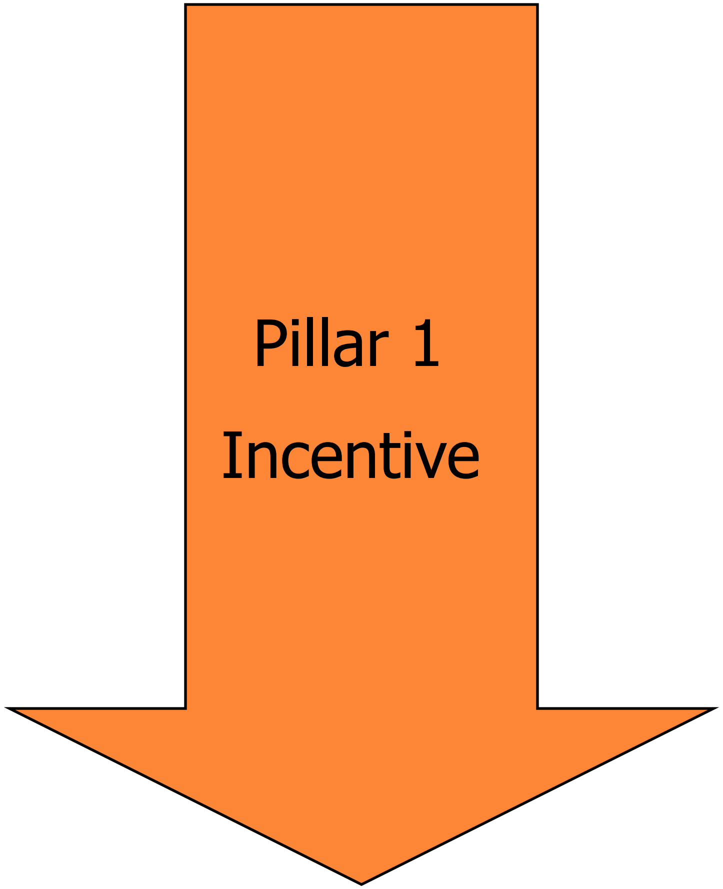
Regulatory Developments

Lubna Farooq Malik
Director - Banking Surveillance Department
State Bank of Pakistan

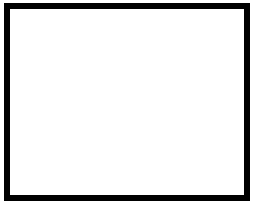
AGENDA

- Regulatory Approaches of Ops Risk
- Adoption of Alternative Standardized Approach
- Draft guidelines on Loss Data Collection
- Draft circular on Fraud & forgeries
- Draft Basel III instructions
- Internal Capital Adequacy Assessment Process
- Revision to Stress Testing guidelines
- Internal Credit Risk Rating (ICRR)

Regulatory Approaches – Basel II

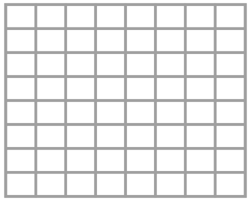


Basic Indicator Approach (BIA)



Standardized Approaches (TSA & ASA)

Advance Measurement Approaches AMA



Regulatory Approaches offered by SBP

- For operational Risk capital charge, SBP has prescribed BIA, TSA and ASA.
- AMA is currently not being offered. However banks/ DFIs are encouraged to adopt international best practices and prepare themselves for early adoption.
- Most of the Banks in Pakistan are on BIA.
- Two banks are on TSA, one bank has been recently allowed ASA while two are on parallel run for ASA.

Basic Indicator Approach

Capital Required

Regulatory capital = Alpha-Factor (α) * Gross Income

α Factor

The Basel Committee has set α at 15%, based on the various calibration exercises.

(It is generally assumed that Operational Risk capital charge would constitute around 12% of the overall economic capital of the banks)

Advantages

- Easy to use by all financial institutions
- No specific qualifying criteria

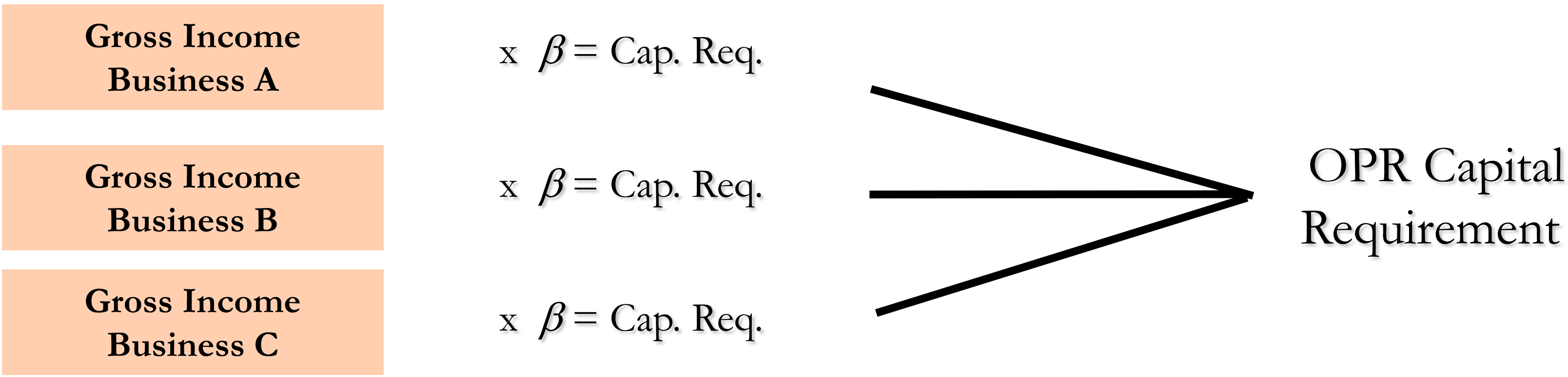
Disadvantages

- No causal relationship between required capital and actual operational risk
- Higher gross income is generally punished by a linearly increasing operational risk charge
- No reflection of the institution-specific Business Profile or Control Environment.

Standardised Approaches (TSA & ASA)

Key Features:

- Institution is split into Eight business lines
- Banks measure the scale of business operations through exposure indicators (EIs) typically Gross Income or loans/advances set for each business line by supervisors
- There are additional qualitative requirements as well
- Capital is calculated by multiplying each business line EI with beta factors set by the supervisor. The beta factor is different for each business line



Standardised Approaches (TSA & ASA)

Business Lines	Exposure Indicator	Capital Factors (β)	Required Capital
Corporate Finance	GI	18%	
Trading and Sales	GI	18%	
Retail Banking	GI (TSA)or Loans/Advances (ASA)	12%	
Commercial Banking	GI (TSA)or Loans/Advances (ASA)	15%	
Payment and Settlement	GI	18%	
Agency Services	GI	15%	
Retail Brokerage	GI	12%	
Asset Management	GI	12%	

STANDARDIZED APPROACHES - CRITERIA

- Banks require prior approval from SBP to use Standardized Approaches for the calculation of Ops Risk capital charge
- Before granting approval, SBP requires a parallel run for at least one year.
- Banks are required to fulfill;
  1. **Qualifying Criteria**
     - Implement effective corporate governance and risk management environment.
     - Set-up appropriate risk reporting systems.
     - Risk assessment system including validation is subject to regular review by auditors.
  2. **Mapping of Business Lines**
     - Develop criteria for mapping activities (current & future) into eight business lines.

Alternate Standardized Approach (ASA)

- Some of the banks have started moving towards TSA/ ASA approaches which would set learning examples for rest of the banks to follow.
- Due to the incentive of reduction in capital charge as a result of m=0.035, banks with considerable commercial and retail loans would eye to adopt ASA for calculating Ops risk capital charge.
- In view of the significant drop in capital charge and the time required to refine internal processes, SBP has imposed **capital floors**.
- Ops risk capital charge under ASA should not fall below 90%, 80% and 70% in the 1^{st}, 2^{nd} & 3^{rd} year respectively, of the capital charge calculated under BIA.

Guidelines on Loss Data Collection

- Objectives include;
  - Enhancement of scope of loss data gathering in line with the Basel II requirements.
  - Provide the industry a minimum set of instructions for consistent recognition of losses
  - Once banks start collecting loss data internally, the same be reported to the data consortium (which may be hosted by SBP or any mutually agreed third party).
  - Standardization of loss data which may be used for comparison and judging the operational riskiness of banks (Supervisory Perspective).

Guidelines on Loss Data Collection --- CONTINUED

- Objectives include;
  - Banks will be required to gather Key Risk Indicators (KRIs) and conduct Risk & Control Self Assessments (RCSAs) whereby an institution may keep an eye on the future dimension of operational risk.
  - These guidelines will further extend the previous guidelines available on Operational Risk Management.
  - Feedback on the draft guidelines have been obtained from PBA and subject specialists.

INSTRUCTIONS ON FRAUD & FORGERIES

- Objectives include;
  - To strengthen the fraud risk management and monitoring function of the banks.
  - Reporting formats would be made in line with the Basel defined Business Lines/ Event-types matrix which would eliminate deficiencies in the existing forms.
  - Banks will have to formulate & implement Anti-fraud policy and whistle blowing program.
  - Board, audit committee and the senior management of banks will carry out quarterly/ annual review of their frauds/ forgeries/ dacoities cases.

INSTRUCTIONS ON FRAUD & FORGERIES --- CONTINUED

- Objectives include;
  - Banks will maintain internal database of unscrupulous borrowers/ third parties.
  - In the next step pooling of such database with PBA or any other mutually agreed arrangement for sharing purposes will be finalized which would help minimizing the chances of repetition of frauds by such parties.
  - The instructions would also cover Microfinance banks.

Draft Instructions on Basel III

- Key Proposal
  - Improve quality and quantity of capital
  - Introduce Leverage Ratio
  - Introduction of Capital Buffers
  - Introduction of Liquidity Ratio
- Preliminary impact assessment based on the BCBS document revealed that majority of our banks will comply with the Basel III.
- QIS on the draft SBP Basel III instructions is being carried out based on financial data as of 30-06-2012 and in this regards the draft instructions were sent to all banks/ DFIs.

Basel III – Key Changes

Topic	Under SBP Basel II	Proposed SBP Basel III
Capital	CAR = 10% of RWA wherein Tier 1 = 5% Tier 2 + Tier 3 = 5%	CET1 = 6.0%, CCB = 2.5% (consisting of common equity) ADT1 = 1.5 % Tier 2 = 2.5%
Minority Interests	Full recognition under Tier-1 for consolidated CAR reporting.	Surplus capital attributable to the minority shareholders would not be recognized.
Loss Absorbency clause	No such clause	ADT1 & T2 capital instruments should have principal loss absorption through either i. Conversion into common share at a pre-specified trigger point ii. A write-down mechanism which allocates losses to the instrument at a pre-specified trigger point.

Basel III – Key Changes

Key Changes	Under SBP Basel II	Proposed SBP Basel III
Deferred Tax Assets (DTA)	Subject to risk weight	DTA has been broken in two parts i. DTAs related to temporary differences (e.g. credit provisioning) are deducted as per threshold treatment. ii. Other DTAs that depend on future profitability of the bank are to be deducted from CET1 after netting with associated Deferred Tax Liabilities.
Significant investment in individual commercial entities	Deducted 50% from Tier 1 & 50% from Tier 2	Instead of deduction, significant investment (beyond 10% threshold) in commercial entities would attract risk weight of 1000%.

Basel III – Key Changes

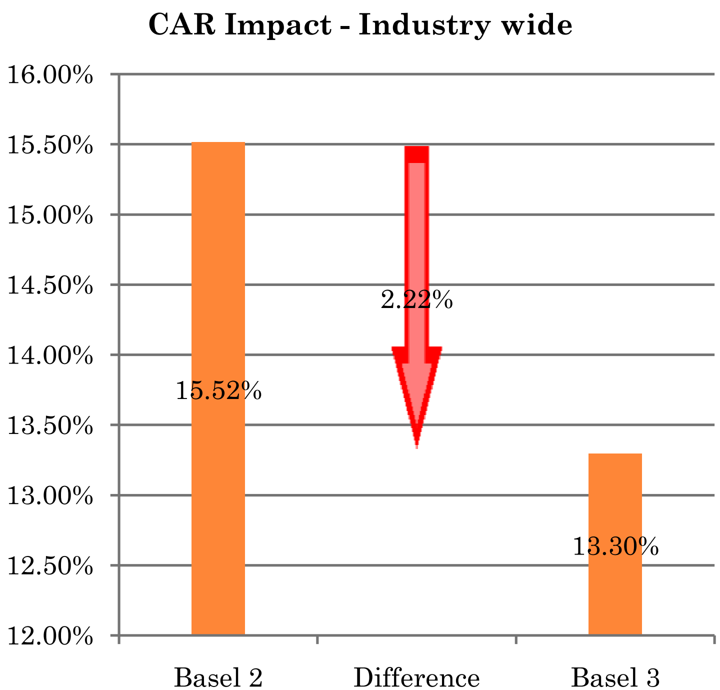
Key Changes	Under SBP Basel II	Proposed SBP Basel III
Significant investment in banking, securities and other financial entities	If < 20%; relevant risk weight applies If > 20%, deduction of 50% from Tier 1 & 50% from Tier 2	All holdings (where bank's investment is not more than 10% of the issued common share capital of the entity) are to be summed. i. If total of all holdings exceed 10% of the bank's common equity (after certain deductions) then the amount above 10% is required to be deducted (Corresponding Deduction Approach). ii. All holdings below the threshold (as mentioned in point i) would be risk weighted. All Significant Investment (where bank owns more than 10% of the issued common share capital of issuing entity) holdings are to be summed. i. All investment which is not common shares (ADT1 & T2) should be deducted. ii. All investment in common shares would be subject to threshold deductions i.e. instead of a full deduction, an amount equal to 10% of CET1 (after certain deductions) would be recognized (i.e., not deducted) and would be risk weighted at 250%. The amount exceeding 10% of CET1 would be deducted as per Corresponding Deduction approach.

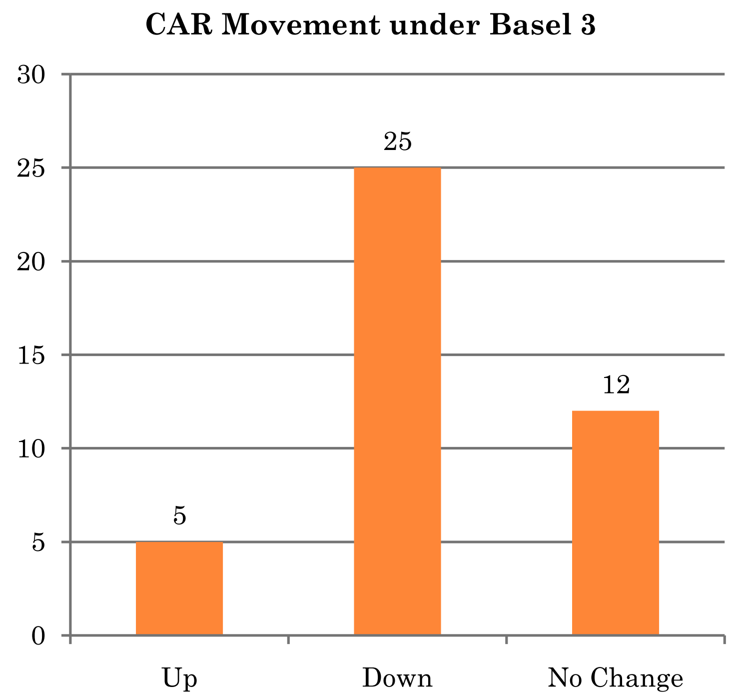
Corresponding Deduction Approach:
The deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself.

Summary of QIS (as of June 30, 2011) based on BCBS proposal

Capital Level	BCBS Proposal	Institutions Compliant (Out of 42 banks/ DFIs)	SBP Proposal	Institutions Compliant(Out of 42 banks/ DFIs)
Min. CET1 ratio	4.50%	37	6.00%	36
Capital Conservation Buffer (CCB)	2.50%		2.50%	
Min. CET+CCB	7.00%	36	8.50%	34
Min. Tier-1 capital	6.00%	37	7.50%	36
Min. Total Capital	8.00%	36	10.00%	36
Min. Total Capital + CCB	10.50%	35	12.50%	30
Leverage Ratio	3.00%	36	3.00%	36

Basel II vs. Basel III





Internal Capital Adequacy Assessment Process (ICAAP)

- Broad guidelines on ICAAP issued in 2008.
- The review of the first ICAAP reports submitted by the Banks/ DFIs reflected a great deal of diversity in terms of scope, coverage, length and format.
- As a result, SBP developed an ICAAP reporting format in the light of global best practices and tailored the same in line with the specific requirement of Pakistani banking industry.
- As a part of consultative process, the ICAAP reporting format was also shared with stakeholders.

ICAAP ---CONTINUED

- It will ensure a minimum set of information from the banks/ DFIs in order to bring some consistency under various components of ICAAP document.
- It would not only make the Supervisory Review and Evaluation Process (SR&EP) more efficient for both the banks and SBP, but would also enhance the comparability of the respective ICAAPs across different banks.
- Almost all the countries have issued separate guidelines on ICAAP, however; development of reporting template is relatively a recent phenomenon in number of jurisdictions.

ICAAP ---CONTINUED

- Banks / DFIs have to submit their ICAAP document based on the financials as of December 31, 2012 on the prescribed template till May 31, 2013.
- The ICAAP reporting template has <u>eight</u> sections supplemented by way of <u>four</u> appendices.
- Banks may further strengthen their ICAAP document with additional relevant information.

Stress Testing Framework

Cognizant of the critical role that stress tests play in identifying the vulnerabilities of banks/ DFIs at the early stages, State Bank of Pakistan (SBP) has adopted two-pronged Strategy .

A- In-house Stress Testing at SBP:

- SBP carries out in-house stress testing of all banks on quarterly basis using both sensitivity analysis and scenario analysis.
- The results of these stress tests are used for assessment/ supervisory action against banks and for internal purposes.

B- Institutionalizing Stress Testing Framework at Banks:

- SBP revised its stress testing guidelines of 2005 vide BSD circular No. 1 of 2012.

STRESS TESTING FRAMEWORK AT SBP

- The instructions have been updated in the light of recent developments in the area of stress testing with the aim of keeping them relevant to the changing business environment.
- Key objectives of the revised guidelines include:
  - To include bank specific shocks based on the historical adverse movement in the risk factors.
  - To rationalize magnitude of shocks, as per the recent volatility in the risk factors
  - To increase frequency of the stress tests
  - Enhance the scope – e.g., liquidity risk measurement
  - To provide guidance in the areas of advanced approaches to stress tests like:
    - Scenario Analysis
    - Reverse Stress Tests
    - Stress Tests for Operational Risk
    - Stress tests for Islamic Banks

(Under the revised guidelines, SBP requires big banks (with market share of above 4%) to start working on advanced approaches of stress testing)

Internal Credit Risk Rating (ICRR)

- SBP's instructions on ICRR of 2007, mainly focuses on rating of the corporate portfolio.
- In order to cover instructions regarding Retail/ consumer Portfolio, BSD has issued circular in 2013.
- Some of the key points of this Circular are as follows:
  - Rating system for retail/ consumer loans may follow a single rating dimension which should be oriented towards both borrower and transaction risk and must capture all the relevant borrower and transaction characteristics.
  - Banks/ DFIs shall develop an application and behavioral scorecards for retail/ consumer exposure.

ICRR ---CONTINUED

- Application scorecards measure the credit worthiness of a customer specifically at the application stage, based on the application/ credit initiation data.
- Behavioral scorecards measure the credit risk of a customer by monitoring the repayment behavior, changes in demographics and customer's compliance with the loan covenants, etc.
- The banks should review and update the assigned scores at regular intervals, which may range from one month to a maximum of one year.
- A list of generic default drivers for application and behavioral scorecards also provided.

ICRR ---CONTINUED

- Banks/ DFIs should validate the predictive power of the default drivers and the model before putting the scorecard in use.
- Moreover, the predicted and actual defaults should be monitored on an ongoing basis and in case of significant deviation, scorecard should be validated.
- The banks should validate the scorecard on annual basis.
- For e-CIB reporting purposes,
  - Application scores can generally be used up to six months and thereafter behavioral scores shall be reported.
  - In case the obligor has been assigned multiple ratings based on multiple exposures, the rating corresponding to the highest risk (lowest rating) should be reported in the e-CIB.

THANK YOU