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BASEL II – PILLAR II Main Guidelines and Practicalities of its Implementation

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Preface

One of the last subjects of the study MSc Business Mathematics & Informatics in the Vrije University of Amsterdam is to write a paper about a subject related to the study. The study is a combination of three fields, which are Economics, Mathematics and Computer Science, a multidisciplinary master, where I chose as specialization the Financial Risk Management field.

The reason why I chose the current topic is because the Basel 2 Pillar 2 is a framework that is being implemented right now in all-major financial institutions. Another reason to choose this topic is that so far great emphasis has been placed in the Pillar 1 implementation but not in the Pillar 2, which makes it more interesting to research.

Executive Summary.

Intention of the paper: To explain in a simple but effective way the main guidelines of the Pillar II of the Basel II Framework, as well as the practicalities of its implementation in the banking community as of today.

The First chapter will cover a brief introduction to what is the Basel 2 Accord since that is the broad platform where the Pillar 2 belongs. In this chapter the pillar 1 will be explained with some detail since it introduces some concepts that will be needed for understanding the second pillar.

The Second chapter will show the principles of the supervisory review process or Pillar II.

The Third chapter will explain some of the issues that rose so far on the Pillar 2 implementation.

The Fourth chapter will include the conclusions and remarks.

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1. Introduction to the Basel II Framework

The Basel II was prepared by the “Basel Committee on Banking Supervision - BCBS” and released in 2004, intended to serve as framework for the international convergence of supervision of the banking system. It is the second of the Basel Accords, being the first one, Basel I, released in 1988. This new framework is a set of recommendations for banking governance and supervision which is not mandatory not even for the members of the BCBS, but that intends to serve as guidelines for firms and regulators to improve their controls and management.

The BCBS is a committee that gathers in Basel, Switzerland and integrated by the following countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States.

Since the Committee actually posses no legal enforcement to oblige even its own members to apply its guidelines, it is important to recall that the countries applying the framework to their regulators institutions do it voluntarily being able to implement or the Basel I or the Basel II completely or partially adjusting to their banking system’ needs.

So, the Basel Accord is more an intention of standardizing risk practices.

The Framework applies for every financial institution (except insurance companies) in a consolidated basis, which means that the risk will be observed in a global basis preventing from double gearing when analyzing the subsidiaries.

The main goals of the Basel II framework are to make the capital allocation more risk sensitive, and align the economic and the regulatory capital among others.

Unlike the Basel I where the focus is on minimum capital requirements, in the Basel II two new pillars were added making a total of 3 pillars:

Pillar 1. - Minimum capital requirements
Pillar 2. - Supervisory review and
Pillar 3. - Market discipline

1.1 Pillar 1

It deals with the capital adequacy ratio for 3 types of risks: Credit, Operational and Market Risk.
2 concepts are used: the Regulatory Capital and the Risk-Weighted Assets.

Regulatory Capital is the net worth as defined by rules adopted by a regulatory agency, which may be different than capital calculated under generally accepted accounting principles. It can be divided into 2: Tier 1 (Core) Capital being the most important one and consisting mainly of the shareholders' equity, which includes the original contribution made by the shareholders (not the current market price) plus retained profits minus accumulated losses; and Tier 2 (Supplementary) Capital including undisclosed reserves, general provisions, hybrid instruments and subordinated term debt among others.
The definition of regulatory capital is very important since it defines the numerator for the capital adequacy ratio.

Risk-Weighted Assets is a concept that weights the firm's assets according to their riskiness and potential for default. It is calculated multiplying the capital requirement by 12.5.

The capital requirement is a bank regulation. Internationally, the Basel Committee on Banking Supervision "BCBS" via the Basel Accord influence each country's banking capital requirements.

The capital ratio is the percentage of a bank's capital to its assets, as weighted by ratios dictated under the relevant Accord.

The First Pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: Credit Risk, Operational Risk and Market Risk.

- The Credit Risk component can be calculated in three different ways of varying degree of sophistication, namely Standardized Approach, Foundation IRB and Advanced IRB. IRB stands for "Internal Rating Based Approach".

- For Operational Risk, there are three different approaches - Basic Approach, Standardized Approach, and Advanced Measurement Approach or AMA.

- For Market Risk the preferred approach is VaR (Value at Risk).

Being the Credit Risk the most important risk within a bank hereby it will be mentioned briefly with some more detail.

For the Standardized approach the RWA or Risk-Weighted Assets is the output of this approach, and after through the formula Regulatory Capital = 0.08* RWA it is calculated the RC.

For the Internal Ratings Based (IRB) approach the Regulatory Capital is the output and then the RWA is calculated via the formula RWA= 12.5* RC (same formula as mentioned just above, but inverted)

1.2 Pillar 2

The second pillar deals with the regulatory response to the first pillar, giving regulators much-improved 'tools' over those available to them under Basel I. It also provides a framework for dealing with all the other risks a bank may face, such as reputation risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. It will be explained with lot of detail in the next chapters.

1.3 Pillar 3

The third pillar greatly increases the disclosures that the bank must make. This is designed to allow the market to have a better picture of the overall risk position of the bank and to allow the counterparties of the bank to price and deal appropriately.

2. Pillar II Main Guidelines: Supervisory Review Process

2.1 Importance of the supervisory review

The relevance of the supervisory review is not only to ensure that the banks will have enough capital to support their operations, but also to promote within the banks the design and application of better risk management techniques. These techniques would be used not only for measurement but also for capital allocation purposes or risk-based pricing, which would come as a next step in the implementation of the guidelines established by Basel II in the Pillar II.

Risk and capital must be balanced, in other words in case of an unbalanced risk the options are or to reduce the risk or to increase the capital. On the other hand if the amount of capital assigned as cover for the risk of the current operations is found to be excessive then there is the option of reducing the capital or increasing the risk via additional investments, which would eventually bring additional revenues.

The supervisors or regulators are expected to request those adjustments as any anomaly is found. In other to allow for a quick response in case of any unbalance it is important that the communication between the supervisors and the banks is fluid.

In any case the increase or decrease of the capital held by the banks should not be considered the only option as response for an increase or decrease in the risks that the bank is exposed to. There are many actions that the bank can execute in order to align the risk level with the capital originally allocated, such as the modification of the provisions levels or simply improve the internal controls, etc. In any case the amount of capital held will not be interpreted as the solution for any un-efficient internal risk control.

2.2 The Four Principles of The Pillar II

Principle 1:

“Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.”

The banks should be able to prove that their capital internal targets are sounded and consistent. Such a process should have the following 5 characteristics:

1. Board and senior management oversight

2. Sound capital assessment
3. Comprehensive assessment of risks
4. Monitoring and reporting
5. Internal control review

The Committee also recognizes the fact that the methodology to be used by each institution will depend on its size, complexity and business strategy of the bank. For instance it is expected that institutions with higher size will migrate to economic capital models.
On the other hand smaller firms can try to take peer analysis of the capital levels among others.

Principle 2:

"Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process."

The supervisor authorities should do on-site examinations, off-site reviews, periodic reporting, etc.

Principle 3:

"Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum."

Even though with the Pillar 2 framework the required capital is calculated, still Pillar 1 is the one regulating the minimum capital allowed. Therefore the required capital can be as low as the figure set up for the Pillar 1, or higher since a buffer could be required to be hold by the supervisors.

Supervisors can take different actions the capital level decreasing below the minimum such as:

• To require all the banks in a certain region or peer group to adopt a single ratio above 8%;
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• To establishing firm-specific target ratios based on each institution's risk profile and risk management capacity, and

• To evaluate the processes around the firm's targets in order to value if the process is acceptable or not.

Principle 4:

"Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored."

In case that the supervisor identifies problems with an institution there are several steps that can be taken, such as simply notifying the institution, restricting the dividends payments, applying a restoration plan, etc.

It states that supervisors must search for intervention in an early stage when anomalies are detected on the risk management system of an institution before it the problem turns bigger.
In certain countries even the supervisors have a legal support to intervene without exposing themselves to legal actions for interference.

At the end the supervisor must assess if a decline in the capital levels is due to a temporal situation or it actually the consequence of a deeper problem requiring for corrective actions.

3. Practicalities of the Implementation of the Basel II Pillar II

3.1 The Implementation in the world as of 2007

As it was already mentioned the Basel 2 Accord was published in June 2004, but nevertheless, even for the member countries of the Basel Committee on Banking Supervision BCBS, the Accord is not officially introduced in the country until the Central Bank or the correspondent supervisory authority adopts it.

United States

In the United States the supervisor authority is the Federal Reserve.
On September 30, 2005, the four US Federal banking agencies (the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) announced their revised plans for the U.S. implementation of the Basel II accord. Compared to other countries this release was late which implied that in general the Basel Accord 2 implementation was going to be delayed 12 months for every bank in the US.

The Federal Reserve has required the Internal Ratings-Based approach for the largest banks, and the standardized approach for the other banks.

European Union

In the case of the European Union the Council and European Parliament introduced the Basel 2 Accord formally through the adoption of the Capital Requirements Directive CRD on the 14 of June 2006.
This CRD comprises two directives: Directive 2006/48/EC (relating to the taking up and pursuit of the business of credit institutions) and Directive 2006/49/EC (on the capital adequacy of investment institutions and credit institutions), the ones that were published in the Official Journal on Friday 30 June 2006.

The CRD came into force the 1st of January 2007 recasting two previous existing directives: the Banking Consolidation Directive (200/12/EC) and the Capital Adequacy Directive (93/6/EEC).

Besides these 2 directives, the Committee of the European Banking Supervisors

had previously released a document called “Guidelines on the Application of the Supervisory Review Process under Pillar 2” in January 2006.

In a next step several countries have introduced the EU Directives into its local legislations like the case of the Netherlands when it was introduced through the Financial Supervision Act (Wet of het financieel toezicht),the one that entered into force on 1 January 2007.

A further step is when a country elaborates a document about the implementation of a certain part of the Basel 2 as it is the case of UK via the FSA with its “Our Pillar 2 assessment framework” released in May 2007.

In the case of the United States a delay has registered on the implementation of the Basel 2 since the release of the US Basel took longer time than originally scheduled.

Other regions

Regulators in most of the countries around the world intend to implement the new Basel Accord with different timeframes and with different scopes.
In response to a questionnaire released by the Financial Stability Institute (FSI), 95 national regulators indicated they were to implement Basel II, in some form or another, by 2015.

In the following sub chapter it will be given more detail about the European Union implementation and in the one after the UK implementation because of its importance in the finance world.

3.2 The Implementation in Europe as of 2007

The ECBS document “Guidelines on the Application of the Supervisory Review Process under Pillar 2” sets out guidance on the supervisory review process (SRP). It gathers the collective views of the EU supervisors about the standards that all credit institutions are expected to follow and the way supervisors will observe them.
It is also encouraged the exchange of information between the different EU supervisors about the processes of implementation of the SRP.

The Supervisory Review Process "SRP"

The main intention of the SRP is to ensure that institutions will cover all the risks that they are exposed to with enough capital, where the relation between risk and capital would become clear.

The SRP extends beyond the ICAAP and SREP to include ongoing supervisory monitoring of the institution's compliance including the terms and conditions in the CRD for being granted approval to use the IRB and AMA (adequacy of risk evaluation systems).

The Internal Governance "IG"

Internal governance is intended for ensuring that the management of the institutions is clearly and explicitly responsible for its business strategy, organization and internal control in a proactive way.
Basically it is just about the way the institution is organized and run, with all the levels of management and responsibilities clearly defined, meaning that they should be explained in a written document. Between these responsibilities it should be included the review of the strategies and policies for managing the risks of the institution, as well as the development and maintenance of strong internal control systems.

The control systems should ensure an adequate separation of the duties of each party involved to prevent conflicts of interest.
It will be also part of the duties of the management to monitor and assess the effectiveness of the institution's internal governance, being also expected to explain the supervisory authority about its decisions and have clear policies for the selection and compensation of key executives.

This framework should also include the way in which the objectives and strategy are placed with the amount of risk that the institution is willing to face, and how the internal control is set up.

About the disclosure and transparency the internal governance refers also to the fact that the institutions should meet the transparency requirements in the conduct of their business.

The ECBS guidelines also set out the EU supervisors' expectations for the internal governance of firms.

Within the internal governance of an institution there must be a clear separation

within the management and the supervision (not necessarily with different boards but different in functions).
An important issue for the internal governance is that the institution should be able to ensure that their risk management functions are well organized to allow for a correct implementation of the risk policies.

The Internal Capital Adequacy Assessment Process "ICAAP"

Within the Internal governance of a firm the ICAAP is a process for which the firm through its management board (including the supervisory function) is entirely responsible and that intends to:

- Identify, measure and monitor the risks that an institution is exposed to.
- Hold an internal capital in relation to the risk profile of the institution.
- Use and develop risk management systems

The ICAAP is responsibility of each institution in its design, implementation and maintenance, where the design should be fully specified with the capital policy being fully documented.
Every institution, regardless of its size of type of business, is expected to develop an ICAAP, the one that should become an integral part of the management process and decision making in the institution.

The framework for the ICAAP should be risk-based, where the planning of the capital should be emphasized together with the relevance of the management. In the case of larger or more complex institutions it may be needed stress and scenario testing frameworks. In any case for all institutions, regardless of their size, it should be taken into account the sensitivity fir the business cycle and other external factors.

The introduction of the ICAAP does not imply that successful models already been used by institutions need to be replaced, it only establishes the need for an adequate framework for all the institutions.
In any case the ICAAP is intended to cover for all types of risk regardless of the classification used (there is no a standard categorization mentioned in the Basel), covering not only the risks included in the Pillar 1 but also the ones included in the Pillar.

This ICAAP should also look forwards, in other words should include the institution strategy for the future together with the macroeconomic factors to take into account. This is important since the ICAAP will be reviewed formally once a year and factors like loan growth expectations, future sources and dividend policy should be taken into account, as well as the time horizon for the proposed

objectives. It should also be mentioned the contingency plan for facing the unexpected events including some detail as for instance the rise of additional capital if increasing the capital to match the risk, or the limitation of some business' lines if the intention is to make the risk levels match the held capital.

As final observation the ICAAP should produce a reasonable outcome where the institution should be able to provide information about its elaboration whenever required and compared with its peer group as long as it is not confidential.

The Supervisory Review and Evaluation Process "SREP"

The institutions develop the ICAAP, but there is need for an adequate supervision from the regulators or supervisor agents. The supervisor authority must review the firm's exposure to the different risks and the ICAAP together with the adequacy of its own funds. Therefore the SREP should be elaborated with the goal of ensuring consistency among institutions disregarding the fact that institutions have different management styles, strategies, or risk profiles. That means to establish a common framework without ignoring the fact that institutions vary in different aspects.

The SREP in any case should apply to all authorized institutions (supervisors authorities) and should be able to cover all the activities of an institution, since the main goal of the SREP is to assess and review the institutions' ICAAP. The results of the SREP will be communicated to the institution including the list of actions that the supervisor would consider necessary to be taken to comply all the requirements. This SREP should be reviewed at least once a year to ensure that is up-to-date, although it does not need to be done necessarily in a full basis (can be reviewed in a partial basis depending on the changes registered by the institutions or external events on the previous year).

The Risk Assessment System "RAS"

The RAS is the tool of the supervisor for the organization, planning and allocation of supervisory resources. It is intended to cover the first phase of the SREP so it is mainly a tool for internal supervisory purposes. It is intended to create a fluid communication canal between supervisor authorities of different countries, which turns to be very useful when dealing with home and host competencies.
The assessment done to institutions by the supervisor authorities must follow some guidelines defined previously in order to allocate resources on an effective way. This is important since not all institutions demand the same amount of attention, and given the limited amount of resources it is important to prioritize efforts.

The assessment for each institution should include a breakdown of it identifying the risks and its weighs, so that the level of detail of the breakdown is proportional to the level of detail of the planning process.
It is important that exists procedures for the quality assurance in order to guarantee the quality and consistency of all the risk assessments.
If an institution's ICAAP turns to be considered inadequate, the RAS should be able to help the supervisory authority in determining the risk profile of the firm.

The ICAAP- SREP interaction

Since we have two different tasks being driven by two different entities the communication between them turns to be very important. That is the reason why the supervisors are expected to have a methodology to structure the dialogue with the institution. Besides since the supervisory assessment is going to be based in the institution's ICAAP it is important that the institution provides all the information needed about the used assumptions and that is open for a dialogue to exchange views about the risk assessment. This is not only important as information for the supervisor, but also because the institution will be able to make changes to the ICAAP in the course of the dialogue.
The supervisor based on the importance of the institution and its complexity will set up the frequency of this dialogue, as well as its depth, including for instance the starting date for the conversations. In the case of big and complex organizations the supervisor could tailor the type of dialogue.

Proportionality

The guidance for both institutions and supervisors will be applied proportionally, making clear that institutions will be able to explain the supervisors any significant difference with respect to the CRD in their risk assessments since there is not a one and only approach.

Scope of application

The CRD Directive will establish the scope of application of the Supervisory Review Process,
The scope of application of the SRP will be determined by reference to the CRD. For EU institutions with subsidiaries in other member states the host supervisor will take the supervisory function over the institution as a group, and then each host member will take a supervisory function over at the subsidiary level.
Is in these cases where the communication among supervisors must be fluent in order to avoid unnecessary duplications of the supervision.

Challenges of coordination between home and host supervisors in the EU

Nowadays most of the banks have a presence in different countries at the same time. In this sense one issue that has been raised and it is common to almost every bank is the home-host supervision. In the implementation of Pillar II that also plays a significant role, specially for those risks not considered by Pillar II and others like the global risk management. Due to this, it is more and more important nowadays to have some sound policy of risk management, having a similar methodology in every country where the bank is positioned.

Meanwhile there has been already significant development in the implementation of the Pillar I worldwide; the Pillar II is still on progress.
Since conflicts can rise between different countries' regulations, it is important to mention that a growing number of countries are publishing their Pillar II evaluation processes, which allows for a better and clearer communication.

Some of the challenges and issues that nowadays are faced by the Committee are:

- Sharing ICAAP approaches across countries;
- Sharing at the supervisory level with the confidentiality implication of study cases of how the approaches were finally implemented
- Improving the channels for coordination and communication with the non-member countries. Important since there are only 13 BCBS member countries and 88 non-member countries, as of September 2004 were expected to apply the Basel II guidelines at least partially.
- Focusing on specific issues like diversification, concentrations and the types of risks not covered by Pillar I;
- Sharing different approaches to validation;
- Working on home-host coordination of the advanced measurement approaches for operational risk implementation and supervisory considerations in the assessment of allocation methodologies.

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The ten requirements for the IAACP from the supervisory banks are:

- Every institution must have a process for assessing its own ICAAP
- The ICAAP is responsibility mainly of the institution;
- The ICAAP's design should be fully specified, the institution's capital policy should be fully documented and the management body (both

supervisory and management functions) should take responsibility for the ICCAP;
• The ICAAP should form an integral part of the management process and decision-making culture of the institution;
• The ICAAP should be reviewed regularly (at least once a year);
• The ICAAP should be risk-based;
• The ICAAP should be comprehensive (covering all the risks);
• The ICAAP should be forward-looking and take into consideration the firm's own plans and conceivable external changes;
• The ICAAP should be based on adequate measurement and assessment processes;
• The ICAAP should produce a reasonable outcome.

The application of the Pillar 2 must be done in parallel since there are 2 main documents, one under the firm’s responsibility: the Internal Capital Adequacy Assessment Process (ICAAP), and the one under supervisory’ responsibility: the Supervisory Review Evaluation Process (SREP)

Some of the risks that are not covered by the Pillar I and are considered therefore for first time within the Basel II are:

- Concentration risk. - The risk that the firm is heavily dependent on a certain type of business or geographical region, in other words the opposite of diversification.

- Liquidity risk. - The risk that the firm will have a cash flow problem or difficulties raising capital.

- Reputation risk. - The risk that the good name of the company could be damaged, usually as a consequence of other risks incurred.

- Strategic risk. - The risk that the bank faces when changes in the corporate structure happens, or for instance the risk incurred with the acquisition of companies, also when changes in the market conditions occur.

- Business cycle risk – The risk faced with the ups and downs of general business conditions.

3.3 The implementation in UK as of 2007

The UK is the country with the higher number of financial institutions within the European Union (with headquarters or subsidiaries), reason why its experience must be included in any study about the Basel implementation.

As in every implementation of a new framework or regulation there are lot of observations that come across the process itself, the ones that must be taken into account.
In the UK it has been already collected different observations and a halfway evaluation has been done where there has been detected problems in the ICCAPs delivered by the financial institutions in UK, especially from smaller firms, where only a few amount of them have the sufficient quality to allow the FSA to carry out a proper SREP without having to request a new submission of the ICAAP.

The concerns raised with this pilot testing are explained below:

Since the ultimate deadline for a firm to have an ICAAP is the 1 January 2008 that implies that the management board should have already approved it before then (during year 2007). As it has been seen many firms are finding that developing the ICAAP is taking longer than expected originating delays in the application of the CRD implementation for many firms.

Another observation is about the explanation for some of the figures. The allocation of capital for some of the Pillar 2 risks is the ultimate goal but it is needed to be known the assumptions made, the method for calculating the numbers and the way how the individual risk are managed, otherwise the figures can not be accepted.

Another issue is the length of the main body of the document, which is recommended to be short (under 30 pages), with additional information being placed in the appendices.

It has been recorded the case of a firm proposing an ICAAP figure below the one established in Pillar I, which it is not possible since Pillar I establish minimum requirements for some of the risks.

Another observation is that smaller firms have not projected forward their business and capital plans the recommended 3 to 5 years. This could hold for the firms that are not able to forecast its business development, where therefore 1-year projection is accepted, but does not hold for firms that in other parts of the ICAAP mention that they are currently developing new products or business lines, case where the firm should be able to make the proper projection of its

business.

Also it has been seen that it was required in some cases to ask firms to revisit their stress testing. The firms are expected to present in a clear way the impact of any scenarios or stress testing. Besides this, the companies should include the impact of financial turndowns in their plans and projected capital reserves.
The stress testing should be also applied wherever there is concentration of assets or liabilities to a particular region.

In the case of some global groups where the FSA is the host supervisor it could also be required the firm's global parent (not only the group and subsidiaries).

It was also received in some cases ICAAP's not signed by the firm's management, which poses a big question about the involvement of the management in the development and implementation of the ICAAP.

In any case all these issues could be easily solved with a more fluent communication between the supervisor and the institution, where it is recommended the quick initiation of such discussions.

The FSA review process is undertaken through the so-called ARROW.

The FSA has also carried a pilot- testing of the Pillar 2 in the year 2006, the one that came to an end in November 2006 (and not September 2006 as it was originally scheduled). This test started with 10 firms initially, ending up with a total of 8 where the firms, which were intended to represent a cross section of the industry, had to submit their ICAAPs and dialogue was held in a fluent way between the FSA and the firms. The main purpose of the test was to test all the practical aspects of the implementation of the ICCAP framework (Pillar 2 in Basel II).

In May 2007 an additional document "Our Pillar 2 assessment framework" was released by the FSA with the intention of giving firms and insight into what they should expect from the supervisor authority to apply during the SREP that is done when reviewing the ICAAPs of the firms.
There has been also published by the FSA two templates for the ICAAP submission, the ones that are suggestions and not mandatory templates. One template is intended for larger organisations meanwhile the other cover smaller firms.

The FSA has published as well a suggested template for the Pillar 2 submissions (i.e. the ICAAP), the one that is merely a suggestion and is not mandatory to be used.

4. Conclusions and remarks

Conclusions

The Basel 2 Pillar 2 is a framework that even though it has already been defined through many documents and regulations is still being adapted and improved. Not only in terms of its applicability to the firms in the practice, but also taking into account the many different existing regulations and country's specific features.

The Pillar 2 implementation has suffered delays but at least in the EU it is expected to be finished for all firms, disregarding of its size of complexity by the 1st January 2008, which it will imply a huge effort for the EU supervisors and institutions in the remaining of the present year.

It has proven clear that the implementation varies according to each region. As example the case of the United States, which it is a state member of the Basel Committee (so it was involved in the elaboration of the Basel 2), but nevertheless it will only request the Basel 2 approach from the biggest institutions.

The Basel 2 Pillar 2 is more extensive on its approach since it incorporates many other risks that originally were not included in the Basel 1 and that have not been included in the Pillar 1.

Even though the ICAAP turns to be a task relying completely on the firm and the SRP is intended to be carried on exclusively by the supervisor, the interdependence of both tools creates an absolute need for a fluent communication between the supervisor authority and the institutions.

Given the home-host supervisors situation (as it happened with the Pillar 1) establishing proper canals of communication among the supervisors of the different countries happens to be very important to avoid work being done in a double basis.

Remarks

It will be very interesting to see how this implementation process will end n December of this year. It exists the option that an extension of the original deadlines will be required in order to comply with all the guidelines at least in the EU members.

Abbreviations

A-IRB: Advanced Internal Ratings Based

BCBS: Basel Committee on Banking Supervision

BIS: Bank for International Settlements

CEBS: Committee of European Banking Supervisors

CRD: Capital Requirements Directive

F-IRB: Foundation Internal Ratings Based

FSA: Financial Services Authority

ICAAP: Internal Capital Adequacy Assessment Process

IG: Internal Governance

RAS: Risk Assessment System

RC: Regulatory Capital

SA: Standardized Approach

SRP: Supervisory Review Process

SREP: Supervisory Review and Evaluation Process

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