Basel II, Pillar 2 (ICAAP) Pre-Implementation Analysis

Abstract

Pillar 2 of the Basel II Accord requires banks to implement an Internal Capital Adequacy Assessment Process (ICAAP). The client engaged Avantage Reply to provide a diagnostic and gap analysis necessary to prepare and plan for the ICAAP methodology, based on existing internal capital and risk management processes currently in place. Avantage Reply provided its findings to the client's executive committee and group risk function, presenting the client with options and a roadmap for completing an appropriate ICAAP.

THE CLIENT

The client is the Luxembourg subsidiary of an international bank with European roots. The primary focus of the client is private banking and corporate lending.

THE CHALLENGE

Pillar 2 of the Basel II Accord requires banks to implement an Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP is designed to ensure banks assess all risks to which they are or could be exposed; maintain sufficient capital to face these risks; and develop and better use risk management techniques in monitoring and managing these risks. It also allows a bank to fully realise the benefits of sound risk management techniques.

The initial challenge was to provide the client with a diagnostic and gap analysis necessary to prepare the ICAAP methodology in line with the CSSF Circular 07/301. The deliverable was not intended to constitute an ICAAP itself. Rather, it presented the client with options and a roadmap for completing an appropriate ICAAP.

APPROACH AND SOLUTION

This phase of the ICAAP planning requires the collection and analysis of all relevant information on the current internal capital and risk management process as implemented by the client (and its connection with the parent entity).

Existing documentation and practices relevant to the ICAAP were identified and reviewed. The review assessed (i) the quality of the format and content of existing documentation; (ii) the completeness and risk type coverage; (iii) the ICAAP approach and methodologies; and (iv) the relevance and applicability of parent entity's standards for the purpose of compliance with the Luxembourg regulator's requirements.

The risk types to which the client is exposed were identified and an inventory created. The inventory included risk types commonly observed in the industry; for example credit risk, concentration risk, counterparty risk, residual risk, operational risk, fraud risk, KYC-related risks, etc.

A gap analysis was prepared to provide an independent and structured assessment of the client's ICAAP capabilities based on regulatory requirements. This assessment represented a roadmap to achieving regulatory-compliant risk and capital adequacy management. The report provided the client with the grounding, insights and structure essential to formulate its ICAAP. The validation of the gaps was achieved through a combination of questionnaires and interviews with key personnel.

Options were provided on how the gaps/findings in the client's current ICAAP capabilities can be closed. It was expected that any gaps in the information contained in the final ICAAP submission document would be supported by closure plans.

RESULTS AND BENEFITS

The client was presented with specific findings in the following categories: comprehensive assessment of risks to which the client is exposed; risk mitigation; capital allocation; scenario testing and; risk management framework and governance. These findings provided the client with options and a roadmap for completing an appropriate ICAAP.

The report was presented to the executive committee of the bank and the group risk function and is being used as the basis to make a number of key decisions:
the approach that the bank will take to complete the ICAAP and close the gaps that currently exist in the risk and capital process;
an assessment of how sophisticated the bank wants to become in terms of the risk management approach (e.g., is it the minimum to meet regulatory requirements, or is it a level of sophistication that is ahead of peer banks?), taking implementation constraints ('embeddedness') into account.
an assessment of what level of capital the management want to hold, and how these things relate the profit and loss-based plans of the bank.

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