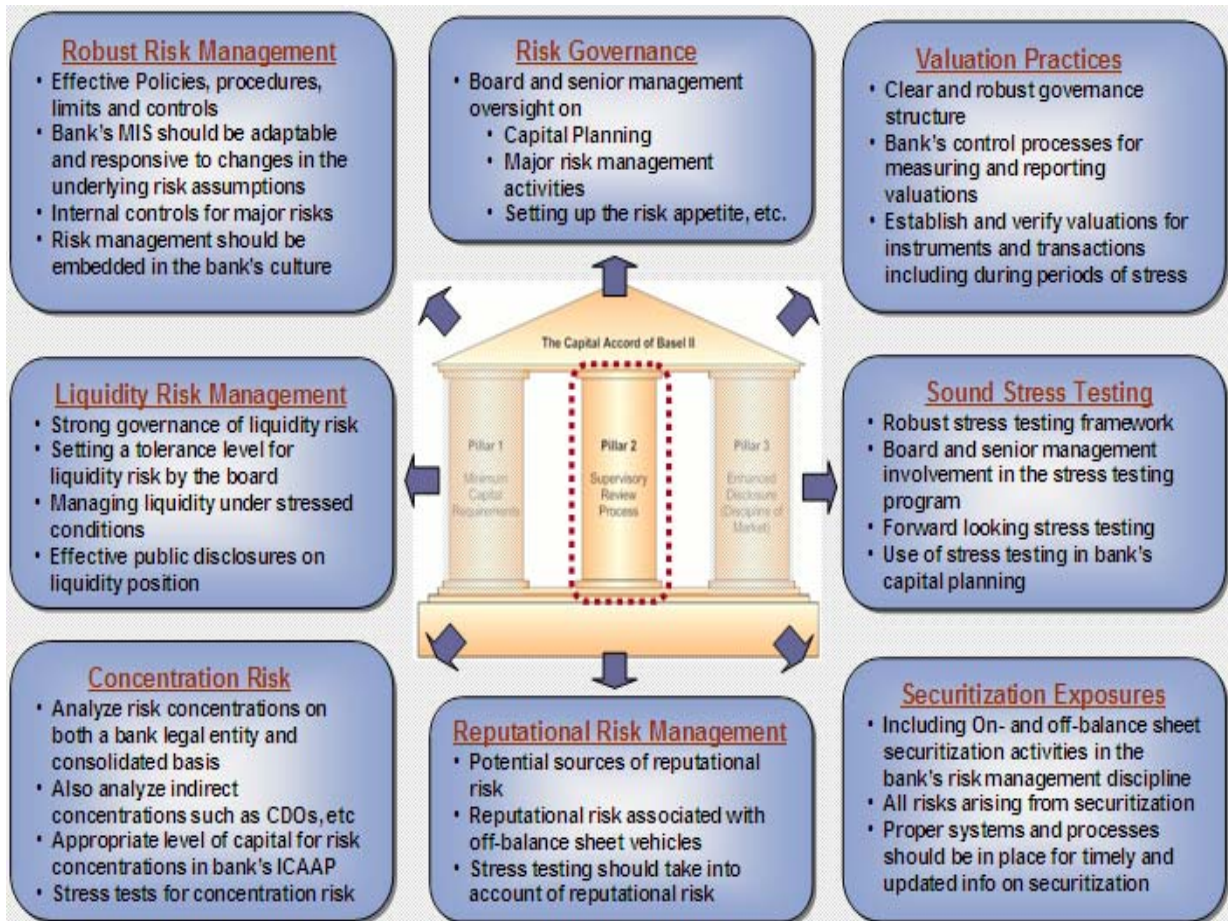
Poor management of liquidity risk, concentration risk, and reputation risk, compounded by a weak stress testing framework, have wrecked the market equilibrium, making them collectively the major causes of the current market turbulence. Post crisis, banks and regulators have been working on a range of measures and regulations to mitigate and avert any future crisis and instill confidence in the market.

The following table provides highlights of the recent regulatory initiatives:

**Table1 - Recent Regulatory Initiatives**

<ul style="list-style-type: none"><li>▪ Basel Committee of Banking Supervision (BCBS) has recently released the following guidelines in the form of consultative documents:<ul style="list-style-type: none"><li>▪ Principles for sound stress testing</li><li>▪ Principles for sound liquidity risk management and supervision</li><li>▪ Range of practices and issues in economic capital modeling and framework</li><li>▪ Proposed enhancements and revisions to Basel II framework</li></ul></li><li>▪ Financial Services Authority (FSA) has released consultative guidelines on liquidity risk management for banks to effectively manage liquidity risk. The recently released 'Turner Review Report' on financial crisis emphasized the key areas of Pillar 2 such as:<ul style="list-style-type: none"><li>▪ Risk management and governance in the banks</li><li>▪ Effective risk-based supervision</li><li>▪ Liquidity regulation and supervision</li><li>▪ Risk-based compensation</li><li>▪ Counter-cyclical capital buffers</li></ul></li><li>▪ Risk regulation has been one of the key focus areas in the recent G20 countries meeting. It was recommended that the Basel committee be expanded to include other countries like India, Australia, China, Brazil, Korea, Mexico, and Russia.</li><li>▪ Reserve Bank of India (RBI) had recently released the ICAAP guidelines for banks operating in India and has recommended a format for submission of ICAAP.</li></ul>
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BCBS had recently released consultative document on proposed Pillar 2 changes covering risk governance, stress testing framework, reputation risk management, liquidity risk management etc. In the figure 2 below, a high level overview of BCBS proposed Pillar 2 changes are depicted.



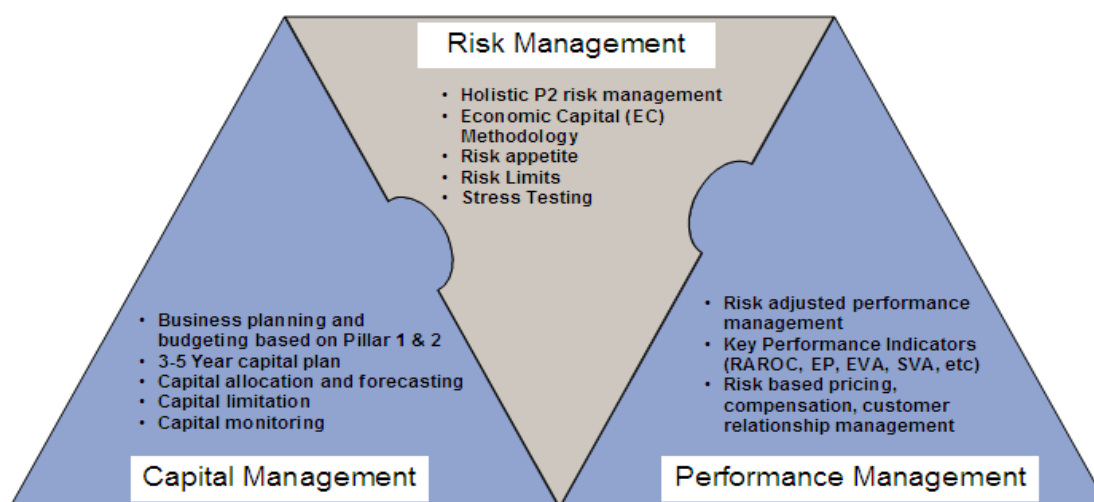
**Figure 2 - A Snapshot of Basel II-Pillar 2 Revisions**

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### 3. Pillar 2 Building Blocks

Capital and Performance need to be tightly coupled with risk management and not seen in silos. It is imperative for banks to assess risk-based capital for entire gamut of risks and effectively manage the capital through adequate planning, allocation, and monitoring mechanisms. With a greater emphasis from regulators on embedding the risk management practices with banks' business strategy and decision making processes, integrated risk-capital-performance will be a key enabler.

Banks have to address the following three key building blocks of Pillar 2 to embed the best practices in risk management. Establishing these three building blocks helps banks derive the actual benefits from Basel II implementation.



**Figure 3 - Pillar 2 Building Blocks**

Banks should adopt a gradual and integrated approach towards establishing a sound Pillar 2 framework in order to leverage the accruing multitude of benefits while addressing the numerous challenges associated with Pillar 2 implementation.

#### 3.1 Key Benefits of Pillar 2 Implementation

- Pillar 2 offers enhanced governance and greater transparency in risk-related processes, enabling the board and senior management to effectively promote the risk management culture across the bank.
- Pillar 2 provides a holistic view of the underlying risks that a bank has, thereby promoting effective management of the identified risks.
- In addition to helping banks complying with the regulatory requirements, successful implementation of Pillar 2 - ICAAP also enhances banks' reputation and improves investor confidence.
- A robust stress testing framework will foster financial confidence and provide a greater cushion to withstand stressful economic conditions.

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- Pillar 2 lays the initial foundations for enterprise-wide risk management by tightly coupling risk management with capital and performance management, allowing effective management of the risk-return trade-off.
  - Increased risk management awareness and exemplary risk management practices can play a positive role in improving the credit ratings of banks. The credit rating agencies (CRAs) have started considering enterprise-wide risk management as a key factor in deciding a bank's credit ratings.

### 3.2 Pillar 2 Implementation Challenges

- In the case of multi-national banks, there are challenges with respect to home/host implementation due to various local regulatory guidelines and timelines on ICAAP.
- ICAAP implementation is a people-intensive exercise with several defined processes and controls spanning various departments of the bank. It is a challenge for the banks to delineate roles and responsibilities and make them ICAAP functional.
- Data availability, granularity, and data quality is a critical challenge for performing stress testing. Banks have to embed the stress test results in their risk-based capital management framework.
- Pillar 2 guidelines are still evolving and there is a greater need for banks to align their ICAAPs with globally adopted best practices for economic/internal capital methodologies.
- Auditing, departmental trainings, and final regulatory submission activities have to be effectively managed as they spread across various divisions of the bank, requiring active involvement and accountability from each division.
- Implementation also brings challenges with respect to the granular measurement of Internal Capital (IC) for effective risk-based capital and performance management. Data management and systems integration is the key to addressing this challenge.
- Statistical modeling presents challenges for advanced ICAAP implementation – EC modeling, advanced liquidity risk modeling, advanced IRRBB methodologies, simulation of qualitative risks and their impact assessment on other risks, scenario-based stress testing, etc.

## 4. Approach to Basel II-Pillar 2 Implementation

Pillar 2 implementation is not merely a tick-in-the-box compliance exercise. An appropriate framework has to be established to derive the strategic benefits listed above by embedding the best practices of risk management in business processes and decision-making activities.

The following figure gives a step-by-step approach to set up a robust Pillar 2 framework.

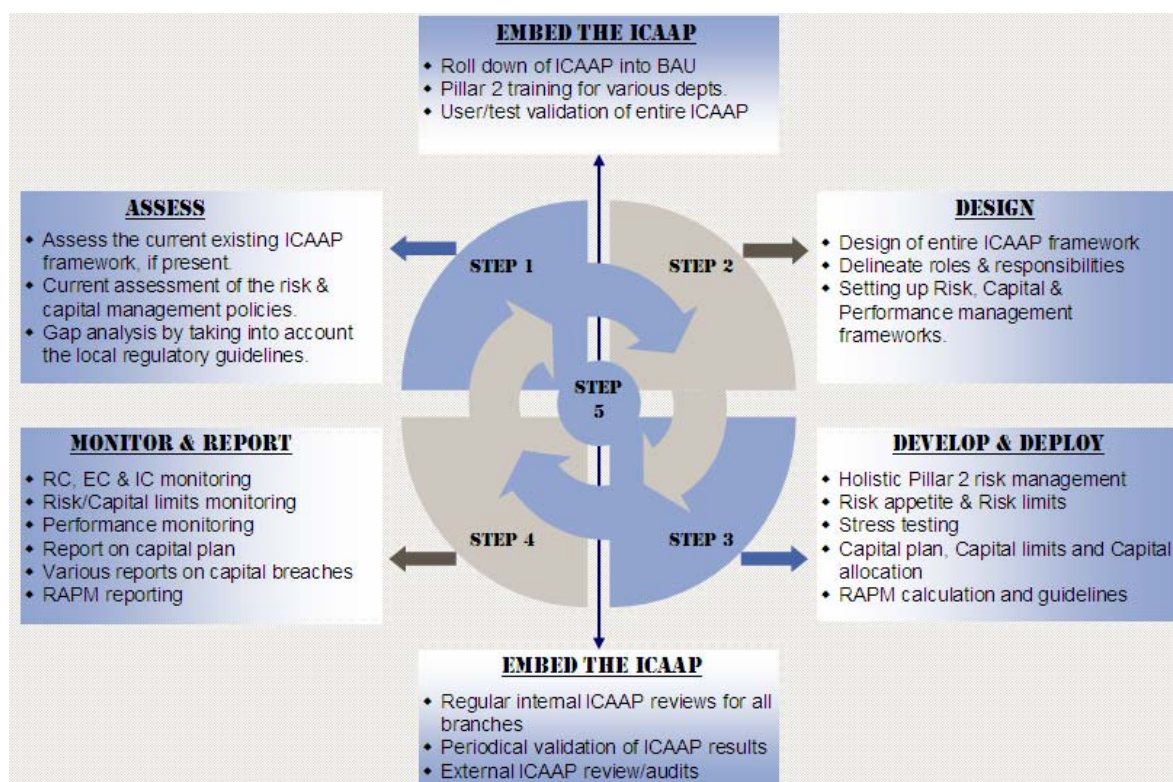


Figure 4 - Pillar2 Implementation Methodology Overview

### 4.1 Step 1: Current State Assessment

This step consists of current state assessment and gap analysis with respect to the regulatory guidelines and global best practices.

Table 2 - Current Assessment

Step	Details
<b>Step 1: Current State Assessment and Gap Analysis</b>	<ul style="list-style-type: none"> <li>• Document and assess the bank's existing risk management framework and governance</li> <li>• Assess current state of risk and capital management policies and procedures</li> <li>• Understand the specific local regulatory guidelines on Pillar 2 – ICAAP (if any)</li> <li>• Analyze the gap between existing and future framework</li> <li>• Set up an implementation roadmap and requirements for ICAAP through a well-defined project plan</li> </ul>

## 4.2 Step 2: Holistic Design of ICAAP

A holistic design of ICAAP framework with a robust governance structure and delineation of roles and responsibilities must be established in the second step.

Table 3 - ICAAP Design

Step	Details
<b>Step 2: Holistic Design of ICAAP Framework</b>	<ul style="list-style-type: none"><li>• Design a ICAAP governance framework</li><li>• Delineate roles and responsibilities</li><li>• Set up a Pillar 2 risk management framework</li><li>• Set up a risk-based capital management framework</li><li>• Set up a risk-adjusted performance management framework</li></ul>

## 4.3 Step 3: Development and Deployment of Key ICAAP Elements

Various key elements that fall under risk, capital, and performance management must be developed and deployed as a part of this important step.

Table 4 - Development and Deployment

Step	Details
<b>Step 3: Development and Deployment of Key ICAAP Elements</b>	<ul style="list-style-type: none"><li>• Establish a bank-wide risk appetite in both qualitative and quantitative terms</li><li>• Develop holistic Pillar 2 risk management (inclusive of both quantitative and qualitative risks)</li><li>• Establish a sound stress testing framework</li><li>• Prepare a projected three-five year risk-based capital plan</li><li>• Set up the guidelines and procedures for allocating the Internal Capital (IC) and managing the capital limits</li><li>• Establish the Risk Adjusted Performance Management (RAPM) guidelines and indicators</li></ul>

## 4.4 Step 4: Monitoring and Reporting

Monitoring and reporting of various ICAAP processes in the form of internal reporting and senior management dashboards should be dealt with in the fourth step.

Table 5 - Monitoring and Reporting

Step	Details
<b>Step 4: Monitoring and Reporting</b>	<ul style="list-style-type: none"><li>• Set up regular monitoring of Economic Capital (EC), Internal Capital (IC), and Regulatory Capital (RC)</li><li>• Establish the risk/capital limit monitoring setup</li><li>• Set up the risk-based performance monitoring</li><li>• Establish yearly reporting on the risk-based capital plan and regular reporting on RAPM</li><li>• Prepare regular reporting in case of breach of capital limits</li></ul>

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## 4.5 Step 5: Embedding into Business as Usual

The final step should address embedding the ICAAP processes into business as usual so that regular monitoring and reviewing processes are in place for effective decision making.

**Table 6 - Embed the ICAAP**

<b>Step</b>	<b>Details</b>
<b>Step 5: Embedding into BAU</b>	<ul style="list-style-type: none"><li>• Engage L&amp;D team to impart Pillar 2 training</li><li>• Roll-down the complete ICAAP processes seamlessly into business as usual</li><li>• Establish regular internal reviews/audits</li><li>• Perform external reviews/audits and incorporate subsequent updates to Pillar 2-ICAAP</li><li>• Validate the ICAAP results</li><li>• Prepare regular ICAAP submissions to various committees (Risk Committees, ALCO, Performance Committee, Audit Committee, etc.), Board of Directors, and individual geography regulators</li></ul>

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## 5. Conclusion

Regulators, Governments and Banks are exploring multiple measures to restore financial stability. Proactive and efficient risk management is the key towards fulfilling this objective. Pillar 2 will occupy center stage, as it requires banks to develop sound risk management processes that will help identify, measure, aggregate, monitor, and control risks.

The rating agencies like S&P have released guidelines where the rating methodology includes the banks' enterprise-wide risk management sophistication. It is imperative that banks attach more importance to Pillar 2 implementation to lay a strong foundation on which layers of sophistication can be built.

Pillar 2 – ICAAP is like a CMM level maturity for banks to continuously improve their risk, capital, and performance management processes. This continuous improvement process is the key for the banks in establishing globally adopted best practices and bringing about a paradigm shift in the enterprise-wide risk culture.

Pillar 2 in the future will focus more on reputation risk, strategic risk, liquidity risk, residual risk and hitherto less visited aspects of other risks. Banks will have to ensure ICAAP incorporates a forward-looking approach for proactive capital and performance management that is aligned with banks' risk profile.

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## 6. Glossary of Terms

ALCO	Asset Liability Committee
BAU	Business As Usual
BCBS	Basel Committee for Banking Supervision
CEBS	Committee of European Banking Supervision
CMM	Capability Maturity Model
CRA	Credit Rating Agency
EC	Economic Capital
EP	Economic Profit
EVA	Economic Value Added
FSA	Financial Services Authority
IC	Internal Capital
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IRRBB	Interest Rate Risk in the Banking Book
L&D	Learning and Development
LR	Liquidity Risk
P2	Pillar 2
RAPM	Risk Adjusted Performance Management
RAR	Risk Adjusted Return
RAROC	Risk Adjusted Return on Capital
RBI	Reserve Bank of India
RC	Regulatory Capital
S&P	Standard and Poor's
SREP	Supervisory Review and Evaluation Process
SVA	Shareholder Value Added

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## 7. References

- January 2009 - Basel Committee on Banking Supervision (BCBS) proposed revisions and enhancements to the Basel II Framework.
- “Application of the supervisory review process under Pillar 2” by Committee of European Banking Supervisors (CEBS).
- March 2008 - “Supervisory Review Process under the New Capital Adequacy Framework - Guidelines for Pillar 2” by Reserve Bank of India (RBI).
- “BIPRU 2.2 Internal capital adequacy standards” by Financial Services Authority (FSA) of UK.
- FSA’s – “The Turner Review - A regulatory response to the global banking crisis”, March 2009

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