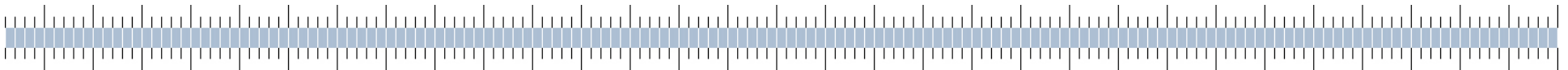


Risk-oriented banking supervision pursuant to Basel II – A German perspective on implementing the SRP



Peter Spicka
Senior Advisor Banking and Financial Supervision
Deutsche Bundesbank
Centre for Technical Central Bank Cooperation

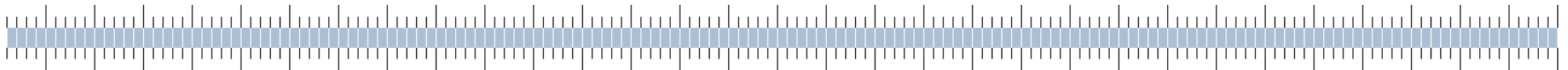


Implementing the Supervisory Review Process –



Agenda

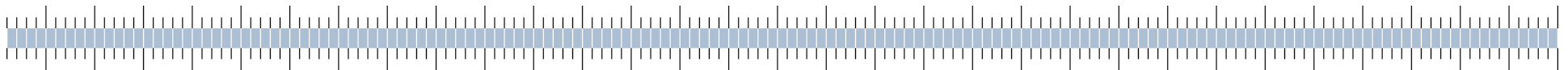
- Institutional framework for implementing Basel II
- The supervisory review process (SRP)
- Banking supervision under Pillar II: SREP in Germany
 - Workflow
 - Scope and classification
 - Individual risk assessment
 - Review and evaluation of ICAAP
 - Supervisory measures
- Experiences, challenges, outlook



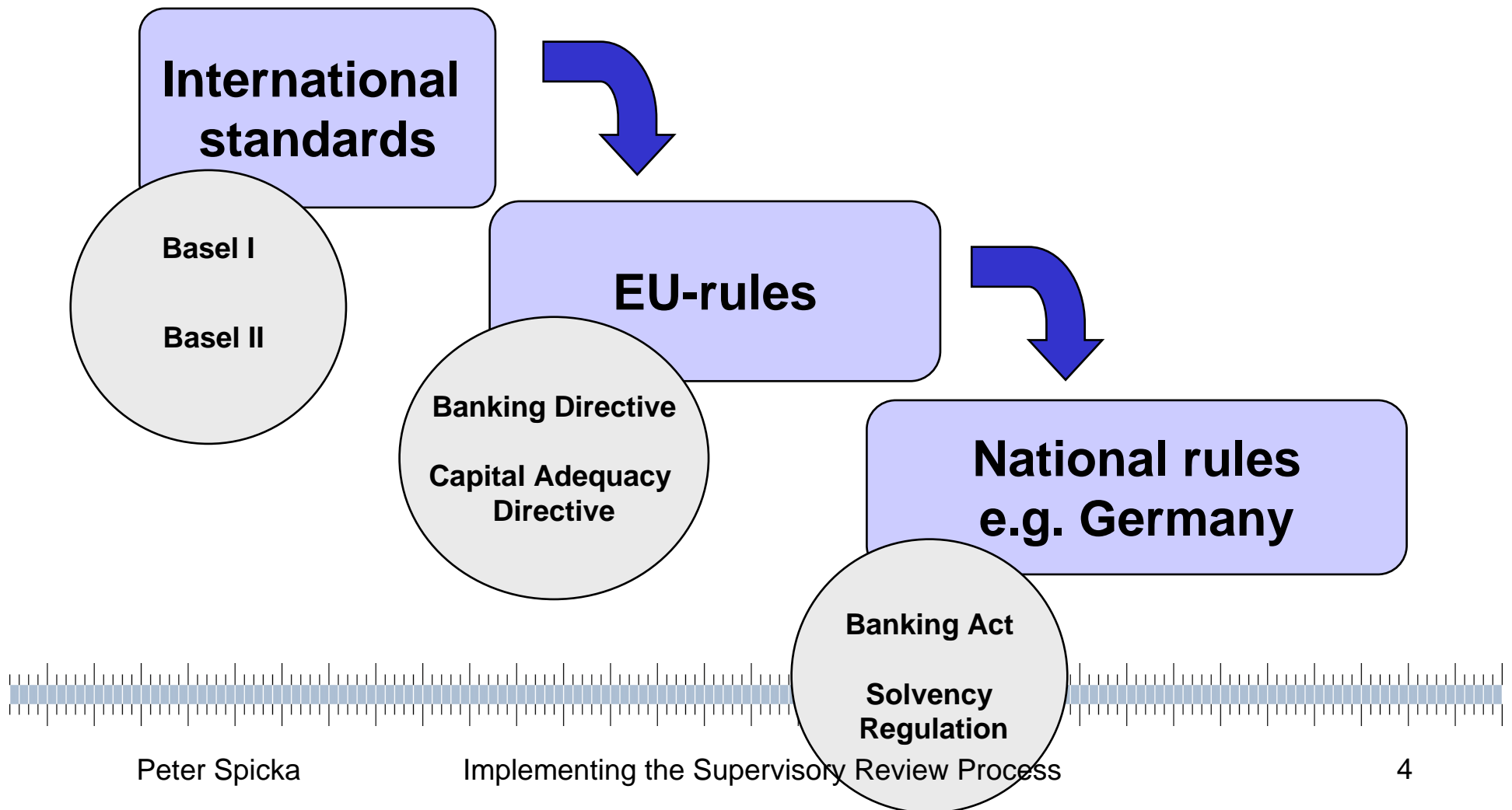
Implementing the Supervisory Review Process



- **Institutional framework for implementing Basel II**
- The supervisory review process (SRP)
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Institutional framework for implementing Basel II



Institutional framework for implementing Basel II

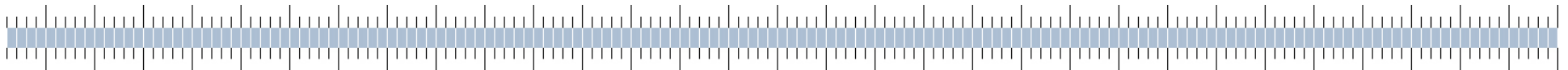


Basel Committee for Banking Supervision

- Formulating broad supervisory standards and guidelines
- Recommending statements of best practices

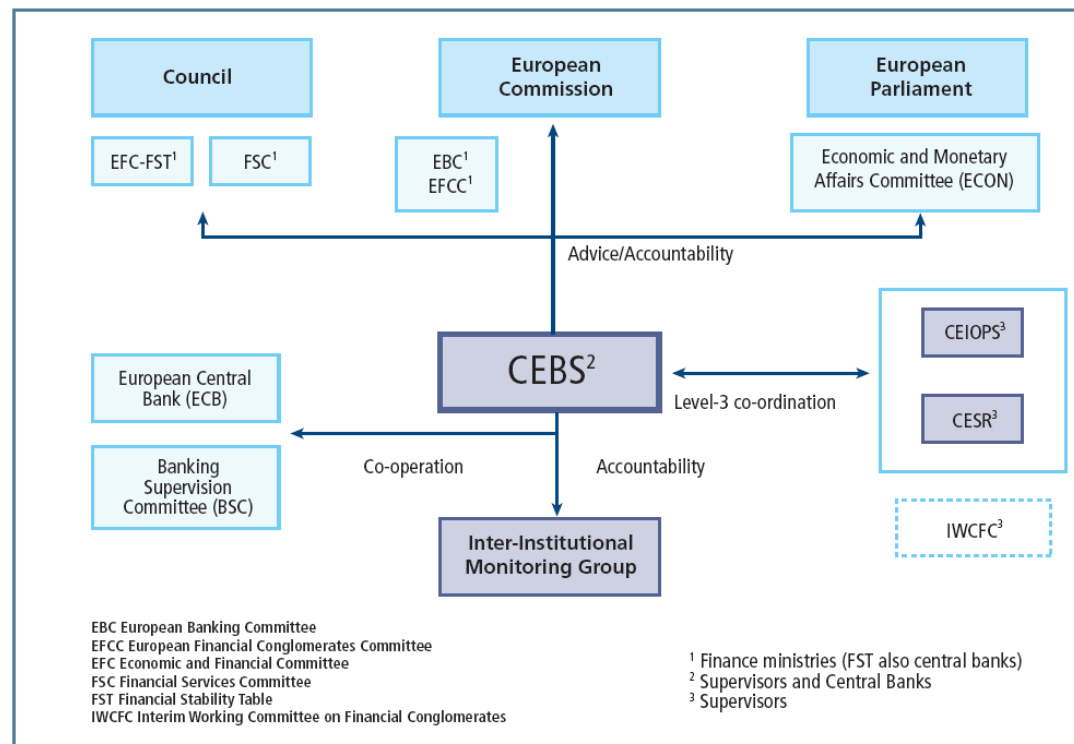
- Does not possess any formal supranational supervisory authority
- Conclusions have no legal force.

Standards morally binding and globally accepted



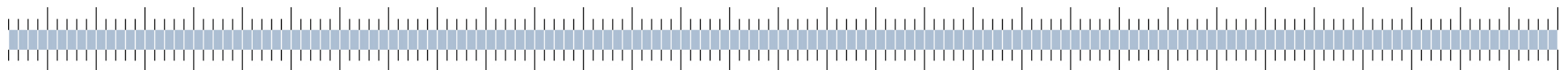
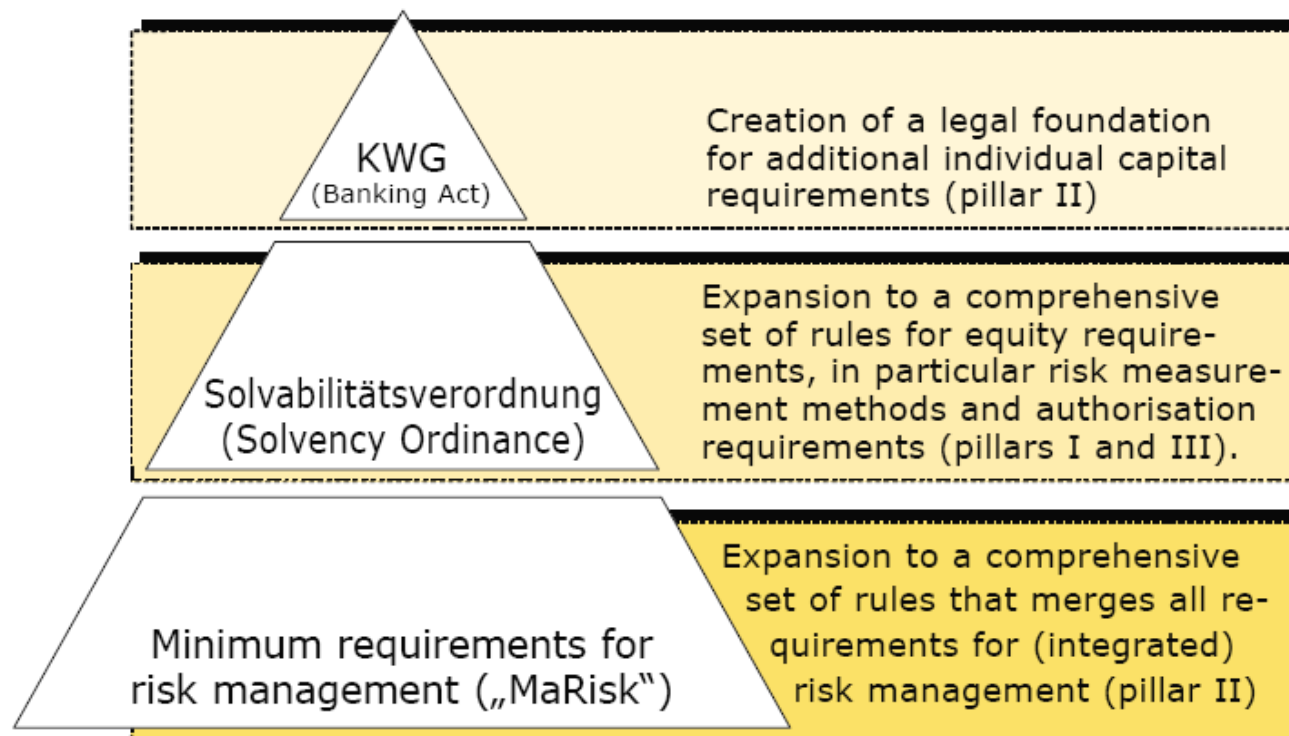
Institutional framework for implementing Basel II

Basel II and the EU



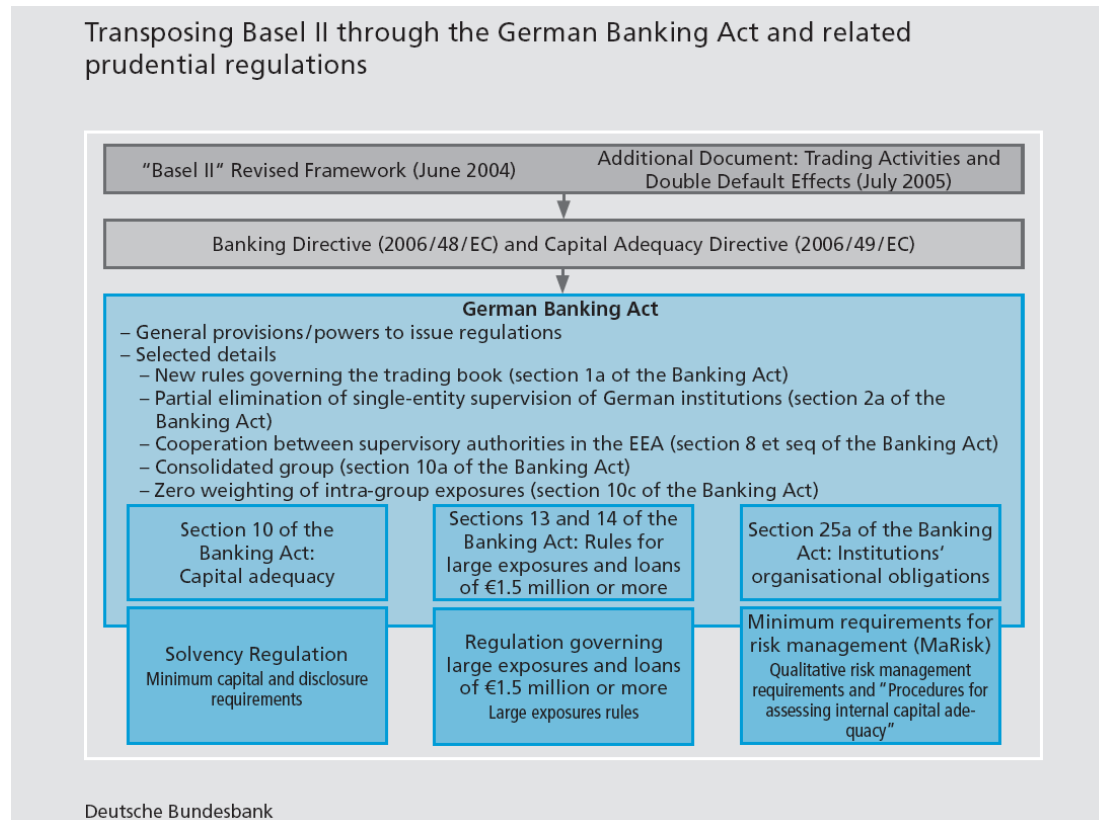
Institutional framework for implementing Basel II

National implementation: Germany



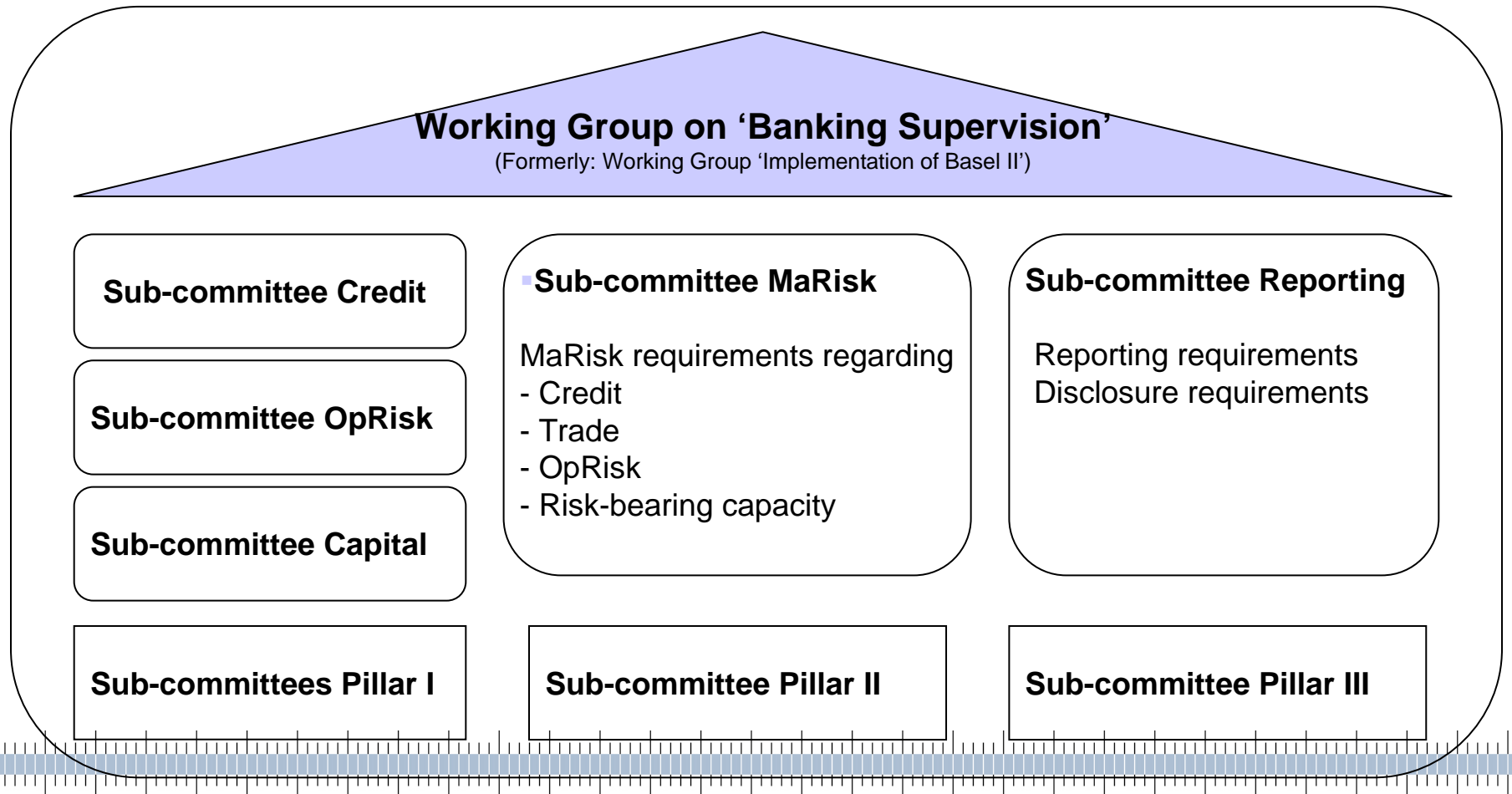
Institutional framework for implementing Basel II

National implementation: Germany



Institutional framework for implementing Basel II

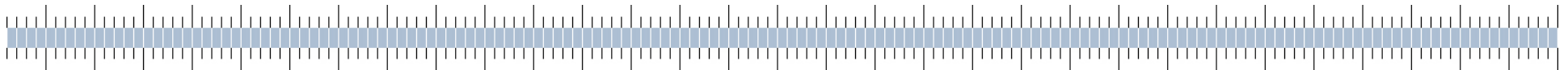
National implementation: Germany



Implementing the Supervisory Review Process



- Institutional framework for implementing Basel II
- **The supervisory review process (SRP)**
- Banking supervision under Pillar II: SREP in Germany
 - Workflow
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 - Review and evaluation of ICAAP
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- Experiences, challenges, outlook

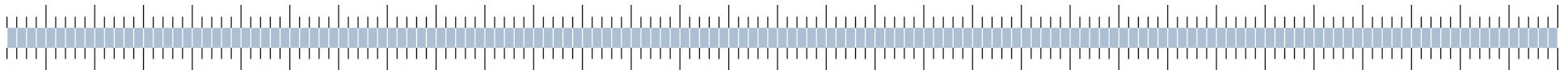


The supervisory review process (SRP)



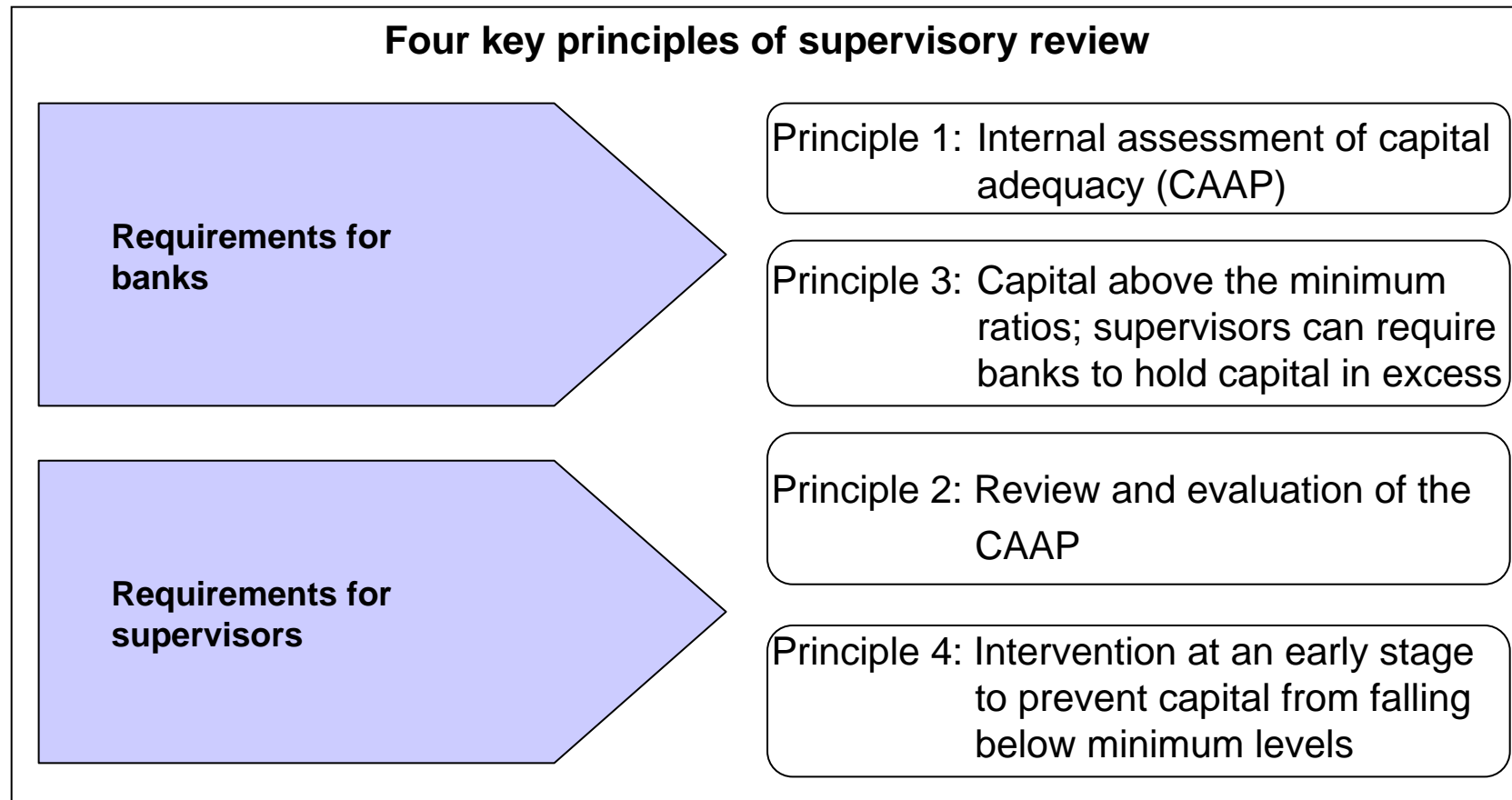
Importance of supervisory review

- Ensure banks to have adequate capital to cover all risks
- Encourage banks to improve risk management techniques
- Recognise responsibility of the bank management for internal capital assessment and capital commensurate with risk profile
- Foster active dialogue between banks and supervisors



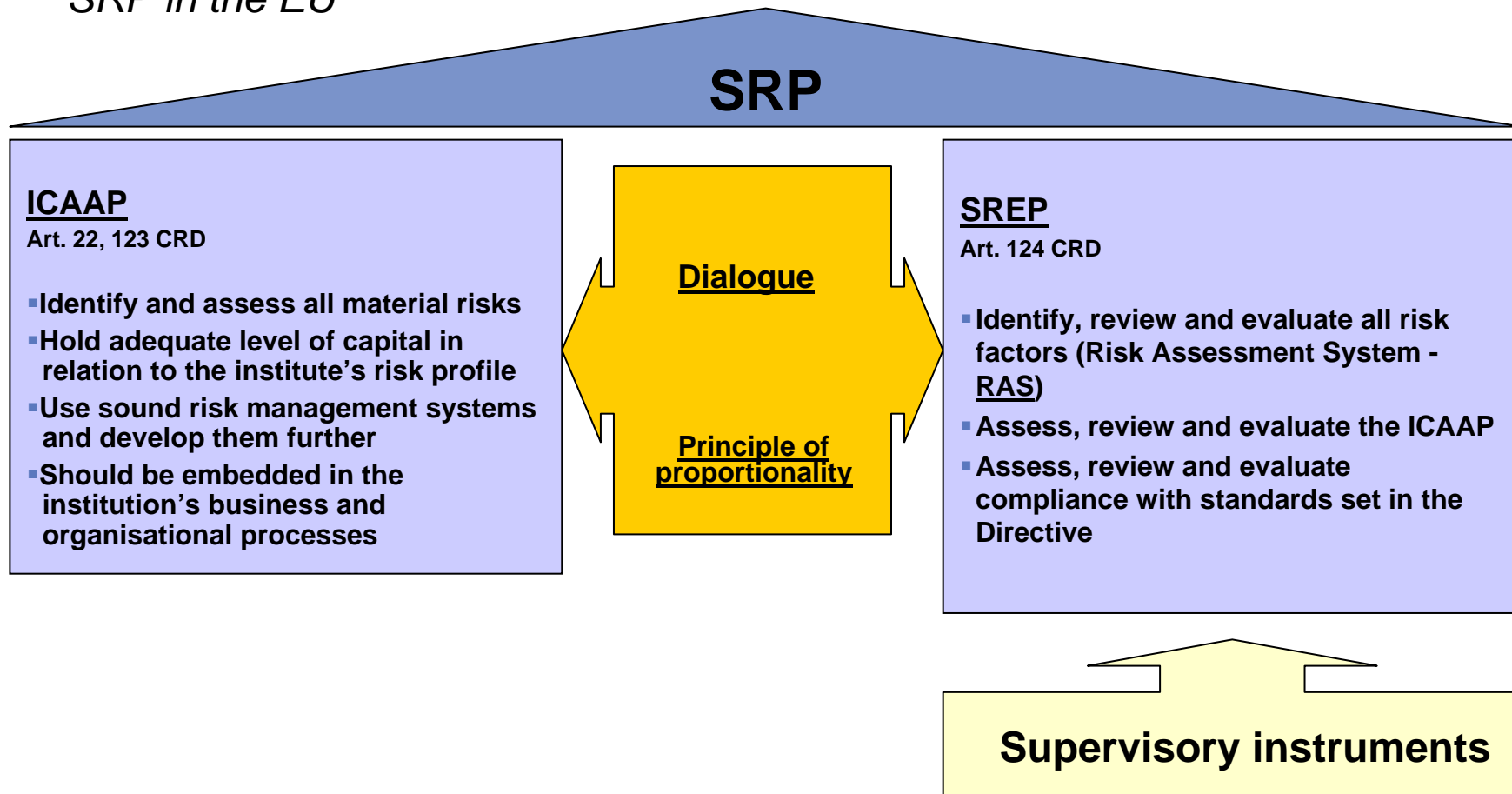
The supervisory review process (SRP)

Basel II and the SRP



The supervisory review process (SRP)

SRP in the EU



The supervisory review process (SRP)

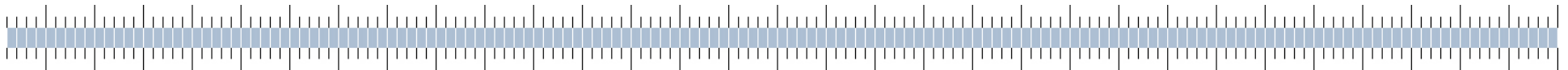


SRP in the EU

Committee of European Banking Supervisors (CEBS)

Four categories have emerged as common to all competent authorities in the EU:

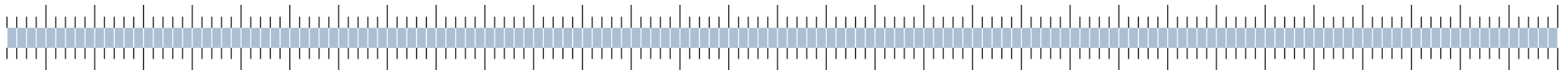
- Scope and classification (including proportionality)
- Individual risk assessment
- Review and evaluation of ICAAP
- Overall assessment and supervisory measures



Implementing the Supervisory Review Process



- Institutional framework for implementing Basel II
- The supervisory review process (SRP)
- **Banking supervision under Pillar II: SREP in Germany**
 - Workflow
 - Scope and classification
 - Individual risk assessment
 - Review and evaluation of ICAAP
 - Supervisory measures
- Experiences, challenges, outlook



Risk-oriented supervision approach – supervisory grades

- **Basic supervision**

All institutions,
independent of size,
systemic relevance and risk
situation

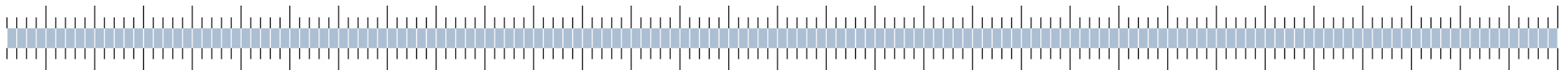
- **Intensified supervision**

Institutions relevant for financial stability reasons

Institutions showing signs of increased risks and/or
organisational weaknesses in basic supervision

Institutions with supervisory information
deficiencies becoming apparent in basic
supervision

Preventative random samples of institutes (without
any specific reason)



Basic supervision - instruments

- Evaluation of annual accounts
- Evaluation of auditor's reports (of the annual accounts)
- Monitoring, analysis and evaluation of regular and event-driven reporting such as
 - Monthly reporting
 - Reporting according to German Solvency Regulation
 - Reporting according to German Liquidity Regulation
 - Reporting according to catalogue of special data
 - Reporting large exposures and loans of 1.5 million euro and more
- **Classification of banks**
- **Prudential discussions on a regular basis**
- **Risk profile**

SREP in Germany – Workflow

Intensified supervision - instruments

Specific collection of off-site information

- Telephone calls/ written inquiries
- Request/processing of documents

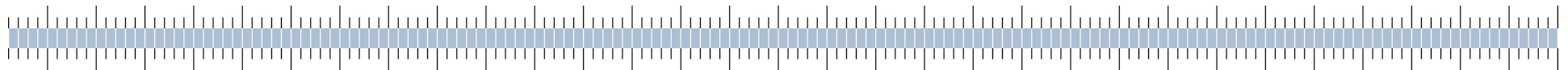
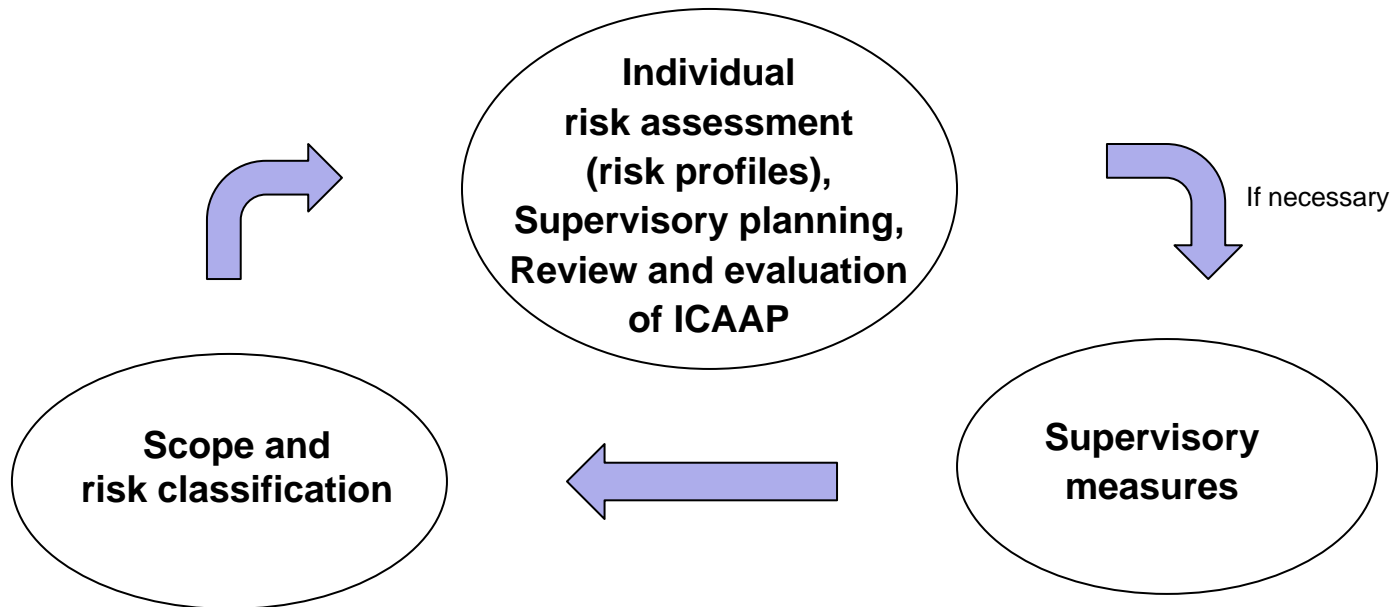
Collection of on-site information

- Ad hoc supervisory consultations
- On-site examinations

Updated risk profile

SREP in Germany – Workflow

Design of the SREP in Germany (including all four required components according to CEBS)

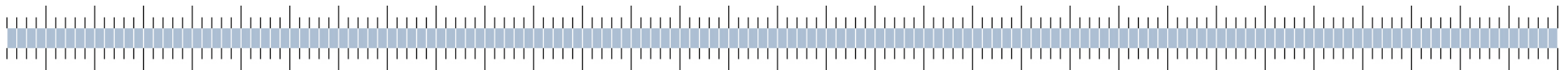


SREP in Germany – Scope and Classification



Objective of risk classification

- Classification of banks in comparison to their peer groups
- At least once a year on basis of evaluation of auditor's reports
- Early warning system
- Risk indicator
- Tool to systemize the assessment of banks (comparability, transparency)
- No supervisory measures initiated



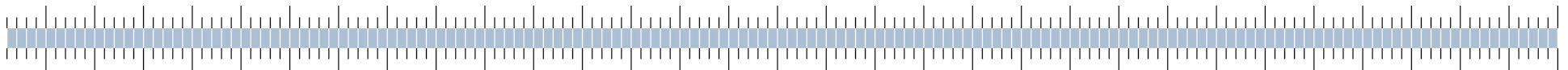
SREP in Germany – Scope and Classification



International comparison

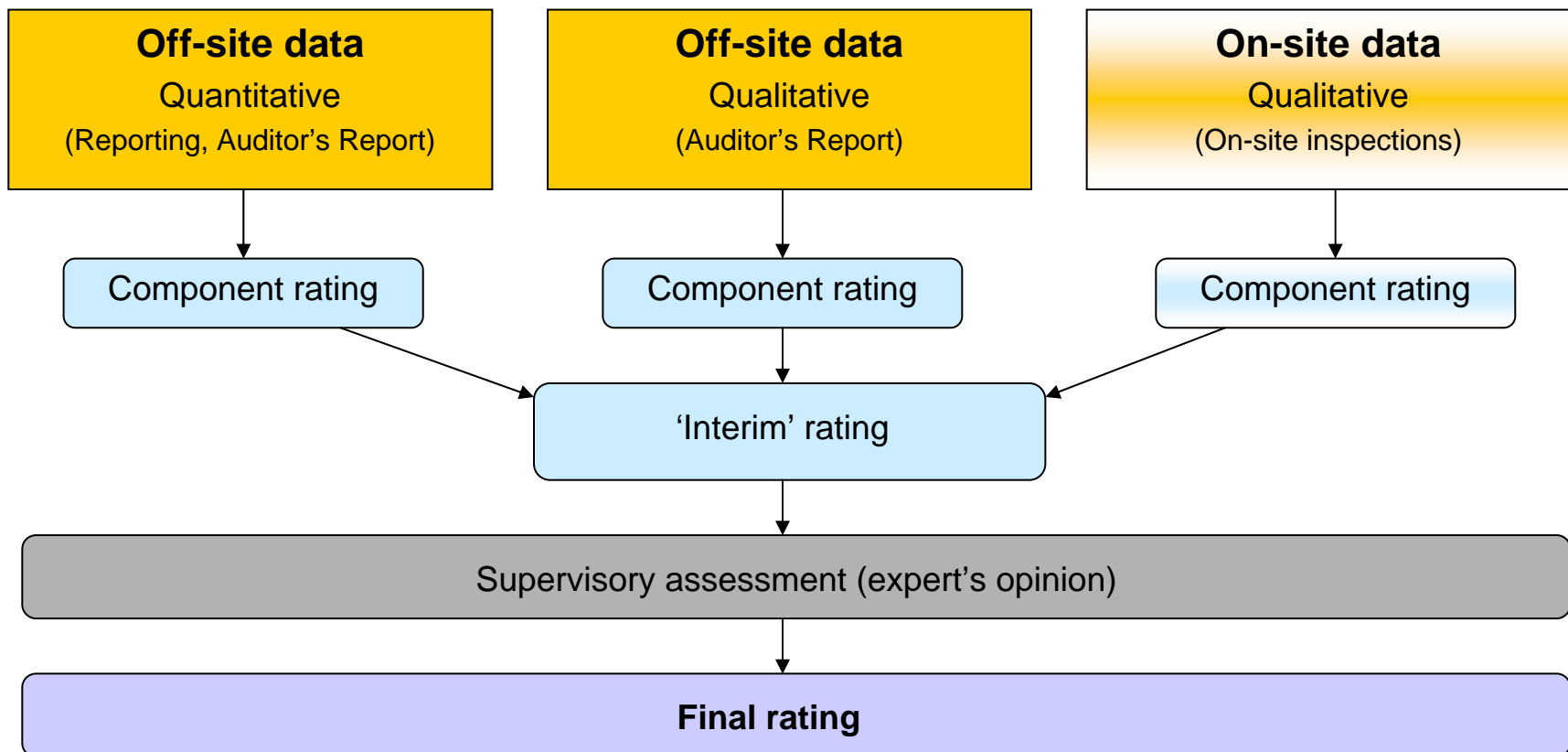
Quite a number of supervisory authorities use comparable instruments, e.g.:

- US (FDIC, Fed and OCC): CAMELS
- UK (FSA): ARROWS (formerly: RATE)
- NL (DNB): RAST
- F (CB): ORAP; SAABA and SIGNAL



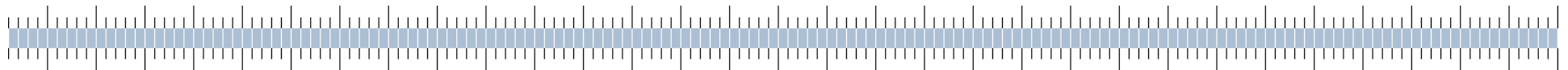
SREP in Germany – Scope and Classification

Structure of the risk classification of banks (SRP-Rating)



SREP in Germany – Scope and Classification

SRP-Rating variants

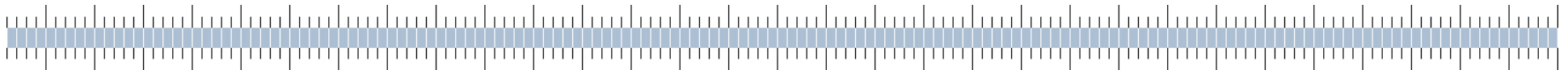


SREP in Germany – Individual Risk Assessment



Risk profile - Definition

- Concise assessment of the key risk areas of an institution
 - Both verbal ...
 - and by a rating (four grades A to D)
- Clarification of those areas of a bank's business and organisation which require more information

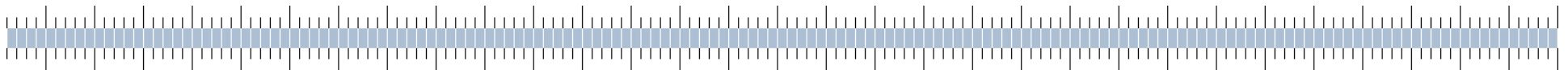


SREP in Germany – Individual Risk Assessment



Risk profile - Objective

- Working tool for supervisors
- For information of supervisory management
- Starting point for supervisory planning
- (Co-ordination between supervisory authority and central bank)

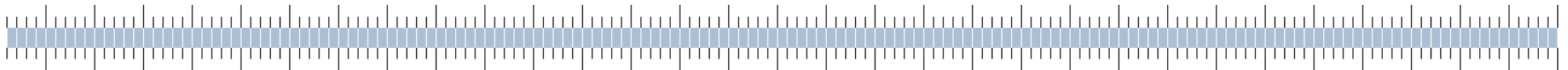


SREP in Germany – Individual Risk Assessment



Drawing up a risk profile - Overview of main components

- Overall assessment
- Assessment by external parties (Banking associations, Rating agencies)
- Company profile / group profile
- Capitalisation
- Profitability and accounting policy
- ICAAP
- Internal governance
- Material risk areas (both risk level and risk control)
- Compliance and money laundering



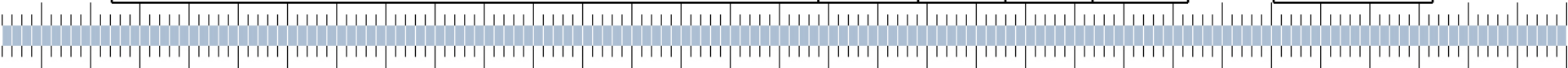
SREP in Germany – Individual Risk Assessment



**Drawing up a risk profile
- structural breakdown**

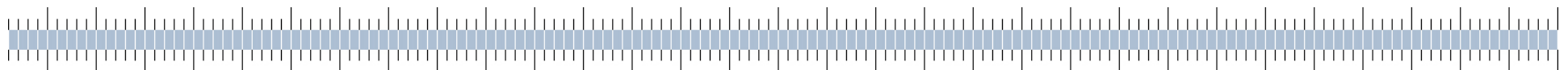
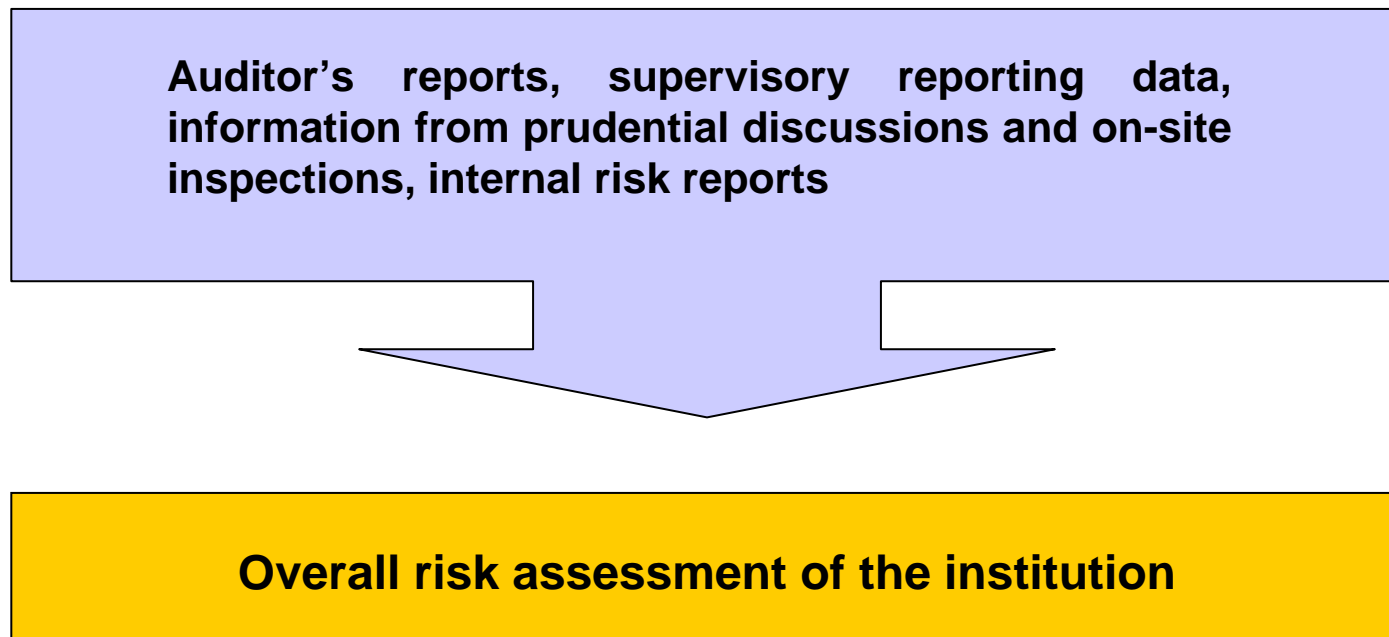
I.	Overall assessment	
I.1	Overall judgement (verbal)	(Grade: ...)
I.2	External grades (e.g. Banking associations)	
I.3	Institute's strategy	
I.4	Partial judgements	

	A	B	C	D	
Company profile					Information required
Capitalisation					
Profitability					
ICAAP					
Internal Governance					
Risk areas					
- Credit risk					
- Market risk					
...					
Compliance (Securities Trading Act)					
Money Laundering					



SREP in Germany – Individual Risk Assessment

Risk profile for large international banks

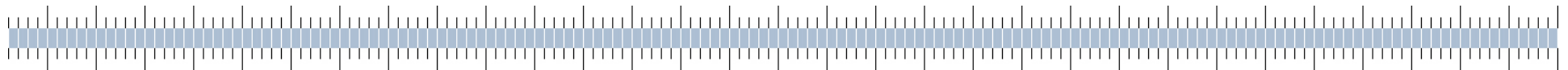


SREP in Germany – Individual Risk Assessment



Additional step: Assessment of a bank's impact on systemic relevance

- High
- Medium
- Low



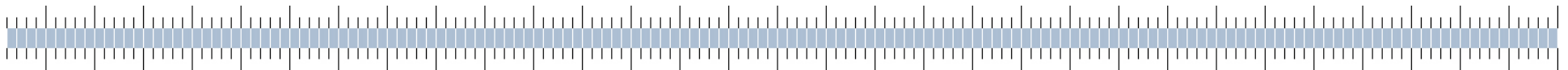
SREP in Germany – Individual Risk Assessment

Results of the risk classification 2006

(comparative figures for the previous year)

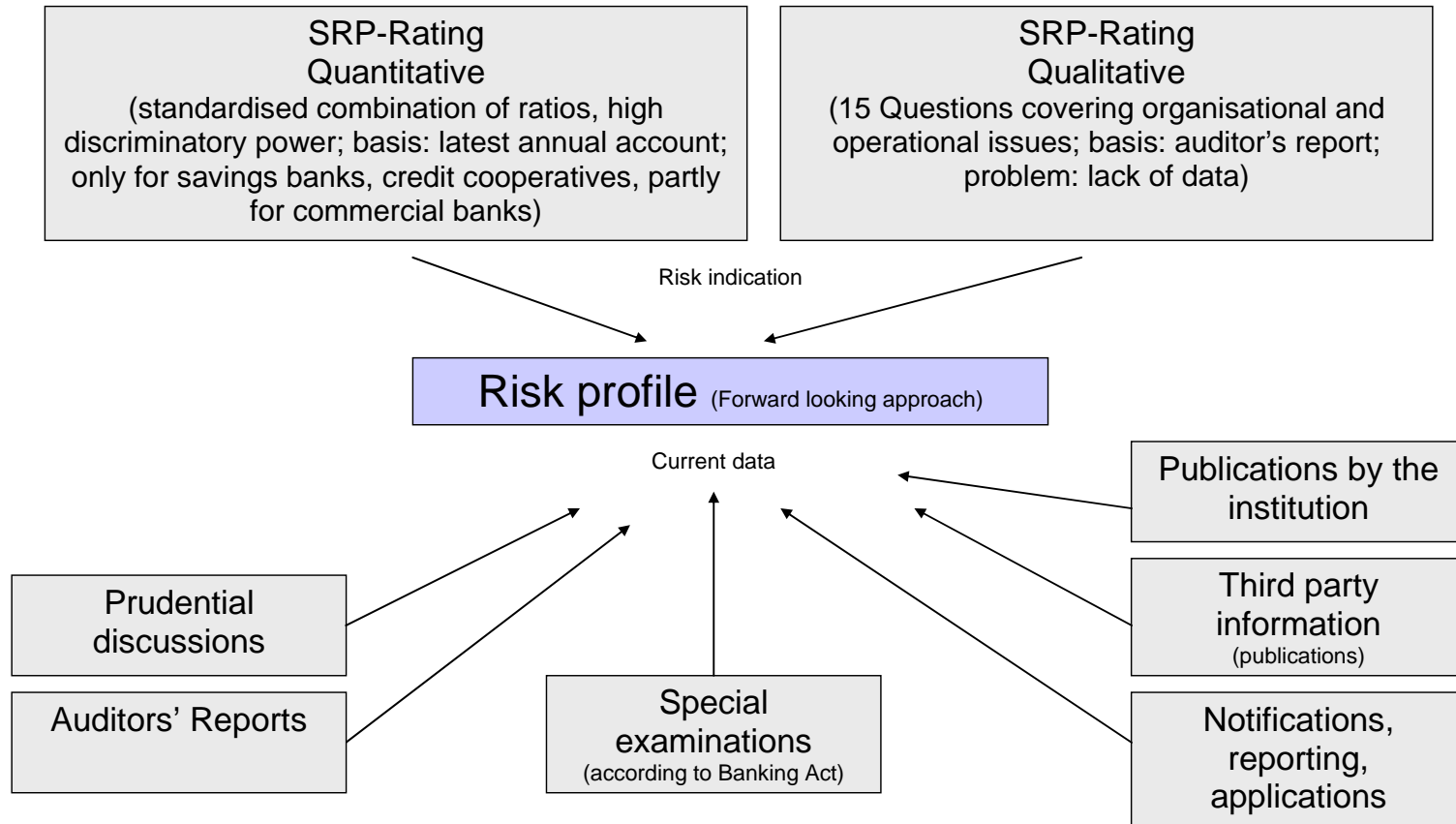
Institutions in %		Quality of the institution*				Total
		A	B	C	D	
System relevance	High	0.6% (0.9%)	1.2% (1.0%)	0.2% (0.5%)	0.0% (0.0%)	2.0% (2.3%)
	Medium	2.6% (1.8%)	3.2% (3.3%)	1.4% (1.3%)	0.3% (0.5%)	7.5% (7.0%)
	Low	35.6% (24.1%)	37.2% (41.9%)	12.6% (16.8%)	5.2% (7.9%)	90.5% (90.7%)
Total		38.8% (26.7%)	41.6% (46.2%)	14.2% (18.5%)	5.5% (8.5%)	100%**

Source: Federal Financial Supervisory Authority, Annual Report 2006, page 70



SREP in Germany – Individual Risk Assessment

Risk profiling - Summary



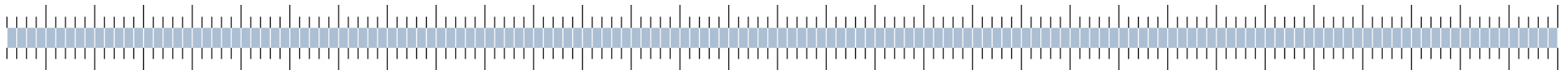
SREP in Germany – Supervisory Planning



Supervisory audit planning

Principle: supervisory reactions on detected weaknesses and information collection to detect weaknesses

- Selection of institutes according to risk profiles
- Selection of institutes for preventative reasons



SREP in Germany – Review and Evaluation of ICAAP

Instruments and procedure

- Inquiries
- Prudential discussions
- On-site examinations

SREP in Germany – Review and Evaluation of ICAAP



Inquiries

- Off-site instrument
- Often by telephone
- Often referring to limited facts

SREP in Germany – Review and Evaluation of ICAAP

Prudential discussions

- Routine supervisory consultations once a year
- Ad hoc supervisory consultations anytime
- Increasing importance

SREP in Germany – Review and Evaluation of ICAAP

Prudential discussions – *possible topics*

- Business development (year of the auditor's report)
- Business development (current financial year, prognosis)
- Risk management and control
- Credit risk strategy
- Auditor's reports notifications
- Risk situation credit business
- Experience MaRisk

SREP in Germany – Review and Evaluation of ICAAP

Kind of examinations (§44 Banking Act)

Internal models examinations

- Approval of applications to use the IRB approach
- Examinations (IRBA, AMA, MRM, Liquidity Risk Models)

SRP examinations (Pillar II)

- Examinations on appropriateness of business organisation (§ 25 Banking Act, MaRisk)
- Examinations on continued compliance with Pillar I and III requirements

Credit business (value) examinations

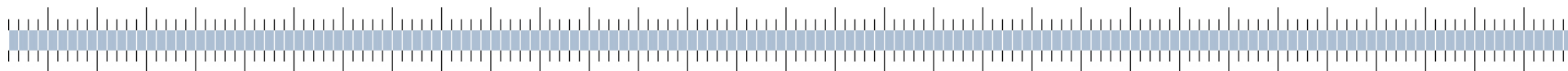
- Examinations of the (quality of) credit business

SREP in Germany – Review and Evaluation of ICAAP



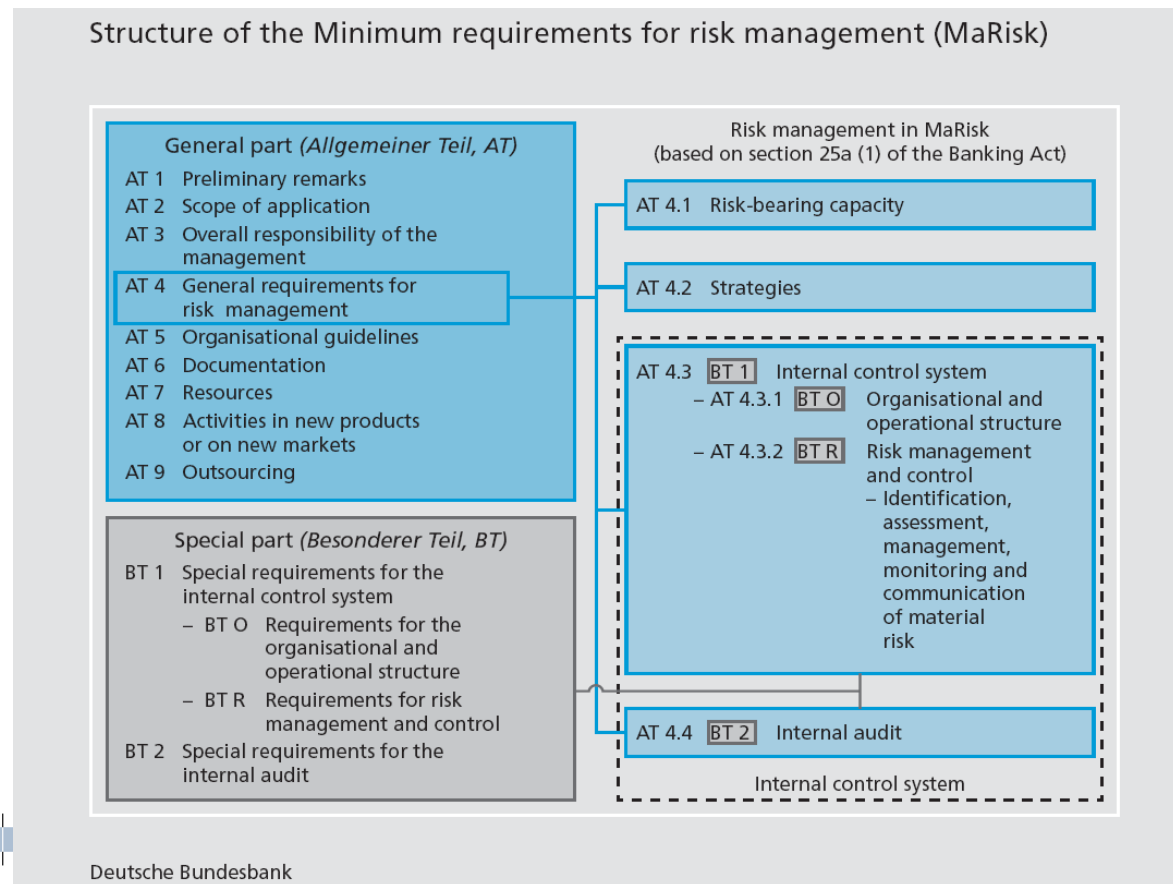
Excursus: 'Minimum Requirements for Risk Management'

- 'Minimum Requirements for Risk Management' (MaRisk) cover the qualitative requirements of Pillar II of the Basel framework for banks
- MaRisk stand for a principle based approach and serve to implement the principle of dual proportionality set forth in the SRP
- On the basis of numerous escape clauses the MaRisk can be applied in a simplified manner depending on the credit institutions' size, business speciality and risk situation



SREP in Germany – Review and Evaluation of ICAAP

Excursus: ‘Minimum Requirements for Risk Management’

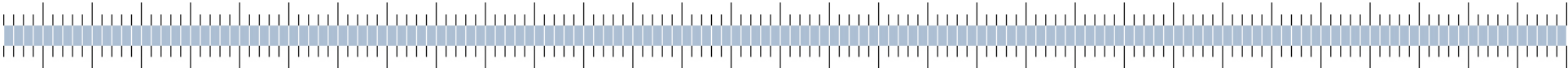


SREP in Germany – Supervisory measures



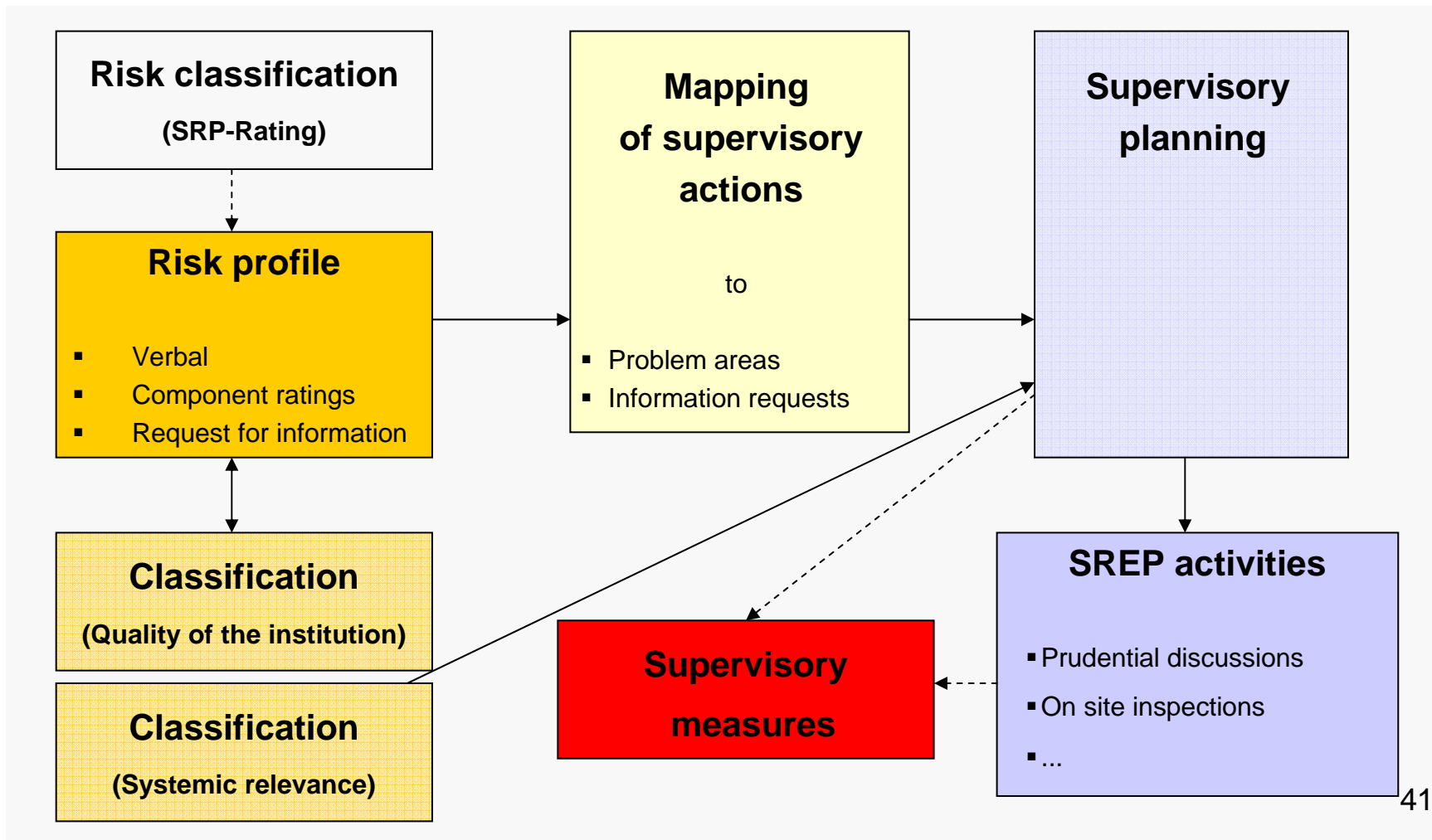
Supervisory measures in the SRP - overview

Informal supervisory measures	
Request to heal undesired developments (diversity of forms: letter with non-binding request, supervisory consultations, request threatening further measures)	
Formal supervisory measures	
Instruction to repair undesired developments in the institution (Basis: SRP specific norm)	§ 25 (1) S.1 Banking Act
Instruction to repair undesired developments in the institution (Basis: blanket clause)	§ 6 (3) Banking Act
Instruction of capital surcharges/risk reduction	§ 45b Banking Act
Sanctions	§§ 35, 36, 56 Banking Act



SREP in Germany – Summary

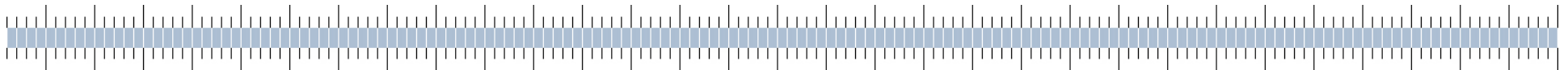
Organisation of the SREP



Implementing the Supervisory Review Process



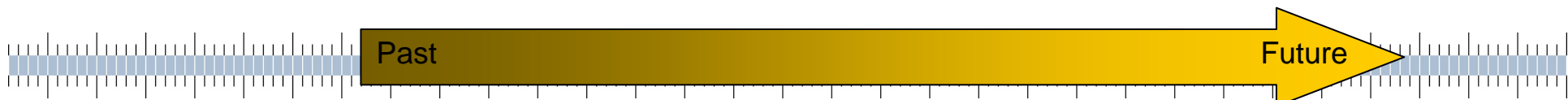
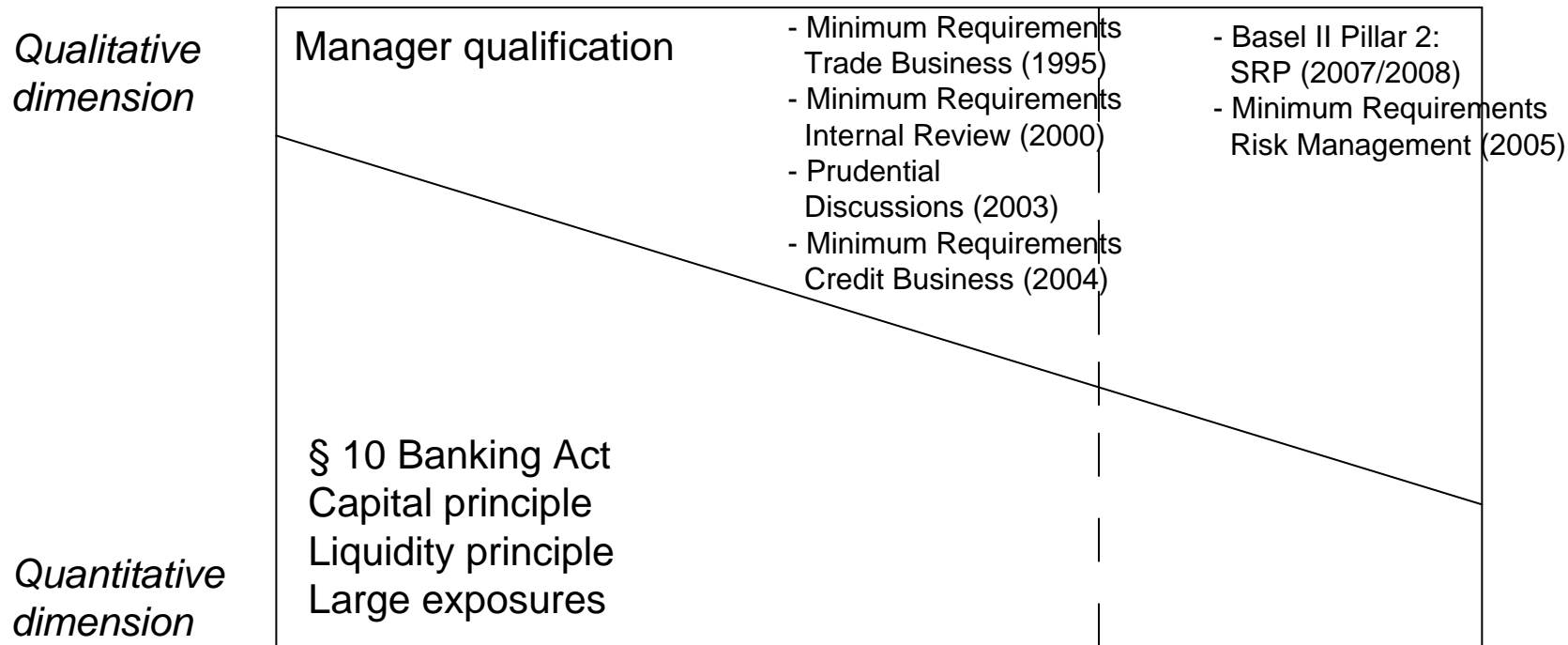
- Institutional framework for implementing Basel II
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- **Experiences, challenges, outlook**



Experiences, challenges, outlook

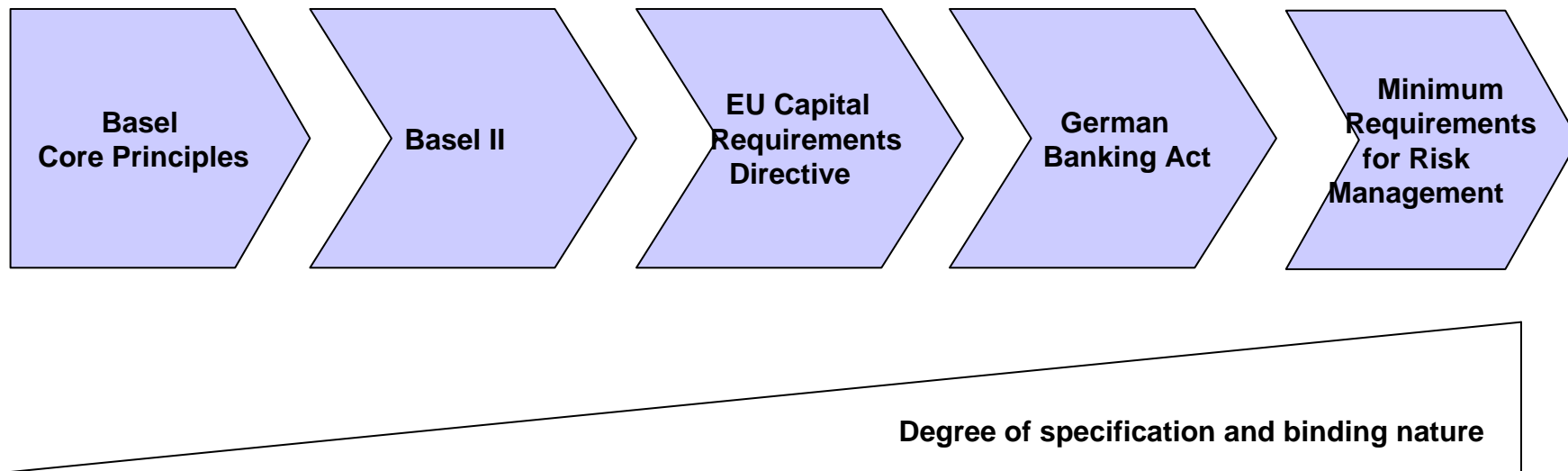
Experience from implementing Basel II in Germany

From a quantitative supervisory modus to a qualitative modus

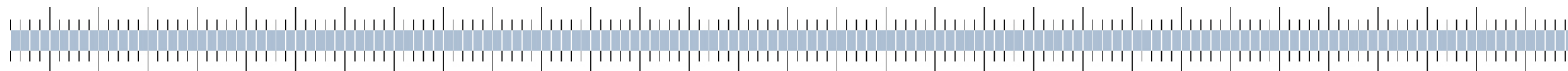


Experiences, challenges, outlook

Experience from implementing Basel II in Germany



Steps to a more qualitative oriented supervision in Germany



Experiences, challenges, outlook

Experience with the use of Basel IRB approaches – Worldwide

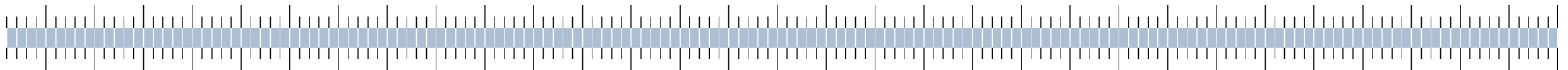
	Foundation IRB	Advanced IRB
G 10	135	154
... of that Europe	122	121
... of that Germany	43	21
Non G 10	20	21
Total	155	175

Experiences, challenges, outlook



Experience with the use of Basel IRB approaches – Germany

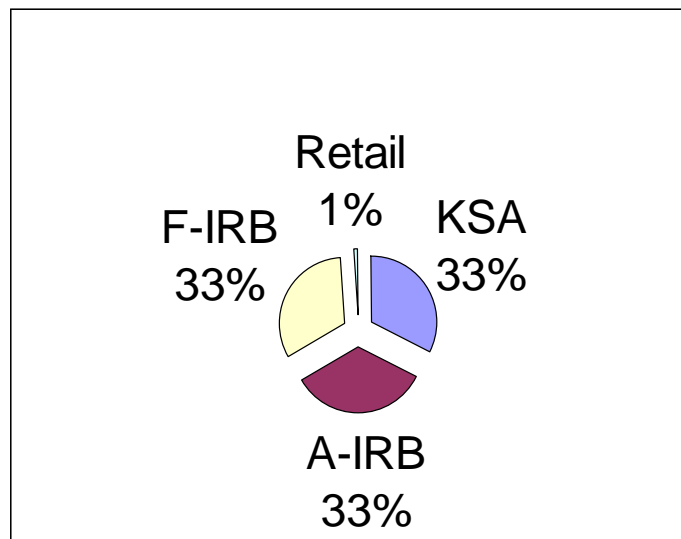
- More than 60 credit institutions in Germany want to use the new IRB approaches (in comparison worldwide: 330 institutions)
- IRBA banks in Germany are either large banks or very specialised banks
- Currently 51 applications (29 banks for the Foundation IRB, 22 banks for the Advanced IRB)
- 16 banks have received their authorisation to use the IRB on 1 January 2007
- In general application process of the IRBA in banks was so far quite satisfying



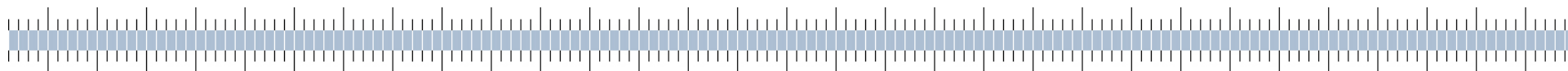
Experiences, challenges, outlook

Experience with the use of Basel IRB approaches – Germany

IRBA banks will cover more than 2/3 of the total assets of all German banks



(in % of total assets of all banks)

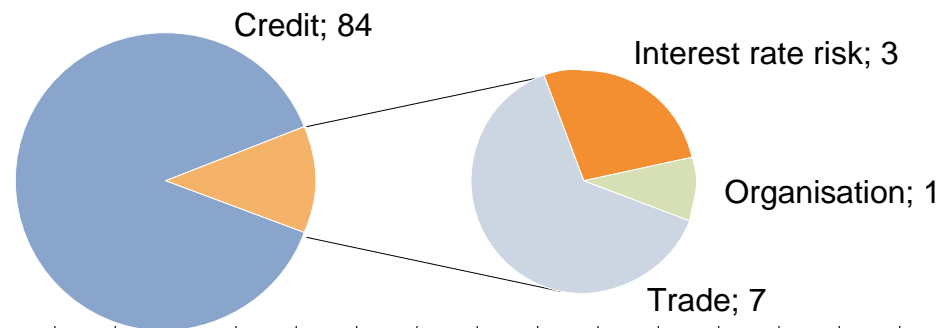


Experiences, challenges, outlook

Experience and feedback from on-site inspections with regard to 'Minimum Requirements for Risk Management'

- In 2006 more than 100 examinations
- Main focus: credit business

Risk management examinations 2006

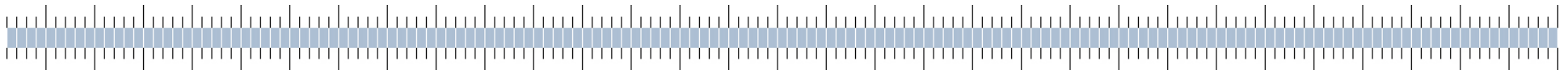


Experiences, challenges, outlook

Experience and feedback from on-site inspection with regard to 'Minimum Requirements for Risk Management'

Typical notifications during examinations:

- Credit process, in particular processing of problem loans
- Segregation of functions
- Risk-management
- Risk-controlling
- Reporting
- Internal audit

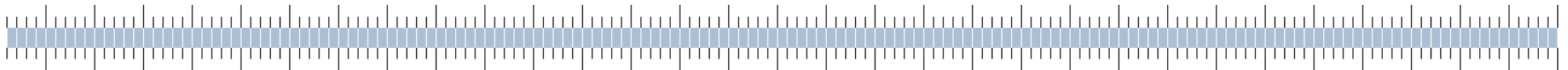


Experiences, challenges, outlook



Qualification of on-site inspectors

- Training program
- On-site training
- E-Learning

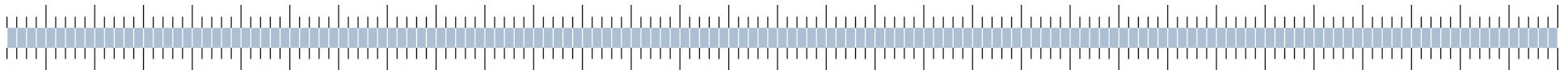


Experiences, challenges, outlook



Training program

- Foundation courses
- Intermediate course
- Advanced courses

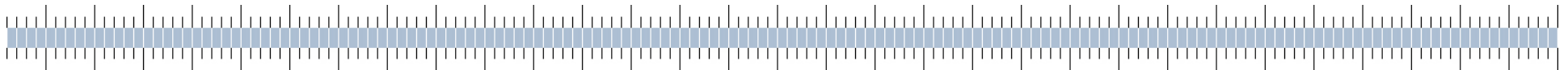


Experiences, challenges, outlook



Training program

- Basic concept: modular structure of courses according to the qualification and experience of the staff (in consultation with their supervisors)
- Maximum length of training: 12 ½ weeks of foundation and consolidation,
3 weeks of specialisation



Experiences, challenges, outlook

Training program

Module	Foundation Length	Consol'n Length	Special'n Length
Q11.1 Banking business, especially lending operations			
Q11.11 Basics of banking business	1 week		
Q11.12 Basics of lending operations	1 week		
Q11.13 Particular features of lending operations		1 week	
Q11.14 Selected Legal Risks within credit business			
Q11.2 Financial mathematics and statistics			
Q11.21 Basics of financial mathematics and statistics	1 week		
Q11.22 Evaluation of financial products		1 week	
Q11.23 Evaluation of financial products and term structure models			1 week
Q11.3 Accounting, audits of accounts and internal audits			
Q11.31 Basics of accounting and audits of accounts	1 week		
Q11.32 Particular features of accounting and audits of accounts		1 week	
Q11.33 International bank accounting practices			1 week
Q11.34 Update of Knowledge and Analysis of bank balance sheets			
Q11.4 Risk controlling at credit institutions			
Q11.41 Basics of risk controlling at credit institutions	1 week		
Q11.42 Market and credit risk models at credit institutions		1 week	
Q11.43 Basics of operational risk management	2 days		
Q11.44 Operational risk models			2 days
Q11.5 National and international banking supervision			
Q11.51 Basics of supervision	1 week		
Q11.52 Minimum requirements for the trading activities of credit institutions and Principles I and II		1 week	
Q11.53 Framework Basel II		1 week	
Q11.54 Audit of internal procedures (IRB)		1 week	
Q11.55 Level of implementation of Basel II at the credit institutions		1 week	
Q11.6 Data processing at credit institutions			
Q11.61 Data processing at credit institutions and audits of IT systems	1 week		
Q11.62 Test procedures and IT security concepts			1 week
Q11.7 Key qualifications for auditors	1 week		
Total duration:	8 weeks 2 days	8 weeks	3 weeks 2 days

Experiences, challenges, outlook

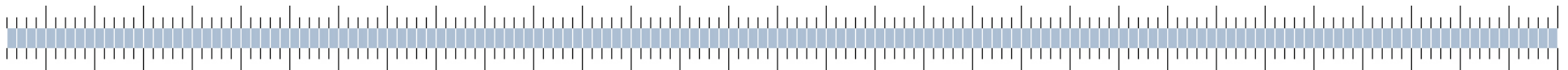


Outlook

- Basel II important step forward with regard to
 - resilience of credit institutions
 - better dealing with risks
 - contribution to the stability of the financial system

- Costs of introduction of new approaches are an investment in the risk management of credit institutions and their ability to survive

- Financing of the economy still possible for reasonable conditions

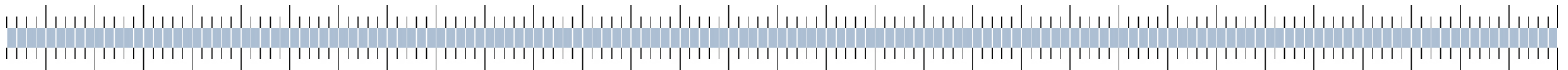


Experiences, challenges, outlook



Outlook

- Topics in focus:
 - Outreach of Basel II
 - Liquidity risks
 - Definition of regulatory capital
- Not any further meaningful regulation activities in the near future
- Intensified communication among supervisors



Thank you very much for your attention!



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