

05/1

Financial Services Authority

Strengthening Capital Standards

Feedback on CP05/3

September 2005



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Annex 1: List of non-confidential respondents

Annex 2: List of priority issues for consultation in the February 2006 CP

Annex 3: Glossary

This Feedback Statement reports on the main issues arising from Consultation Paper 05/3 *Strengthening capital standards*.

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Copies of this Feedback Statement are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

1 Overview

Introduction

- 1.1 In this Feedback Statement, we respond to the comments we received on our Consultation Paper CP05/3 ‘Strengthening Capital Standards.’¹ We published this in January 2005, along with draft Handbook text for implementing the Capital Requirements Directive (CRD) in the UK. It complements our continuing communication efforts which include work with trade associations, targeted mailings to specific sectors and a dedicated Basel 2/CRD implementation website². In addition to this, we encourage firms to maintain a close dialogue with their FSA supervisors and trade bodies to discuss how the CRD requirements will impact on them.
- 1.2 We received 45 responses to CP05/3, including a joint industry response submitted by the British Bankers’ Association (BBA), the London Investment Banking Association (LIBA), the Building Societies Association (BSA), the Council of Mortgage Lenders (CML) and the Finance & Leasing Association (FLA)³. We are grateful to all respondents for their submissions, which have helped us develop our approach to several policy issues exposed in CP05/3 – in particular in relation to national discretions and the specific instances where we were proposing to be superequivalent to the CRD. The responses will allow us to finalise our policy proposals – which are subject to final changes to the CRD text and examination of the constraints within it – and present them in our follow-up CP on ‘Strengthening Capital Standards’ planned for February 2006⁴. That CP will also contain the entire draft Handbook text for implementing the requirements of the CRD in the UK⁵.

1 CP05/3 documents: www.fsa.gov.uk/Pages/Library/Policy/CP/2005/05_03.shtml

2 CRD/Basel 2 implementation site: www.fsa.gov.uk/Pages/About/What/International/basel/info/index.shtml

3 There is a list of non-confidential respondents in Annex 1

4 Annex 2 lists the main consultation areas for the February 2006 CP.

5 A small number of CRD requirements will appear in our SYSC module. See 1.21.

- 1.3 This Feedback Statement clarifies several policy positions we set out in CP05/3. For ease of reference, it also follows the same chapter sequence. An additional chapter on senior management understanding has been added. While more general implementation issues are dealt with in this Overview, we cover specific policy areas in the relevant chapter.

Key feedback messages

Practical implementation

- 1.4 In parallel with the development of new Handbook rules and guidance, we have been working with firms to prepare for practical implementation of the CRD. In particular, we have increased our work with firms planning to apply for advanced approaches. Communication on practical implementation issues is primarily through firms' relationship managers, but we have also started to publish information on our website and in 'Dear CEO' letters (see chapter 17). We will continue to do this in the run-up to implementation.
- 1.5 We have indicated that our overall approach to implementation will be proportionate. But, for firms applying for advanced approaches, we have also indicated that we intend to look closely at how they meet requirements for the use test and senior management understanding – see our 'Dear CEO' letter to relationship-managed banks and building societies in May 2005⁶ and on our website. The waiver process, through which advanced status will be approved, is by no means a formality. It will involve rigorous challenge by supervisors. We will be looking for firms to acknowledge frankly any shortcomings and to take a conservative approach while making improvements. If necessary, we will not approve waiver applications where insufficient progress has been made in important qualitative areas, such as the use test or senior management governance. We will not agree waiver applications where there are clear shortcomings in modelling parameters which have a significant impact on capital levels, unless the firm proposes appropriate conservatism to compensate for this.
- 1.6 The use test is one of the key components of the new framework. Firms must demonstrate, by using internal risk-management and decision-making processes, their confidence that the estimates they produce from internal models do not result in an understatement of risk parameters. We expect to see model estimates play an essential role in decision-making and risk management. There is more detail on the use test for credit risk in paragraphs 7.45-7.49 and for operational risk in 11.4-11.5.

6 The 'Dear CEO' letter for banks and building societies: www.fsa.gov.uk/pubs/ceo/messages_crd.pdf

- 1.7 The role of senior executives is vital in ensuring the adequacy of Internal Ratings Based (IRB) rating systems. Senior executives must be sufficiently well-informed to be able to provide adequate challenge as part of the rating system approval process. The governance of rating systems will be a key area of focus in assessing IRB waiver applications.
- 1.8 We provide more detail on our stance on senior management understanding in Chapter 18. In particular, we have provided some examples of what a 'general level of understanding' might involve.

Definition of capital

- 1.9 The draft CRD, by and large, does not extend to the definition of capital, which is planned for review in both Basel and EU forums between now and 2009. We believe that it is desirable as a longer term goal to have common rules on the definition of capital for all banks, building societies and investment firms, as set out in CP05/3. But we agree that this should, preferably, be achieved through changes to EU directives. The Own Funds Review (OFR) will, we hope, bring the EU directives up to date, and lead to greater convergence with Basel. So we have decided, in response to feedback, to delay implementation of certain proposals in CP05/3 until the OFR has been completed. This will avoid a two-step change in the requirements. Our detailed feedback is set out in chapter 3.

Navigating GENPRU and BIPRU rules and guidance

- 1.10 In response to comments we received about the difficulty of navigating parts of the draft Handbook text in CP05/3, in particular the GENPRU chapter, we are exploring ways to make it easier for firms to consult our proposed rules and guidance in these areas.
- 1.11 Where we change the order of material in our draft GENPRU chapter, we will advise insurers in the planned February 2006 CP to note these changes to the extent that they affect them.

FSA-Industry groups

- 1.12 We continue to work with the industry in our Standing Groups and have established additional ones for market risk and Pillar 2 in the last few months. Since we published CP05/3, some Standing Groups have formed expert groups to examine particular policy issues. We are grateful to all participants in the Standing Groups and expert groups for their submissions as we develop our final policy proposals and Handbook rules and guidance. Please consult chapters 2, 5, 7, 8, 9, 10, 11, 13 and 14 and our website⁷ for an update on the expert groups' work.

⁷ CRD Standing Groups: www.fsa.gov.uk/Pages/About/What/International/basel/csg/index.shtml

International developments since CP05/3

CRD/Basel 2 implementation timeline

- 1.13 The progress of the draft CRD through the EU legislative process is entering a critical phase. At its plenary session on 26-28 September 2005, the European Parliament is scheduled to vote on a package of amendments agreed by its Economic and Monetary Affairs Committee on 13 July 2005. A considerable number of those amendments either replicate the Council of Ministers' position as agreed by EU Finance Ministers at ECOFIN in December 2004 or are designed to correct typographical or cross-referencing errors in the draft directive. Subject to the outcome of that vote, the prospects for agreeing the directive in a single reading under the UK Presidency of the EU remain positive.
- 1.14 The Basel Committee and IOSCO issued a joint consultation paper in April 2005 on the Trading Book Review (TBR). Within the EU, the intention is to incorporate the TBR provisions into the draft CRD text when the Parliament votes on it. The new CRD rules bearing on trading book positions are due to come into force on 1 January 2007 (not 2009 as stated in CP05/3 paragraph 1.22).
- 1.15 A further Quantitative Impact Study (QIS5) on the market impacts of the Basel Framework across the Basel Committee's Group of Ten (G10) participant countries is under way. We are grateful to the 20 UK firms participating in this exercise. We will use the data from the completed QIS5 workbooks in connection with the Basel Committee's recalibration discussions from April 2006 and our further cost-benefit analysis of CRD implementation in the UK (see chapter 16).

Committee of European Banking Supervisors

- 1.16 In recent months, the Committee of European Banking Supervisors (CEBS) has published several consultation papers⁸ on CRD implementation. This material – intended to reflect a common understanding among CEBS members of how certain aspects of the legal framework can be made operational – will provide a useful frame of reference in implementing the CRD. In all our work in CEBS, we continue seeking outcomes that are consistent with our risk-based philosophy and statutory objectives.
- 1.17 In implementing the CRD, we intend to be guided by the CEBS material and will reflect this in our Handbook where appropriate. This will be subject to our established process disciplines, including cost-benefit analysis. We indicate in the following chapters and paragraphs how we are taking forward the CEBS proposals as we develop policy:

8 CEBS consultation papers: www.c-ebs.org/Consultation_papers/consultationpapers.htm

- CEBS CP09 ‘Guidelines for cooperation between consolidating supervisors and host supervisors’ (see 1.25).
- CEBS CP03 (second) ‘Application of the Supervisory Review Process under Pillar 2’ (see 4.3, 4.4 and 9.3).
- CEBS CP07 ‘The recognition of External Credit Assessment Institutions (ECAIs)’ (see 5.36 and 6.2-6.7).
- CEBS CP10 ‘Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches’ (see 1.25, 7.4, 7.25, 7.28, 7.40, 7.44, 7.52, 7.56, 7.64, 7.67, 7.75, 7.81, 7.84, 7.86, 7.114, 7.122, 7.134, 11.2, 11.8 and 17.8).

Home-host requirements

- 1.18 We recognise that multi-national groups having to apply the CRD and/or Basel 2 in several jurisdictions are concerned about the outcome of discussions on home-host arrangements and the implications of differing national implementation rulebooks and timetables. We are working with our colleagues in CEBS to reach agreement on the home-host processes at the European Economic Area (EEA) level. For non-EEA countries, especially those at the G10 level, we are working with our regulatory counterparts in colleges of supervisors to understand how they are implementing the Basel Framework. In chapter 17, we explain how this affects firms intending to apply for the advanced approaches to credit risk and operational risk.
- 1.19 CEBS CP09 (and the corresponding parts of CP10) are expected to result in home and host supervisors in the EEA having a practical operational framework for the Supervisory Review Process under Pillar 2 (see chapter 4), and, for firms applying for the advanced approaches to credit risk and operational risk, for the Approval Process for Model Validation under Pillar 1 (see chapters 7, 11 and 17).

Handbook restructuring and further consultations

- 1.20 Once made, our new rules in the GENPRU and BIPRU chapters will effectively replace much of the current, extensive IPRU Handbook regime relating to prudential controls for banks, building societies and those investment firms that will be subject to the CRD. We will update our explanation of the new structure in Handbook Newsletter 67 in September 2005. This will overtake the commentary given in the relevant section of Handbook Newsletter 57 (November 2004) and complement Annex 1 of CP05/10 on Reviewing the FSA Handbook.

- 1.21 We plan to consult as soon as we can in 2006 on the SYSC module of the Handbook. This consultation will include the small number of CRD requirements which will not appear in GENPRU or BIPRU, but will appear in SYSC. Our intention is to create a common platform in SYSC of systems and controls requirements to comply with the CRD and the Markets in Financial Instruments Directive (MiFID).
- 1.22 Following publication of our February 2006 CP, we intend to consult on Handbook changes that are a consequence of implementing the CRD (so-called ‘consequentials’). This consultation is expected to take place in the second quarter of 2006.

Waivers, concessions and individual guidance

- 1.23 The CRD will introduce fundamental changes to large parts of the prudential framework. In some cases, we – or one of our predecessor organisations – will already have issued firms with waivers, concessions and individual guidance relating to rules that will be superseded by the CRD. With the exception of two specific areas outlined below, it will not be practicable to grandfather any existing waivers or concessions for CRD firms⁹. Insurance waivers will continue unaffected.
- 1.24 Where we are not grandfathering existing waivers, concessions or individual guidance, firms will have to consider whether to apply for them under the new rules. In deciding this, firms will have to consider their specific circumstances and the wording of the new rules and general guidance in the Handbook. Firms should note that there will be only limited scope to grant new waivers within the constraints of the CRD. This is because we have adopted a copy-out approach to substantial parts of the directive. In addition, we will be unable to make issuing fresh individual guidance a priority during the initial period of the new prudential regime.
- 1.25 Firms must also consider whether they need to apply for new waivers to benefit from treatments that are available by notification in the existing IPRU regimes. For instance, certain investment firms can currently obtain an exemption from consolidated supervision by notifying us that they meet the relevant conditions. But, under the CRD, the exemption will only be available by waiver. Existing exemptions will not be grandfathered, so a firm wishing to benefit from the consolidated supervision exemption will need to apply for a new waiver. The conditions for granting the exemption under the CRD are tighter than the current conditions. Firms should not presume that an existing exemption under current rules will be sufficient to meet the Financial Services and Markets Act statutory tests for a continuation under the new rules. They should consider this carefully before submitting any applications for waivers.

⁹ Individual guidance will not be grandfathered, except to the extent that it is interpretation of a rule that is substantially unchanged and complies with CRD requirements.

- 1.26 Firms wishing to apply for new waivers or individual guidance are encouraged to do so early, particularly if they need a decision in time for the 1 January 2007 implementation date. We will provide more details early in 2006 – on our website and through relationship managers – to manage this process effectively.
- 1.27 The two areas where we intend to grandfather certain existing treatments accepted under the IPRU regimes (whether by way of waivers and concessions or simply by compliance with existing IPRU text) are¹⁰:
- The definition/composition of capital, as this area was not directly affected by CRD. There will be some cases where we propose to grandfather an aspect of the treatment of a class of transaction or capital instrument, and seek to do so through transitional rules. In other cases, the general approach in paragraph 1.24 will apply. So firms will have to consider the specific circumstances of their own capital resources – and the wording of the rules and general guidance in GENPRU 2.2 – to determine whether they need a waiver and this can be justified. We do not expect any widespread need for new waivers of GENPRU rules which correspond to waivers or concessions under the IPRU regime.
 - The concentration risk regime pending the outcome of the EU review expected in 2007. To the extent that the substance of a Handbook provision has not changed, firms may continue to rely on existing waivers or individual guidance. For clarification, this will not apply in the context of the proposed new framework relating to intra-group exposures where, while certain individual provisions may not change, it is proposed that the overall framework should. (For feedback on respondents' comments about intra-group exposures and concentration risk, see chapter 8). It should also be noted that any waivers or guidance that are inconsistent with the requirements of EU legislation will not be carried forward.
- 1.28 We intend to grandfather these treatments, including waivers and concessions, by using transitional rules. Where we do this, firms will need to check that their particular circumstances are covered by the transitional rule, but do not then need to apply to us for new waivers or guidance. In other cases, as explained above, firms will have to apply for new waivers if needed.

Smaller firms and investment firms

The CRD does not make particular provisions discriminating for or against smaller firms or investment firms. But we recognise that, in practice, particular implementation challenges may arise for smaller investment firms. Our intention is to take a pragmatic approach but we acknowledge that there will not be scope for this in all circumstances. We recognise the diverse nature of investment firms in terms of size and business operations and intend to take account of this when formulating our Handbook rules and guidance.

¹⁰ The rules on liquidity risk have not changed; so, there will be no requirement to grandfather.

We are engaging with smaller firms to understand fully the issues they may be facing in implementing the CRD. We are maintaining a close dialogue with the relevant trade bodies. In addition, we responded in July 2005 to specific questions posed by our Smaller Businesses Practitioner Panel (SBPP) on the impact of CRD implementation on smaller firms. The sections of this Feedback Statement relevant to the SBPP response, along with other feedback of particular interest to smaller firms and investment firms, are in the following chapters and paragraphs:

- our supervisory approach to reviewing smaller firms' ICAAP for Pillar 2 (4.7);
- the definition of 'significant' for the standardised approach to credit risk in the context of retail portfolios (paragraph 5.4);
- the timing of the drafting of our BIPRU text for the standardised approach to credit risk (5.5);
- the simplified standardised approach to credit risk (5.7-5.8);
- exposures to institutions (5.9-5.11);
- our proposals to allow smaller firms to apply a flat 20% risk-weight for short-term, local currency exposures to institutions (5.13, paragraphs 4-8);
- monitoring of residential property insurance policies (5.15-5.16);
- exposures secured by and leases relating to commercial real estate (5.17-5.19);
- our intention to exempt limited licence and limited activity investment firms from operational risk capital requirements (10.5-10.6);
- consolidated supervision and the treatment of goodwill for investment firm groups (paragraphs 12.7-12.9); and
- mortgage indemnity insurance (13.3-13.5).

CRD, MiFID and RAO

For most investment firms the scope of the CRD is clear. But there are still some uncertainties about its impact on some specific types of investment firm, such as locals, commodity firms, corporate finance firms and venture capital firms. This is because of the way the CRD interacts with the MiFID. The latter will replace the Investment Services Directive when it comes into effect, which is currently expected to be in April 2007.

We plan to consult on our implementation of the MiFID by December this year, and the Treasury is expected to consult at about the same time on the changes it needs to make to the Regulated Activities Order (RAO) to take account of the changes that the MiFID will introduce. On 25 July, we sent a 'Dear CEO letter'¹¹ to all relationship-managed investment firms which are likely to be affected by the CRD and for which we are home supervisory authority. As with the letter we sent in May to banks and building societies, its objective was to inform and to initiate a dialogue with firms about the key areas of implementation.

Once these consultations are published, we will be able to finalise our work on a chart which shows how a firm's RAO permissions map across to the CRD categories. However, in the meantime, we expect firms to be proactive in contacting their relationship managers to discuss any specific queries they may have.

Consumers

As the objectives underlying the CRD and its planned implementation in the UK are primarily prudential in nature, it will affect consumers only indirectly. We did, however, update our Consumer Panel in July 2005 on two aspects of CRD implementation which might have an impact on consumers.

The first issue concerns small specialist lenders who focus on consumers with poor credit histories and who might be forced to leave the market because of the increased costs of capital and compliance. At this stage, we believe that any detrimental impact on consumers' access to credit will be limited, as the new retail risk-weight under the CRD is, in most cases, likely to be 75% compared to 100% under the current regime. So lower capital costs would go some way to offsetting any increase in compliance costs for such lenders. In developing our policy proposals, we are doing what we can to be flexible and keep any increase in lenders' costs to a minimum.

The second issue concerns lenders who may choose to market credit cards in preference to term debt, because the former will attract a lower capital charge. The concern has been that this could raise the cost of borrowing for some consumers and exacerbate concerns about levels of indebtedness. However, firms have indicated to us that pricing is not primarily driven by their regulatory capital requirements.

11 The 'Dear CEO letter' for investment firms: www.fsa.gov.uk/pubs/ceo/invfirms_crd.pdf

2 Scope of application

Introduction

- 2.1 In CP05/3, we consulted on various proposed modifications to the solo prudential requirements for a firm that is a member of a group, including the proposed detailed criteria to be met to permit solo consolidation.
- 2.2 CP05/3 also contained our current thinking on the integrated groups regime in the form of a revised integrated groups proposal¹². We updated our CP97 proposals in light of developments at the European level. In developing this proposal, we also took into account comments made by the Credit Risk Standing Group (CRSG).
- 2.3 Work is continuing, in conjunction with an industry expert group, on both solo consolidation and the integrated groups regime. We will include our final proposals in the February 2006 CP.

Responses to individual questions

Solo consolidation

Q1: Do you agree that the overall package of solo modifications achieves an appropriate balance? If not, what amendments would you suggest? And why?

- 2.4 In its joint response, the industry stated that it wanted to see the finer detail of our solo modification proposals before commenting on the overall package. Other respondents were broadly supportive and particularly welcomed the proposals to retain solo consolidation for deposit-takers and to make it available to investment firms.

¹² In CP05/3, an overview of the integrated groups regime was presented in chapter 2 (questions 5, 6, 7), capital risk-weighting aspects were discussed in chapter 5 (questions 24 and 25), relevant IRB approach matters were discussed in chapter 7 (question 49) and concentration risk issues were discussed in chapter 8 (questions 112-114).

2.5 A few respondents felt that we should no longer require a firm to deduct investments in subsidiaries from solo capital. They argued that retaining this requirement would result in competitive distortion between the UK and other EEA countries that would waive the deduction. One respondent asked us to consider reinstating the current special treatment for building societies' mortgage indemnity captives. Under IPRU (BSoc), a society is allowed to deduct only 25% of its investment in such a subsidiary, provided that it is consolidated for regulatory purposes.

2.6 **Our response:** We do not intend to change our general requirement to deduct investments in subsidiaries and participations from solo capital. We see deduction as a key tool for ensuring appropriate distribution of capital as part of a balanced package of solo modifications. So, while we will not exercise the national discretion to risk-weight investments rather than deducting them as some other Member States will allow, we will adopt concessionary policies that other Member States will not implement.

We considered whether the existing treatment of building societies' mortgage indemnity captives should be retained. We have reviewed the evolution of these captives since N2¹³ and analysed the impact of removing this special treatment, which we think is very small. We have concluded that it is now the right time to have a common approach on treating insurance captives for both banks and building societies. So we do not intend to change our position on this.

Q2: Are the proposed solo consolidation conditions appropriate? If not, what modifications would you suggest? And why?

2.7 Most responses to this question came from firms that have practical experience of the existing solo consolidation regime. The majority had some concerns about our proposed conditions for including a subsidiary in the solo consolidation. These fell into two broad categories:

- that certain aspects of the conditions in the ECOFIN text itself were too onerous; and
- that some of our proposed detailed criteria were inappropriate.

2.8 By far the most widespread concern related to the requirement that there be no impediment to the prompt repayment of liabilities by the subsidiary to the parent 'on demand'. Respondents stated that a strict interpretation of this ECOFIN condition could either prevent solo consolidation or discourage good risk management practices. In particular, they noted that many subsidiaries are typically funded on a term basis that matches the maturity of their assets. This

13 N2 – 1 December 2001, when the FSA obtained its statutory powers under the Financial Services and Markets Act 2000

approach to funding hedges liquidity and interest rate risks in the subsidiary. Respondents also noted that these subsidiaries could not be funded in the market without losing the benefit of solo consolidation, because another condition in the CRD requires all material liabilities (or assets) to be to the parent firm.

2.9 Some respondents also asked how we would interpret the condition that there be no impediment to the prompt transfer of own funds by the subsidiary.

2.10 **Our response:** If the present ECOFIN text becomes final CRD text then the requirement on prompt repayment of liabilities on demand will become a CRD condition, which we must carry forward into our rules. But we would prefer to see the 'on demand' language removed from the ECOFIN text. If this language is retained unchanged in the final CRD text, the relevant expert group will consider what, if anything, can be done to alleviate this constraint. It will also look at the condition relating to the transfer of own funds.

2.11 Respondents asked for more information about how we intended to apply the condition that the parent's risk management procedures cover the subsidiary. Some proposed that we should focus on 'policies' rather than 'procedures', or that the subsidiary's risk management techniques should be 'consistent' with those of the parent. Another suggestion was that we should focus on whether the subsidiary's activities are managed as they would be if they were undertaken by the parent.

2.12 Respondents queried in particular our observations that:

- it is unlikely that this condition will be met if the activities of the subsidiary are of a type not carried on by the parent; and
- if the parent uses an advanced approach that is suitable for the activities of the subsidiary, we will expect its use to be extended to cover the subsidiary.

2.13 **Our response:** We agree that a key principle underlying this condition is that a solo consolidated subsidiary should be managed as though it were a branch of the firm. We will incorporate this principle into the draft Handbook material on solo consolidation.

The expert group is developing a position paper that will explain in more detail how the industry sees the risk management condition for solo consolidation. We will take this into account in developing our proposals for February 2006 CP.

Q3: Do you think that we should specify in more detail the information that firms should provide in order to 'demonstrate fully' that there are no serious impediments to the transfer of own funds or repayment of liabilities by a solo consolidated subsidiary to its parent? If so, what issues would you like us to cover?

2.14 Responses to this question were mixed. The majority said that we should not provide more information. They thought that additional guidance could be

too prescriptive and would reduce flexibility, especially given the variety of uses for solo consolidation. But it is worth noting that many of those taking this view also asked for more detailed information on the solo consolidation conditions under question 2 above.

2.15 In contrast, a few respondents thought that we should give more information on what firms needed to do to satisfy us that this condition had been met. Others felt that we should provide more detailed guidance on all of the qualifying criteria for solo consolidation.

2.16 **Our response:** As is evident from the responses, it is difficult to strike a balance between certainty and over-prescription. But it is clear from the responses to questions 2 and 4 that we do need to set out our expectations of firms. So we aim to work with the expert group to develop material for inclusion in the Handbook.

Q4: Would our proposal to limit solo consolidation by reference to a capital distribution test prevent you from solo consolidating subsidiaries that would otherwise be eligible? Would this cause a capital deficit in the relevant firms? If so, could surplus capital be transferred from other entities in the group and at what cost?

2.17 Most respondents objected to the capital distribution test, although a few said that it would not affect them. They considered the proposal was superequivalent, and did not think that we had made a strong enough case for it. They also felt that such a test was unnecessary if the other solo consolidation conditions had been met. And some noted that a constraint based on tier one capital could be particularly difficult for investment firms because of their higher gearing levels. Respondents also asked various detailed questions about how the test would work in practice.

2.18 **Our response:** We have received a paper on this subject from the expert group. The group's view is that the capital distribution test proposed in CP05/3 is unnecessary and does not address the risk that capital in a solo consolidated subsidiary might not be transferable to the parent firm, as required under the CRD. The group also commented that the proposed test was disproportionate and explained how it could put UK firms at a competitive disadvantage.

We have had regard to industry responses and the work done by the expert group on this issue. We agree that our rules and guidance must principally be directed to securing that a subsidiary is not solo consolidated if there are impediments to the transfer of capital to the parent. So, as a priority, we will aim to work with the expert group to develop Handbook text explaining what we will expect firms to do to demonstrate that they have met this condition.

But we still believe there is a residual risk that, in the limit, transfer mechanisms will not prove effective. Many of them have not been tested in practice to any

significant extent. Should capital not be transferable when it is needed in practice, the consequences for consumers and markets could be very significant. So, while we accept that the capital distribution test proposed in CP05/3 was too harsh, we intend to retain a test, albeit at a more modest level, in our proposals in the February 2006 CP. The expert group proposed some possible alternatives, which we will discuss with the group in more detail.

Integrated groups

Q5: What impact on competitive advantage do you think the integrated groups regime will have?

- 2.19 Some respondents commented that it was appropriate to apply an integrated groups regime to banks, building societies and investment firms as part of a package or measures potentially available to groups of firms whatever their legal nature. Others, however, thought that the proposed integrated groups regime was not conducive to an international level playing field and went against the EU Treaty's freedom of establishment. They were concerned that the current wording of the CRD does not permit zero-weighting of intra-group exposures to non-UK group companies.
- 2.20 Some respondents stated there would be higher capital requirements for business carried out through non UK subsidiaries and the proposed large exposure limits would act as a potential constraint to such business development. The Joint Industry response referred to a survey it had undertaken among certain large banks and which indicated an additional capital requirement of £3.7 billion to comply with the new rules. One respondent noted that it did not expect the new integrated groups regime would have a major impact. It also expected that some firms would be likely to move certain overseas activity into their home regulated firms to ensure there was no real impact.
- 2.21 **Our response:** We note respondents' preference for the 0% risk-weighting to be made available to non-UK exposures. However, the draft CRD currently restricts the availability of the 0% risk-weighting. Article 80.7(d) requires that the counterparty be established in the same Member State as the firm and our proposed integrated groups regime continues to reflect the conditions contained in the current draft CRD. Our feedback on the proposed concentration risk treatment of cross-border intra-group exposures is provided in the context of questions 112-114 in chapter 8. We would be extremely interested to receive a detailed analysis of the £3.7bn additional capital requirement referred to in the Joint Industry response. We consider that this information could be very helpful when finalising our proposals. A detailed analysis would allow us to properly assess the net impact and interaction of our proposals and the assumptions underpinning the figures in this complex area of cost-benefit assessment.

Q6: Is our overall approach to integrated groups clear?

- 2.22 Some respondents commented that while the overall approach to the integrated groups regime was clear, or clearer than the proposals set out in CP97, they remained opposed to it. In several aspects, the proposals themselves were thought to be complex and difficult to implement in practice. Others felt that the links between the components – standardised, IRB and concentration risk – of the integrated groups regime were not clear.
- 2.23 Others thought that an assessment would be possible only when we had published all of our proposed policies for groups and Pillar 2 proposals – so that they could assess the complete regulatory regime.
- 2.24 A number of respondents thought it would be helpful to have more guidance and explanation. Some thought this should take the form of additional rules and guidance and others suggested additional materials (e.g. worked examples, an overview of the integrated groups regime) be included in annexes to the Handbook.
- 2.25 Some respondents asked us to clarify how the integrated groups regime and solo consolidation interact.
- 2.26 **Our response:** We note the requests for additional guidance and clarification on a number of matters. Additionally, we note the difficulties that some respondents encountered in navigating and linking the elements of the integrated groups regime. We will consider this aspect further when finalising the Handbook text. However, in general terms we consider the overall structure, which reflects that of the draft CRD, not to be unduly complex. Concerning the suggested complexity of certain aspects of the proposals – in particular (i) the link between permanent partial use under the IRB approach and the availability of the preferential concentration risk treatments and (ii) the operation of the ‘diverse blocks’ concept – we comment further on these in the context of question 49 in chapter 7 and questions 112-114 in chapter 8.

Q7: What are the implications for firms of implementing the integrated groups regime?

- 2.27 Respondents generally welcomed the potential ability to exempt certain intra-group exposures from large exposure limits and the availability of a preferential risk-weighting. But concerns were expressed about some of the eligibility conditions and their interpretation and application.
- 2.28 In addition to the question of capital costs (see question 5), some respondents thought there might be significant costs associated with the implementation, reporting and maintenance of the proposed integrated groups regime. One respondent thought it unlikely that the proposals would lend themselves to automation and that the processes would heavily rely on manual intervention.

2.29 The Joint Industry group questioned the timing of the introduction of the proposed concentration risk elements of the integrated groups regime.

2.30 **Our response:** As noted in our response to question 5, the 0% risk-weighting for intra-group exposures is not available on an EU or Basel 2 basis (Article 80.7 of the draft CRD). Our proposals for an integrated groups regime have to reflect the current version of the draft directive.

We note the comments and concerns regarding the interpretation of the eligibility conditions for forming a UK integrated group and the requests for guidance on these. We also note the comments and concerns about costs, complexity and practicality. Relevant aspects are being further discussed in the context of the work of the industry expert group. On the question of timing, see our response to questions 112-114 in chapter 8.

3 Capital resources and valuation

Introduction

3.1 In CP05/3 we consulted on:

- proposed changes to our requirements on the composition of capital that firms must hold;
- the definitions of individual capital resource items; and
- general rules for valuing assets, liabilities and income statement items.

Some of the changes were needed to implement the draft CRD. We proposed other changes to make our rules consistent between banks, building societies and investment firms to create a level playing field in the capital markets. The policy of harmonisation was a continuation of the principles and proposed rules we consulted on in 2001 through CP97 (Integrated Prudential Sourcebook).

Overall summary of responses

- 3.2 Many respondents welcomed harmonisation and the proposed tiers of capital that would be available for all types of firm. Many expressed concern, however, about those proposals that would result in new requirements which were tougher than those set by the CRD. Some respondents questioned whether in attempting to harmonise the regime across sectors, we had fully justified these areas of superequivalence.
- 3.3 Another common, and related, message in the feedback was concern that we were proposing to change the capital rules at this stage even though the draft CRD, by and large, did not extend to defining own funds. The definition of capital will be subject to major review in both EU and Basel fora. The results of the Own Funds Review (OFR) in the EU are expected to be implemented by 2009. Some respondents commented that as the OFR was imminent, now was the wrong time to introduce new superequivalent capital treatments which would tend to pre-empt or prejudice its outcomes.

Policy direction and timing

- 3.4 We believe that it is desirable as a longer term goal to have common rules on the definition of capital for all sectors. The principal properties of capital, essentially loss absorbency and permanence, are the same for all firms. But we agree that preferably this should be achieved through changes to EU directives. Although the basic rules on capital are contained in EU directives, these are in need of radical overhaul. And whereas our banking rules have undergone periodic updates to reflect developments in Basel to take account of the use of hybrid capital instruments, the rules for building societies and investment firms have not been updated in a similar way. The OFR will, we hope, bring the EU directives up to date, and lead to greater convergence with Basel. So we have decided, in response to feedback, to delay implementation of some of the proposals in CP05/3 until the OFR has been completed. This will avoid a two-step change in the requirements.
- 3.5 Essentially, we see the issue as one of timing. Apart from the limited relaxations we are prepared to make to the existing policy for banks, we are still committed, longer-term, to the policy approaches outlined in CP05/3, which we believe are justified.

Responses to individual questions

Innovative tier 1

Q8: Should the concept of innovative tier 1 capital be extended to building societies and investment firms?

- 3.6 Most respondents supported the proposal to also apply innovative tier 1 capital to investment firms. This is because it will provide firms with the same options in designing their capital resources and will help create a level playing field between regulated firms.
- 3.7 However, most building society respondents did not support the proposal to apply the innovative tier 1 classification to Permanent Interest Bearing Shares (PIBS). They were concerned there may be additional costs involved in issuing PIBS which comply with our non-innovative requirements and there may be no, or a limited, market for such instruments on economically feasible terms. Building society respondents felt that the proposed policy would disadvantage them against banks, which have access to a wider range of tier 1 capital instruments due to the difference in corporate structure between the two sectors. So the building society sector – both through the Building Societies Association and direct from some building societies – responded that PIBS should continue to be treated as non-innovative tier 1 capital without distinction according to their features.

3.8 The Joint Industry response expressed concern that our rules did not allow firms to use innovative tier 1 capital to meet Pillar 1 capital requirements. This response also asked us to clarify how our proposed rules on indirectly issued tier 1 capital would operate.

3.9 **Our response:** We have decided not to implement most of the PIBS policy we proposed in CP05/3 until the OFR is completed. We intend to pursue harmonisation, through the OFR, which will give us the opportunity to review the treatment of PIBS features in a wider European context. But for now we will not restrict the use of PIBS for building societies where they have innovative features, such as step-ups. We will still allow the more generous limit on PIBS that we proposed in CP05/3.

The terms of all PIBS will, however, have to provide the issuer with full coupon discretion. That is, we will retain the proposed rule that PIBS issuers must never be obliged to pay a coupon in cash. We are retaining this part of the policy as we have seen evidence that there is a market solution to mitigate the impact – including cost – of requiring fully discretionary coupons, bearing in mind the mutual status of building societies.

We will continue our existing policy for banks – and the proposed extension of policy to building societies and investment firms – to exclude innovative tier 1 capital from counting towards the Pillar 1 minimum. The use of innovative tier 1 capital will be addressed as part of the OFR. Rather than pre-empt the outcome of this, we will leave our policy unchanged for now.

Our proposed rules on indirectly issued tier 1 capital only apply at the solo level. Indirect tier 1 capital, raised through solo consolidated entities or raised for group purposes only, will be covered by separate rules in BIPRU 2.1 and BIPRU 8.

GENPRU rules and guidance

Q9: Are the draft rules in GENPRU 2.1 and 2.2 understandable and is their application to your firm clear?

3.10 Some respondents noted that the principles and rules were clear. However, many commented that the structure of the chapter was not ‘user-friendly’ and, in particular, that the relevant requirements for investment firms were difficult to find and apply. Some respondents requested we develop standard subordinated debt forms to help small firms.

3.11 **Our response:** Our objective is to make the rules as easy to interpret as possible, so we have taken many of the industry suggestions on board. Where appropriate, we will include extra guidance. We will introduce a contents page for quick reference and include tables showing the various options for calculating capital resources available to investment firms. We will re-order the rules which should help with navigation. Re-ordering should also make clearer the order in which deductions are made. We are considering other changes to the chapter to address

industry concerns about the user-friendliness of the material. Finally, we would in principle support industry proposals to develop a standard subordinated debt form.

Definition of capital resources

Q10: Taken as a whole, does our definition of capital resources result in an appropriate standard for the quality of capital across all different types of firm?

- 3.12 Many respondents expressed support for the framework that has been developed but there were some specific areas of concern.
- 3.13 **Our response:** We have considered the concerns raised by industry on each of these items and in some areas, described below, we will change the policy.
- 3.14 Some respondents commented that the proposal to deduct the full amount of individual material holdings in other financial and credit institutions is superequivalent and could create additional volatility. The Joint Industry response noted that our policy proposal – of not including notional positions in calculating net exposure to material holdings – was superequivalent.
- 3.15 **Our response:** We will remove the superequivalent aspects of the material holdings rules for investment firms, namely the requirements on aggregate positions in the non-trading book and the excess trading book position. However, we believe that the draft CRD requires the amount of any holding above 10% of another firm's capital to be deducted in full. We will therefore retain this requirement. And we will continue with the policy that firms should not take into account short positions in calculating their material holdings exposure – other than in respect of the excess trading book position, as this is required by the draft CRD. We will retain the proposed requirement for investment firms to deduct reciprocal cross holdings of capital instruments to the extent that these are not material holdings. This is necessary to prevent the risk of artificial inflation of the firm's capital position. We will continue with the relaxations for banks proposed in CP05/3.
- 3.16 Some respondents expressed concern about the proposal to extend to building societies the policy on deducting connected lending of a capital nature, particularly where the future use of solo consolidation was uncertain. The Joint Industry response questioned how the policy on deduction for connected lending of a capital nature would be applied, given that the proposed rules could be interpreted inconsistently.
- 3.17 **Our response:** We will not require building societies to deduct connected lending of a capital nature at this stage. This would be superequivalent to current directives, so we will defer our decision until the OFR is completed. We have listened to concerns about how the connected lending deduction will be applied and we have decided to narrow the scope of the deduction for banks. We will redraft the rules to take into account risk mitigants – such as collateral or an

unfettered ability for the lender to terminate the lending without penalty. But the lender must be able to demonstrate that it could terminate in practice.

3.18 Many respondents were concerned that the requirement for a QC opinion on loss absorbency was unreasonable, and asked whether the legal certainty of the opinion could be obtained through other professional advice.

3.19 Some respondents questioned the requirement to give six months' notice of intention to repay tier 2 instruments, as the corresponding rule for innovative tier 1 instruments only required one month's notice.

3.20 **Our response:** We will relax the proposed requirement for a QC opinion for banks, building societies and investment firms – to require a properly reasoned legal opinion from an independent source. Independence, in this context, means having had no previous involvement in the capital issue documentation.

We will reduce to one month the required notice period for banks, building societies and investment firms of intention to repay tier 2 instruments.

As part of harmonising the rules between tier 1 and tier 2, we have decided to extend the tier 1 credit spread step-up test to tier 2 capital. So, firms raising innovative tier 1 or tier 2 capital can include a step-up at year 10 of up to 50% of the initial credit spread.

3.21 Many investment firm respondents expressed concern over the proposed introduction of a limit on their use of preference shares compared to core tier 1 capital.

3.22 **Our response:** We will not apply the preference share restriction to investment firms at this stage, which would be superequivalent to current directives, but we will defer consideration of this issue until the OFR. We will maintain this restriction for banks, as we still believe that it is reasonable to require that at least 50% of a firm's tier 1 capital comprise highest quality capital (that is, ordinary shares and retained earnings). This is also a Basel standard.

3.23 The requirement to deduct all interim losses, rather than only material losses caused some concern as it is superequivalent to the directives. We also received a response questioning the treatment of negative goodwill¹⁴.

3.24 **Our response:** We will not apply the proposed new policy in CP05/3 requiring investment firms to deduct all interim net losses from tier 1. Rather, we will retain the current policy requiring deduction of only material losses from tier 1, at this stage. We will defer our decision on whether to implement the proposed CP05/3 policy until the OFR is completed.

Negative goodwill will be a component of tier 1 capital resources. This relaxes the current treatment for banks and continues the current treatment for building societies and investment firms.

14 Negative goodwill arises when the fair value of the purchase consideration is less than the fair value of the net assets acquired.

3.25 Some respondents queried why amortised tier 2 could not be used in the tier 3 bucket. Respondents also asked about the proposed exclusion of tier 3 for covering settlement and counterparty risk for investment firms.

3.26 **Our response:** Amortisation ensures that only a percentage of the value of the tier 2 instrument counts towards capital resources as the instrument nears its maturity date. If amortised tier 2 amounts were allowed to count as tier 3 capital then 100% of the capital would still be counting towards capital resources and the amortisation rule would be undermined. However, if a tier 2 instrument is due to be amortised a firm can choose to reclassify it as tier 3 capital subject to notifying us and subject to the instrument meeting the requirements for tier 3. To avoid doubt, our proposed rules require amortisation to be done on a straight line basis, not on an annual step basis.

The draft CRD introduced a new and explicit exclusion of tier 3 capital for covering settlement and counterparty risks. Our proposed policy in this area is consistent with it.

3.27 Respondents noted the exclusion of the right to sue for unpaid amounts in tier 2 instruments. There was a comment that this could impact upon the ability to raise capital in certain jurisdictions.

3.28 **Our response:** We recognise that in certain jurisdictions the contractual terms of a capital instrument cannot exclude the holder's right to sue for due but unpaid amounts. However, we require that the only remedy for non-payment of an amount due can be petitioning for a winding-up or proving for the debt in liquidation. If a firm issues an upper tier 2 instrument in such a jurisdiction then there should be no circumstance in which an amount is due and payable, other than pure operational risk (that is a failure to exercise the right to defer/cancel a coupon). So the right to sue should not arise and its exclusion should not pose a problem. If a firm issues a lower tier 2 instrument in such a jurisdiction then we may accept a limited right to sue that only applies to unpaid interest, while the firm meets its regulatory capital requirements. The firm would need a waiver from our rule and we would review each case separately.

Q11: Would the proposed changes to the definition of capital resources in GENPRU 2.2 and to the Fixed Overhead Requirement (FOR) in GENPRU 2.1 affect your costs in a material way? Would they significantly affect decisions on the amount and composition of your capital?

3.29 Most respondents stated that the proposals would not affect their costs or decisions in a material way, except in some of the specific instances noted above, where we are adjusting our response. Some respondents stated that they were uncertain of the potential affect.

3.30 Respondents welcomed the new FOR regime and the decision to make the capital resources requirement for ‘limited licence’ firms the higher of the FOR and the credit and market risk charges. The industry asked for an explanation of the proposal not to allow the collateralisation of illiquid assets, which is currently a feature of Chapter 10 of IPRU (Inv).

3.31 **Our response:** We aim to be a proportionate regulator and therefore welcome comments that our policy will not have a material impact on the industry’s costs. We have demonstrated that we are prepared to reconsider policy proposals whose cost-benefit justification is not clear-cut.

The rationale behind our illiquid assets regime is that illiquid assets are assets that a firm could not realise within 90 days as part of an orderly winding up. So, our initial view is that collateralising such assets would not enable the firm to realise their value within 90 days. We do not believe that this policy is superequivalent to the draft CRD. We have, however, received further representations from industry on this issue after the end of the consultation period, which we will consider before reaching a conclusion.

4 Individual capital adequacy standards

Introduction

- 4.1 In CP05/3, we consulted on the new individual capital adequacy standards reflecting the provisions of Part 3 of the Basel Framework (Pillar 2) and the draft CRD. We described two key components: the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP). We also provided firms with detailed guidance on the characteristics their ICAAPs should possess, given not only their size and complexity but also the sectors within which they operate.
- 4.2 The comments we received were, in the main, supportive of the way in which we propose developing the Pillar 2 framework. However, in addition to views on the specific questions posed in CP05/3, many respondents asked us to provide greater clarification in other areas such as: how the SREP and the ICAAP would come together given their different objectives; the treatment of diversification benefits; and how Pillar 1 and Pillar 2 stress tests were to be reconciled so as to avoid double-counting. Smaller firm respondents felt that sensitivity analysis would be inappropriate in view of the simplicity of their business.
- 4.3 We will provide more information on how we will take into account the ICAAP, diversification effects, stress tests and scenario analyses and proportionality in our February 2006 CP. We also expect that our views will continue to evolve as we work with other supervisory authorities and firms gain more practical experience of the Pillar 2 regime as it is developed. We intend to continue feeding back to firms our thoughts on such issues through the Pillar 2 Standing Group, newsletters, sector briefings and other informal mechanisms to make the Pillar 2 process efficient and effective for both firms and us.
- 4.4 In the February 2006 CP, we will also make appropriate references to the second CEBS consultation paper on Pillar 2, issued on 20 June¹⁵, and a third CEBS CP, planned for late autumn 2005, which will develop the individual risk buckets and building blocks used in Pillar 2.

15 CEBS CP on Pillar 2: www.c-ebs.org/Consultation_papers/CP03-second.pdf

Responses to individual questions

Q12: How do you assess the balance struck between prescription and guidance in relation to the ICAAP? Will our rules and guidance be sufficient for less complex and smaller firms?

4.5 Although many respondents considered the balance to be about right, conflicting views were expressed. ‘Larger’ firms felt that the guidance was overly prescriptive and ran the risk that we could interfere with management best practice and sound existing governance structures. On the other hand, ‘smaller’ firms:

- sought more granularity, particularly with regard to some sectors e.g. more detail of what our proposals mean for securities firms together with some worked examples of what such firms need do to comply with the rules; and
- wanted an early dialogue and guidance in developing their ICAAPs.

4.6 Non-relationship-managed firms that responded speculated about the level of our resources available to review their ICAAPs and wondered whether we would simply resort to the setting of a conservative capital requirement without reviewing their ICAAPs in any detail.

4.7 **Our response:** We consider the balance between prescription and guidance to be broadly right, particularly if we do not prescribe a particular confidence level to which firms’ ICAAPs should be calibrated for regulatory purposes. We do not wish this section of our Handbook to become much larger than the draft rules and guidance in CP05/3. Nor do we wish to set precise boundaries between large or small, sophisticated or unsophisticated businesses as we think this may lead to the development of two regulatory regimes rather than a single proportionate one.

We encourage larger firms to view the proposed guidance material as guidance and not rules. We do not consider it prescriptive to state that we will find it easier to place reliance on firms’ ICAAPs which follow the guidance, since this does not exclude us relying on firms’ ICAAPs which take a different approach.

We are engaging with several smaller firms and trade bodies as we develop our supervisory approach to reviewing firms’ ICAAPs. Realistically, it is not practical to provide individual guidance to all firms in advance of the implementation of the Pillar 2 regime and formal reviews of their ICAAPs. However, as the process develops and experience is gained we will give the industry feedback on developing ICAAPs through informal channels such as sector briefings.

For most non-relationship-managed investment firms, we are likely to work on the presumption that the Pillar 1 capital requirements will be sufficient to meet our regulatory objectives. We aim to keep the intensity of our review of such firms’ ICAAPs to a minimum consistent with the UK’s obligation to implement properly the directive’s provisions but taking into account the systemic importance of such firms.

Q13: Is our approach to group ICG clear and appropriate?

4.8 In general, respondents felt that the approach to group ICG had been clearly explained. Some respondents, however, could not understand why we had restricted consideration of capital assessments to those based on the consolidated financial position of the UK group only. They suggested that this distinction was arbitrary and did not reflect how many international groups were organised. Some respondents also commented – despite the emphasis placed on the dialogue with firms which we see as a vital part of the SREP – that if we disagreed with a firm about its ICAAP we would still unilaterally give ICG. Consequently, respondents wanted greater understanding on what would happen if there was a disagreement and whether firms would have the right of appeal against ICG.

4.9 **Our response:** Our focus on the UK group as a basis for reviewing ICAAPs stems directly from Article 71 of the draft CRD. This obliges ‘parent credit institutions in a Member State’ to comply with Article 123 (broadly the ICAAP). This definition requires us to ensure that UK groups comply with the requirements of the directive. Our review can extend beyond that if necessary. We aim to be pragmatic where international parent institutions play a significant role in establishing risk management processes and capital adequacy, but we also need to form our own view of the capital adequacy of those UK entities which we regulate and whose domestic business we are best placed to evaluate.

Where we give ICG, we will explain the reasoning and seek firms’ agreement. We will aim to resolve differences of opinion through further analysis and discussion, perhaps making use of reviews by independent experts on an exceptional basis. If no agreement can be reached, then we will have the option to use our own initiative powers under section 45 of the Financial Services and Markets Act to vary a firm’s permission and impose a modified capital requirement. Using such powers brings with it rights for the firm concerned to challenge our decision, which may then ultimately be reviewed by the Financial Services and Markets Tribunal.

Q14: Would it be helpful if we provided guidance on the confidence level to be used in firms’ ICAAP? If so, we would welcome thoughts on a confidence level for, and the correlation assumptions between, each of the major risk groups you consider appropriate.

4.10 There was little support for the prescription of confidence intervals. Respondents argued that:

- the prescription of confidence intervals would imply the use of sophisticated modelling techniques capable of estimating a probability distribution but these would not be adopted by all firms;

- we would have difficulty in understanding how confidence intervals were being used unless firms had modelling tools which made use of such concepts; and
- using confidence intervals would not, contrary to expectations, facilitate peer group comparisons.

4.11 However, one respondent wondered what the absence of a prescribed confidence level for banks, building societies and investment firms would mean for overall integrated supervision.

4.12 **Our response:** We have decided not to prescribe in guidance a confidence level to which we expect firms' ICAAPs to be calibrated, where they are driven by such an explicit assumption. When we review firms' ICAAPs based on an assumed overall probability distribution and particular confidence level, we will expect those firms to be able to explain their choice of assumption and to be able to provide some sensitivity analysis. This is so we can gauge the variation in capital assessments based on alternative assumptions. In forming our view of the appropriate level of ICG, we will then be able to benefit from a dialogue with the firm which takes account of a range of possible calibrations of its model. This will help us maintain appropriate consistency between different firms.

5 The standardised approach for credit risk

Introduction

- 5.1 CP05/3 continued the consultation started in CP189 on the standardised approach. In CP05/3, we consulted on three main types of issue: those areas where feedback from CP189 indicated that additional consultation was required; other areas where we believed additional guidance would be useful; and certain significant national discretions where we wanted to consult on our proposed approach.

FSA-Industry expert group

- 5.2 The consultation exercise has helped us resolve several key issues identified in CP05/3. It has also prompted additional assessment of several other important issues. Significant progress has been made in many of these areas in the context of our work with the expert group on the standardised approach, which has focused on two main areas.
- 5.3 Firstly, the expert group has attempted to provide guidance on a series of individual issues arising from different aspects of the standardised approach. It will provide such guidance in the form of a series of frequently-asked questions (FAQs) to be issued in the next few weeks. Several of these issues have revolved around the treatment of residential real estate (see sections 5.15-5.30), while others have involved the issues concerning commercial real estate and the treatment of local and regional governments addressed in paragraphs 5.17-5.19 and 5.23-5.26. In addition, we have addressed the issue concerning the treatment of charities for risk-weighting purposes¹⁶.

¹⁶ The CRD allows for charities to receive preferential treatments to the same extent as other entities. This will result in a 75% risk-weight should the charity qualify for treatment as a retail SME. If charities do not qualify as a retail SME, they may be treated as a corporate; and if they do not qualify either as a retail SME or corporate, they will be classified as 'other items' under Article 79 and afforded a risk-weight of 100%.

- 5.4 Secondly, the expert group has addressed the issue of what exactly constitutes ‘significant’ in the context of the requirement under the definition of ‘retail’ asset class that ‘the exposure must be one of a significant number of exposures with similar characteristics such that the risks associated with such lending are substantially reduced’. The industry has argued that unless we adopt a relatively low threshold of ‘significant’ in this context, small firms may be at a considerable competitive disadvantage to larger firms using the Internal Ratings Based (IRB) approaches. We believe that we are making good progress in addressing the needs of small firms in this area and hope to make our proposals available in the near future.

Draft BIPRU text

- 5.5 An area of work outstanding concerning the standardised approach is the formulation of draft BIPRU text. We understand that industry, and especially small firms, would welcome early sight of text to provide additional clarity on the implementation of the new regime. Drafting is now in progress and we hope to provide a draft text for discussion with the industry to our expert group and Credit Risk Standing Group (CRSG) in the near future.

Risk sensitivity of the standardised approach

- 5.6 The Joint Industry response expressed concern that our approach of seeking to adopt risk-sensitive national discretions compounded the conservatism already perceived to be built into the standardised approach. In view of its increased risk sensitivity, it is the case that the standardised approach can result in increases in risk-weightings for certain exposures. However, we continue firmly to support an approach based on enhanced risk sensitivity. We consider that this key objective has significant benefits – including more efficient capital allocation, enhanced resilience of firms and incentives for improvements in risk management.

Simplified standardised approach

- 5.7 Another area of work that we have undertaken since publishing CP05/3 is the creation of a ‘simplified’ version of the standardised approach for small, limited licence and limited activity firms that have only incidental credit exposures. It would be prohibitively costly for these firms to establish the systems needed to include the credit assessments of ECAs in their regulatory capital calculations.

- 5.8 We propose that, rather than having to risk-weight exposures individually, firms eligible to adopt the simplified approach apply a single risk-weight to all exposures in each exposure class. The ‘simplified’ risk-weight will be the risk-weighting for unrated entities or the ‘without prejudice’ risk-weighting for the given exposure class¹⁷. For other asset classes in which ratings do not influence risk-weights, firms on the simplified approach would adopt the same treatment as firms on the standardised approach¹⁸. We will issue a paper in the next few weeks providing full details of our proposals.

Responses to individual questions

Exposures to institutions

Q15: What is the impact of not taking up the discretion to weight short-term local currency exposures on the basis of the sovereign rating?

- 5.9 Industry respondents stated that the decision not to adopt this discretion would have a significant adverse impact – particularly for small firms. This is because it would result in a more conservative risk-weight for exposures to firms in credit quality steps 4 to 6 (50-150%) than the 20% risk-weighting that would likely apply under the sovereign approach.
- 5.10 The industry also believed that the decision not to take up the discretion could reduce the average duration of market funding available to lower-rated or unrated firms. This is because there will be a direct incentive for lenders to reduce the term of their relevant exposures to three months or less.
- 5.11 **Our response:** We are sympathetic to the concerns of industry in this area and now propose to weight short-term local currency exposures on the basis of the sovereign rating.

Our original decision not to adopt this discretion was based on the fact that the definition of short-term exposures in the original draft CRD consistently referred to exposures with an original effective maturity of three months or less. This meant that unrated short-term local currency exposures to institutions would be afforded the same risk-weight regardless of whether we adopted the discretion or not¹⁹.

17 100% for sovereigns, PSEs, corporates and CIUs; 50% for institutions (20% for short-term exposures) and for Regional/Local Governments (treated as institutions)

18 75% risk-weight for retail (providing the criteria listed in Article 79(2) are met), 35% for residential real estate exposures meeting the requirements in Annex VI, 150% for regulatory high risk

19 CRD Annex VI, Part 1 paragraphs 31 and 36.

However, changes in the ECOFIN text have created inconsistencies in the definition of short-term exposures. The definition in paragraph 36 has been revised to refer to exposures with a residual maturity of three months or less, but the definition in paragraph 31 continues to refer to original effective maturity. This inconsistency means that the treatment of local currency exposures to unrated entities will now differ depending on whether we adopt the discretion to risk-weight them according to the sovereign approach.

Accordingly, we now propose to adopt the discretion to weight short-term currency exposures on the basis of the sovereign rating.

Risk weighting of residential mortgages

Q16: To what extent do loss data support or challenge our proposed 80% LTV eligibility threshold for the 35% risk-weight for residential mortgages?

5.12 Firms strongly supported our proposal to increase from 75% to 80% the Loan-To-Value (LTV) threshold below which a 35% risk-weight will be applied to residential mortgages. Industry argued that data provided by the Council of Mortgage Lenders (CML) would support an eligibility threshold for the 35% risk-weight of at least 85%.

5.13 **Our response:** Our interpretation of the loss data provided by the CML remains that an 80% LTV threshold is prudentially appropriate once over-the-cycle considerations are taken into account. In its general comments, industry also accepts that this threshold seems prudent. Consequently, we propose to maintain the approach to risk-weighting exposures backed by residential real estate adopted in CP189 and CP05/3; namely:

- apply the 35% risk-weight to loans with an LTV up to 80%; and
- for the part of the loan in excess of 80% LTV apply a marginal 75% risk-weight if the unsecured exposure meets the criteria specified in Article 79 (2) to qualify as a retail exposure, or apply a marginal 100% risk-weight otherwise.

We believe this is a favourable treatment which minimises the potential for ‘cliff edge’ effects and takes appropriate account of the presence of the collateral and the priority consumers give to mortgage repayment. It makes full use of the limited flexibility available in the CRD text.

There is a further area of our work with industry on mortgage lending. This is the issue of whether exposures to residential mortgages should be included in calculations determining if the aggregate exposure owed by a creditor to the credit institution exceeds €1m for defining the retail exposure class. We stated in CP05/3 that the draft CRD requires mortgages to be included. However, industry has argued strongly that they should be excluded from the aggregation calculations. We do not

believe that it is necessary on prudential grounds to include the fully and completely secured part of a residential mortgage loan in the aggregation calculation. So we have seen the matter within the legal constraints provided by the draft CRD. While the exact wording remains under consideration in the context of ongoing EU negotiations, we think the correct interpretation is likely to be that such secured amounts should not be included in the aggregation calculations.

In addition, the expert group for the standardised approach has been working towards providing guidance on several specific issues surrounding the risk-weighting treatment of different mortgage exposures. We provide a summary of the approach taken in these areas below, but will be issuing full guidance via a series of frequently-asked questions (FAQs) in the near future.

The treatment of second (or subsequent) mortgages secured on the same property: In situations where there is more than one exposure secured on the same property, we propose that such exposures be aggregated and treated as if they were a single exposure secured on the property. In such instances, exposures totalling 80% of the value of the property would potentially be eligible for a preferential risk-weighting of 35%, with the remainder receiving a 75% risk-weight (providing the other criteria for treatment as a residential mortgage are met).

The treatment of exposures secured on overseas residential properties: We propose to adopt a stance that ensures that 'local conditions' apply for exposures backed by residential properties in other EEA countries. This means that the treatment afforded to residential real estate located in other Member States will be based on the treatment adopted by the competent authority in the jurisdiction in which the property is located, i.e. it will receive the treatment afforded by local implementation of the relevant sections and discretions of the CRD. This approach has the advantage of creating a level playing field for UK firms competing with local providers in other jurisdictions and will result in a risk-weighting that is commensurate with the risk deemed to exist within the local market by the relevant competent authority. We will provide guidance on how to treat exposures secured on property in locations outside CRD-jurisdictions in the coming period. However, it should be noted that in respect of third country mortgages our freedom of action is likely to be significantly constrained by the provisions of the CRD.

The treatment of residential property taken as collateral against a loan to a wealth vehicle or Special Purchase Vehicle: A loan to a wealth vehicle/SPV for the purpose of buying a residential property, occupied or let by the owner or beneficial owner, can potentially attract the preferential weighting available to residential mortgages providing that all the criteria specified in the CRD²⁰ to be eligible for such treatment are met.

20 Annex VI Part 1, paragraph 45.

We note that in its response the Joint Industry expressed some disappointment that CP05/3 removed the option for firms to risk-weight at 45% all its residential mortgage exposures, without referring to LTV. Given that the majority of responses to CP189 did not support the original proposal for a 45% risk-weight – and that aspects of it will be sub-equivalent to the requirements of the draft CRD – we do not propose to re-introduce this option.

Q17: How appropriate are the criteria we propose to ensure that the house price indices used by firms for updating LTVs are relevant? How might the criteria be improved?

- 5.14 Respondents saw the criteria we proposed concerning house price indices as being generally appropriate. However, they asked us to make clear the requirement that the administration of the index be independent of the firm.
- 5.15 In addition, respondents sought clarification on what was necessary to comply with the requirement that the lender should have procedures to monitor that the property taken as protection was adequately insured against damage. They noted that this requirement may require complex and costly new monitoring systems.

- 5.16 **Our response:** The purpose of the independence criterion was to ensure that any house price index used for valuation was as objective as possible and not open to influence for risk management, regulatory capital or business purposes. So we support the industry's proposal that house price indices produced by a department of a firm will meet the independence criteria, if the administration of the index is fully and demonstrably independent of the risk management and lending functions.

We also acknowledge concerns that the additional systems burden to monitor adequate insurance policies against each property would be disproportionate to the overall loss experience associated with default events coinciding with insurance events on an uninsured property.

The requirement²¹ for a firm to monitor insurance procedures is designed to ensure that the value of the secured property – or claim under an insurance policy – will be sufficient to cover any exposure if there is a default. We understand that it is not unduly burdensome for a firm to ensure that an insurance policy has been taken out on a property at the start of the loan or to require that obligors report changes in insurance coverage. We would expect firms to do this as a matter of course. However, we appreciate that the practical implications of monitoring how individual obligors adhere to this requirement could prove problematic.

21 CRD Annex VIII, Part 2, paragraph 8(d)

As an alternative, we believe that this requirement could be met by a contingency insurance policy taken out by the firm itself, covering a portfolio. This is provided that the firm can demonstrate that the policy covers an adequate level of uninsured losses at any time.

Exposures secured by commercial real estate and leases relating to commercial real estate

Q18: To what extent does loss data support or challenge our proposal to risk-weight at 100% exposures secured by or subject to leases on commercial real estate?

- 5.17 Respondents argued that a single category for all commercial real estate (CRE) was not sufficiently risk-sensitive, as there was a verifiable relationship between the loss history of CRE exposures and its loan-to-value. The trade associations offered to work with us to produce historical data they believe will demonstrate that exposures secured by CRE deserve a more favourable risk-weight than unsecured exposures.
- 5.18 Respondents also raised concerns about UK firms potentially being at a disadvantage if other competent authorities exercised the discretion to risk-weight CRE located within their territory at 50%.
- 5.19 **Our response:** We continue to believe that the loss history of exposures backed by CRE implies that it would not be prudent to risk-weight such exposures at 50% and propose to maintain our CP05/3 approach. However, we remain open to any data that industry may provide to demonstrate that CRE exposures deserve a more favourable risk-weight than unsecured exposures.

We do not believe that industry's concerns about an uneven playing field are valid. It will not be possible for overseas firms to adopt a 50% risk-weight for exposures to CRE based in the UK. This is the case even if their own competent authority has adopted the 50% discretion, as adopting the preferential risk-weighting only applies to 'commercial premises situated within their territory'²². As a result, overseas firms operating in the CRE market in the UK will have to risk-weight such exposures at 100%.

As outlined in CP05/3, we will adopt a stance that will ensure 'local conditions' apply with respect to exposures backed by CRE in other EEA countries. So, where exposures are backed by commercial property located in a Member State that permits the use of a 50% risk-weight, UK firms will be permitted to use the 50% weighting for their CRE exposures in that market. Such an approach should ensure a level playing field for UK firms in other Member States. And it will result in a risk-weight proportionate with the risk deemed to exist within the local market by the relevant competent authority.

22 CRD Annex VI, Part 1 Paragraphs 48 and 50

Regulatory high risk categories

Q19: To what extent do loss data support or challenge our proposed risk-weight of 150% for private equity and venture capital exposures?

- 5.20 Respondents strongly opposed our proposal to risk-weight private equity and venture capital exposures at 150%. They argued that such a risk-weighting was too severe in the case of certain high quality equity exposures and would place the UK at a competitive disadvantage compared to other countries that did not adopt the discretion (and risk-weighted such exposures at 100%).
- 5.21 The trade associations stated they would like to explore with us whether they could provide historical data to demonstrate that a 100% risk-weight was appropriate for exposures to this sector.
- 5.22 **Our response:** Our perception remains that a 150% risk-weight is appropriate for venture capital and private equity exposures. This is given the typical creditworthiness of the counterparty and the status of the lender's claim on the borrower in case of default.

However, we remain open to persuasion if the industry can provide data showing that the risks associated with such exposures justify a 100% risk-weight.

Exposures to regional governments, local authorities and public sector entities

Q20: Would a list of UK regional bodies eligible for treatment as central government exposures be helpful? Which entities do you believe should be on this list, and why?

- 5.23 Respondents agreed that a list of UK regional governments and local authorities eligible for treatment as central government exposures would be very helpful. This is providing that we could commit the resources needed to maintain the lists' accuracy on an ongoing basis.
- 5.24 **Our response:** We have started to assess which, if any, UK regional and local governments meet the requirements specified in the draft CRD²³ to be treated as central government risk. We hope to complete this assessment shortly and we will then be able to publish a provisional list of UK regional governments and local authorities to be risk-weighted like central governments. We will provide a list for discussion to our expert group and the CRSG.

²³ The revised directive states that 'exposures to regional governments and local authorities shall be treated as exposures to the central government in whose jurisdiction they are established where there is no difference in risk between such exposures because of the specific revenue-raising powers of the former, and the existence of specific institutional arrangements the effect of which is to reduce their risks of default'.

In cases where local and regional governments do not qualify to be treated as central government risk, they will be treated as institutions. However, given the special risk position of these entities, we propose that they be treated according to the Central Government Risk-weight Based Method (Option 1). In this context, we believe this is the most appropriate risk-sensitive approach. It is likely that UK institutions falling into this category will continue to receive a risk-weighting of 20%.

Q21: Would a list of UK public sector entities eligible for treatment as institutions be helpful? Which UK public sector entities do you believe would fall into this category, and why?

5.25 Respondents agreed that a list of UK regional governments and local authorities would be very helpful to firms, as long as we committed the resources to maintain an accurate list of these on an ongoing basis. The industry said that such a list would be important in securing a level playing field between firms. This is because it would remove the possibility for arbitrage on the basis of the classification of PSEs adopted by individual firms.

5.26 **Our response:** The key issue in this area is to establish an appropriate definition of what constitutes a PSE eligible for treatment as an institution and publish guidance on how the industry itself should categorise different entities. We expect such a definition to be similar to the current definition outlined in IPRU (Bank) Chapter BC 3.2.9. And we expect it to identify the bodies which carry out non-commercial functions on behalf of – and are responsible to – central, regional or local government.

This approach would be consistent with the principles-based approach that industry has asked for in implementing the draft CRD. It would also be in line with the approach we currently take in this area. With the help of the expert group, we will try to define what constitutes a PSE eligible for treatment as an institution in the coming period.

We understand that industry may wish to draw up a list of PSEs it considers to qualify for treatment as institutions. We have no objection to this initiative.

Collective Investment Undertakings

Q22: Is our approach to high risk CIUs appropriate?

5.27 Respondents believed that further consideration was needed in this area. The Joint Industry response argued that the lack of a rating alone does not necessarily imply high risk. However, it did recognise that specific features such as high levels of leverage would justify a higher risk than 100%. Some respondents stated that our proposal needed to be developed further to better reflect the different types of CIUs and the fact that ratings sometimes relate more to performance and qualitative factors than to credit risk.

- 5.28 **Our response:** The industry's comments are essentially in line with our thinking in this area and have highlighted a textual error in CP05/3. We meant to propose a 150% risk-weight in cases where a CIU did not have external credit assessment AND had specific features – such as high levels of leverage or lack of transparency – that prevented it from meeting the eligibility criteria laid out in the draft CRD. To provide further guidance in this area, we welcome the industry's offer to contribute further to the discussion of the relevant features of a high-risk CIU. We propose to take this matter forward with our expert group and the CRSG.

Collateral eligible for securing due past loans

Q23: What impact will not taking up the discretion to extend eligible collateral for past due items have?

- 5.29 Respondents did not believe there would be a material impact if we did not take up the discretion to extend the definition of eligible collateral for past due items.

- 5.30 **Our response:** Given the industry's response, we maintain the stance adopted in CP05/3. We believe that the recognition of collateral should remain limited to those firms that meet the eligibility criteria specified for CRM purposes. So we do not propose taking up the discretion to widen the definition for the secured portion of past due loans.

Conditions for forming a UK integrated group

Q24: Is the proposed application of the integrated groups regime for capital purposes sufficiently clear?

Q25: Is the balance and focus of our proposed additional guidance for the conditions for integrated group status appropriate? What further guidance might be required in respect of the conditions?

- 5.31 A number of respondents, including the Joint Industry response, said that the approach of the integrated groups regime as set out in CP05/3 was clearer in general than in CP97. However, respondents did not support the geographic limit set on the availability of the 0% risk-weighting. Some wanted it to be available to all of a firm's intra-group exposures in the EU, while others said it should be available to all intra-group exposures – wherever in the world the counterparty was located.
- 5.32 Some respondents asked us to further explain the minimum conditions for a UK integrated group. In particular, they queried the application of the requirement of the need for prompt transfer of own funds or repayment of liabilities (CP05/3, paragraph 5.33(f)).
- 5.33 Respondents asked why insurance companies could not be included in an integrated group. They also asked us to confirm the eligibility of building societies.

5.34 **Our response:** We are pleased that respondents thought the proposals were clearer. We note the general wish for the 0% risk-weighting to be available on a wider basis but, as noted in response to question 6 in chapter 2, our implementation proposals must reflect the current draft of the CRD. Moreover, as we comment in the context of questions 112-114 in chapter 8, we still believe there are good grounds for distinguishing between intra-group exposures within the UK and such exposures in a cross-border context. This matter is, however, the subject of ongoing discussion with the industry expert group.

We note the request for additional guidance, in particular on the minimum conditions for forming a UK integrated group. We will consider further, in conjunction with the expert group, what extra guidance we can give. However, we have a stated preference of giving minimal additional guidance on top of the draft CRD requirements.

Insurance companies are not eligible for inclusion in an integrated group as they do not meet the conditions set out in Article 80.7 of the draft CRD. For example, they do not qualify as one of the counterparty types listed at Article 80.7(a). Holdings in insurance companies are deducted; they are not consolidated on a full or partial basis and so do not comply with Article 80.7(b). However, the banking and investment subsidiaries of insurance groups are eligible to form integrated groups providing they meet the required conditions.

Building societies, as credit institutions, are of course eligible to form an integrated group provided they meet the conditions.

Export Credit Agencies

Q26: Would a list of eligible Export Credit Agencies be useful?

5.35 We received no responses to this question.

5.36 **Our response:** We will adopt the principles proposed by CEBS in its recent CP07 on 'The recognition of External Credit Assessment Institutions (ECAIs)'²⁴ about the use of Export Credit Agencies (ECAs) for risk-weighting purposes. Consequently, we will seek neither to undertake a recognition process for ECAs equivalent to the one required for ECAIs, nor to publish a list of eligible ECAs. Instead, we shall simply ask firms that wish to use an ECA's credit assessments to demonstrate that they meet the requirements specified in the draft CRD. In practice, this means that eligible credit assessments from ECAs will need to be either a consensus OECD score or the credit score generated by an individual ECA that participates in the OECD arrangements.

24 CEBS CP07 on ECAIs, Part 4: www.c-eps.org/pdfs/CP07.pdf

6 Outline of our approach to ECAIs recognition and mapping

Introduction

- 6.1 In CP05/3, we outlined our initial thinking on aspects of recognising External Credit Assessment Institutions (ECAIs). We gave:
- an overview of what we envisaged the recognition process would involve;
 - an initial indication of how we would interpret some of the recognition requirements stated in the draft CRD; and
 - an outline (in Annex 6) of the information that ECAIs would be required to submit as part of their recognition.

EU convergence on ECAI recognition and mapping

- 6.2 Since we published CP05/3, we have been closely involved with CEBS' efforts to seek EU convergence on issues of ECAI recognition and mapping. On 29 June, CEBS issued CP07 on 'The recognition of External Credit Assessment Institutions (ECAIs)'²⁵, in which it outlined the common approach that Member States propose taking in terms of:
- an agreed recognition process for Member States to adopt, including a joint assessment process to be undertaken in cases where ECAIs seek recognition in more than one jurisdiction;
 - a common understanding of the recognition requirements that all competent authorities will adopt when assessing ECAI eligibility; and
 - a standard set of information requirements concerning an ECAI's methodologies, practices and internal arrangements that all competent authorities will require when undertaking ECAI recognition. There was general agreement with the approach we proposed, with our basic interpretation of the recognition criteria and our objective of reducing the compliance and information requirements associated with recognition.

25 CEBS CP on ECAIs CP07: www.c-ebs.org/pdfs/CP07.pdf

- 6.3 We believe that the CEBS proposals will go a long way to ensuring that ECAI recognition is both practical and proportionate. On the one hand, the substance of the CEBS consultation paper is very much in line with the stance we proposed in CP05/3. And it seems to strike the appropriate balance between the prudential need for supervisors to be satisfied about the suitability of an ECAI's credit assessments for regulatory capital purposes, and our desire to limit the level of intervention and administrative burden on ECAs.
- 6.4 On the other hand, with all Member States strongly moving towards such a unified approach this will further streamline the recognition process. Most obviously, the creation of a joint assessment process for ECAs seeking application in multiple jurisdictions will go a long way to prevent administrative duplication for both ECAs and competent authorities. Together with the creation of a common understanding of the CRD requirements and a common set of information requirements, this will minimise the likelihood of ECAs having to provide different information in different jurisdictions. It should also significantly enhance competent authorities' confidence in undertaking indirect recognition.
- 6.5 As indicated in CP03/5, we propose to follow the procedures CEBS agreed on. This is because we believe this will streamline the recognition process considerably, while allowing us to meet the prudential requirements of the CRD. We indicate below what the CEBS proposals mean for each of the areas we consulted on in CP05/3.
- 6.6 Our future work in the area of ECAs will focus on mapping and will again be channelled through the CEBS Working Group. The Group has already recommended adopting the mapping framework proposed by the Basel Committee²⁶ and issued some general principles to be adopted by competent authorities when mapping ECAs' 'fundamental' credit assessments²⁷. We will now work to determine the mapping of credit assessments for securitisations and CIUs, as initial analysis has shown that they may not fit neatly in the framework proposed by the Basel Committee for 'fundamental' credit assessments.
- 6.7 Discussions are currently in progress on the extent to which the regime for ECAI recognition may require some legislative intervention. Consequently, you should read this chapter bearing in mind that the specifics of the legal framework for ECAI recognition will not be fully known until the CRD text is finalised and decisions about possible legislative aspects in this area have been reached. The timetable for recognition remains as indicated in paragraphs 6.22-23 below.

26 Basel Framework, Annex 2

27 CEBS CP07 on ECAs, Part 3

Responses to individual questions

Direct and indirect recognition

Q27: Do you agree that, where appropriate, we should use direct and indirect recognition of ECAIs?

6.8 Generally, respondents agreed with our objective to avoid multiple recognition procedures across different Member States. Respondents were unanimous that we should look to use indirect recognition, whenever appropriate, and highly supportive of our efforts – via CEBS – to achieve convergence in this area. Some respondents questioned whether such objectives could best be met through a single Europe-wide recognition process.

6.9 **Our response:** To reduce the administrative burden, we propose to adopt indirect recognition wherever appropriate. We believe that the subsequent strong level of convergence achieved by CEBS' Member States on the interpretation of recognition requirements will increase the scope for indirect recognition considerably.

We support attempts to streamline the recognition procedures across Member States. We strongly advocate CEBS' proposal for Member States to coordinate efforts and undertake a joint assessment of eligibility in situations where ECAI recognition is being sought in more than one Member State. However, we note that creating a single body with sole responsibility for ECAI recognition on a Europe-wide basis is not a feasible option. This is because the draft CRD legally requires each competent authority to be ultimately responsible for decisions on ECAI eligibility.

Direct recognition

Q28: Do you agree with our proposal to recognise ECAIs at a group level?

Q29: Do you agree with the proposal to require additional recognition of joint ventures? In what other circumstances might additional recognition be necessary?

6.10 There was general agreement that group recognition was appropriate, providing that competent authorities were reassured about the commonality between the members of the group covered by the application. Respondents were supportive of our view that there only needed to be separate recognition of individual entities – such as joint ventures – where there were substantial differences compared to the main ECAI group.

6.11 We expect that, in general, ECAIs will be recognised at the group level, as this is the most practical approach, given the business models adopted by many international ECAIs. It is also consistent with the position being adopted within CEBS. Under this approach, additional recognition for group entities – such as joint

ventures – will only be required where there are significant differences in comparison with the main ECAI group. For example, in cases where the entity is subject to different control or where its processes differ significantly from the parent’s ‘core’ approach.

Recognition requirements

Q30: Are the guiding principles we propose to adopt for ECAI recognition appropriate?

Q31: Is the information specified in Annex 6 sufficient and appropriate to request in order to assess compliance with the recognition requirements?

- 6.12 Respondents generally agreed with the principles that we proposed to adopt for ECAI recognition and our efforts to ensure that the application process would not be overly burdensome.
- 6.13 To this end, respondents suggested we look to reduce the scope of regulatory assessment by leveraging as far as possible off existing market mechanisms, such as market reputation, evidence of a good ratings track record and adherence to the IOSCO code of conduct.
- 6.14 There was a strong view amongst ECAI respondents that the recognition process should not be prescriptive, as it would need to be flexible to take account of different business models and credit assessment procedures. So there was general agreement with our proposal that recognition should avoid direct assessment of methodology, although some firms did believe that ECAIs’ ratings methodologies should be subject to same scrutiny as IRB models.
- 6.15 One respondent strongly opposed the requirement for at least one firm to indicate willingness to use an ECAI’s ratings for regulatory capital purposes.
- 6.16 **Our response:** We propose to adopt CEBS’ approach concerning recognition and the information that ECAIs will be required to provide. In most areas, these are in line with the approach we proposed in CP03/5. In particular, we note CEBS’ proposals that competent authorities should avoid making a direct judgment about whether an ECAI’s methodology is objectively correct. Instead, they should ‘concentrate on assessing whether the credit assessment process adopted by an ECAI produce credit assessments that embody a sufficient level of consistency and discrimination to provide the basis for capital requirements under the Standardised and Securitisation Based Approaches’. In addition, CEBS advocates the requirement that an applicant ECAI ‘should demonstrate that at least one institution in the Competent Authority’s jurisdiction intends to use its credit assessments for prudential risk-weighting purposes’.

The approach taken by CEBS towards recognition looks to leverage off existing market mechanisms wherever possible. For example, CEBS advocates that competent authorities should view strong market standing and evidence of a track record of producing robust credit assessments as a good indication that the ECAI's methodological processes are sufficiently objective for the purposes of the CRD. And this means they potentially reduce the level of assessment that competent authorities have to carry out themselves.

On the basis of this approach and consultation with the industry, CEBS has put forward a streamlined list of information that ECAIs will be required to provide as part of a 'Common Basis Application Pack'. We propose that this Pack will form the basis of applications submitted by ECAIs for recognition in the UK.

Recognition process

Q32: Do you agree that applications for recognition should be made by the ECAI itself?

6.17 All respondents agreed that it was appropriate for ECAIs – and not firms – to make applications for recognition.

6.18 **Our response:** The recognition process outlined by CEBS allows for competent authorities to receive applications for recognition either from the ECAIs themselves or from institutions that intend to use the ECAIs' credit assessments for risk-weighting purposes. We propose to maintain our position in CP05/3 and receive applications only from ECAIs.

Q33: Do you believe that the proposed recognition classes are appropriate? Are there any other product segments (such as UCITS) where separate recognition classes may be required?

6.19 Respondents agreed with our approach to have a small number of recognition classes based on broad product categories. ECAI respondents noted that further sub-division (e.g. by geography) would not be desirable as it would result in samples too small for statistically significant analysis (e.g. transition matrices, default studies and mapping).

6.20 The Joint Industry response requested further information on how competent authorities would assess ECAIs without a seasoned track record or those seeking recognition in new segments, beyond their existing recognition.

6.21 **Our response:** CEBS has proposed having just three separate recognition categories: structured finance (including securitisation); public finance (sovereigns, municipalities etc); and commercial entities (including corporates and financial companies). We now propose to adopt these broad asset classes as the basis of the ECAI recognition process, and undertake separate assessment of the ECAI's methodology in each of the broad asset classes they are seeking recognition for.

We also propose to adopt the procedures outlined in the CEBS consultation paper about recognising ECAIs with a limited ratings track record. In some cases there is little or no quantitative evidence to support the robustness of an ECAI's credit assessments. For these, competent authorities will need to undertake a more detailed assessment of the ECAI's methodological and other processes to be satisfied that the eligibility criteria are met.

Timetable for recognition

Q34: If you are a bank, building society or investment firm, do you think this proposed timetable would allow sufficient time to implement the standardised approach?

6.22 Industry respondents raised concerns about the lack of time firms may have to implement systems after ECAIs are formally recognised. They also noted that smaller firms, in particular, may require longer lead times to implement necessary systems.

6.23 **Our response:** We are sympathetic to the concerns of firms in this area and have been pressing CEBS to advance the recognition of ECAIs as soon as possible. While formal processes cannot begin before the CRD is finalised and transposed, we intend to be in a position to receive and assess informal applications, as far as legally possible, in the near future.

Providing there are no major changes to the proposals put forward in the CEBS consultation paper, we aim to begin receiving applications from ECAIs as soon as practicable after the end of the review of it.

To help firms, we propose undertaking ECAI recognition in waves. We will look first – if the application flow permits – at those ECAIs most likely to be used by firms, if recognised, for risk-weighting purposes. We hope that this will allow us to announce a core list of eligible ECAIs, with their mappings, before the end of the first quarter of 2006. We continue to work towards the objective of recognising (and mapping) by the end of the second quarter of 2006 all ECAIs that submit an application by the end of the first quarter.

Ongoing recognition

Q35: If you are an ECAI, do you agree with our proposed approach to ongoing recognition?

6.24 Respondents urged that ongoing recognition should not become overly-burdensome. They said that competent authorities should adopt common requirements in this area and should place strong emphasis on quantitative data when assessing whether ECAIs remained suitable for regulatory capital purposes.

6.25 Respondents also sought clarification that on identifying concerns, competent authorities would first seek a dialogue with the ECAI, rather than remove ECAI recognition instantaneously.

6.26 **Our response:** We believe that the recent developments within CEBS should allay industry concerns in this area. Convergence on a core set of principles in this area – and the proposal for ongoing recognition to also be undertaken on a joint basis – should minimise any differences between different Member States.

In addition, we believe the proposed basis for ongoing recognition should not prove burdensome for ECAIs: CEBS proposing that ‘on-going assessments should be tailored to the purposes of the CRD and should be limited to ensuring that eligible ECAIs continue to meet the criteria that led to their recognition’. We believe that this will mirror initial recognition in placing strong emphasis on market mechanisms such as quantitative evidence of a good ratings track record.

As stated in CP05/3, we expect competent authorities to initiate a dialogue with ECAIs if there is a change in criteria that led to initial recognition. De-recognition would only occur if such problems persist to the extent that the ECAI’s ratings were not longer suitable for regulatory capital purposes.

Q36: What types of analysis do you believe would be adequate to fulfil a requirement for back-testing?

6.27 ECAI responses confirmed our belief that statistical analysis of the robustness of ratings would revolve around default studies and migration studies.

6.28 **Our response:** We believe that default studies and migration matrices are the best quantitative techniques for validating the robustness of an ECAI’s credit assessments. So, in line with CEBS’ recommendation, we propose that back-testing using such techniques be undertaken for each of the ‘market segments’ an ECAI is seeking market recognition for.

Mapping

Q37: Do you think that our approach to mapping is appropriate?

6.29 There was general agreement with our approach at high level, although there were some esoteric observations about potential technical problems associated with the approach to mapping outlined in the Basel Framework.

6.30 **Our response:** The CEBS Working Group has also recommended using the framework for mapping provided by the Basel Committee. The Group has outlined general principles in this area. These include:

- the use of three-year Cumulative Default Rates (CDRs) as the key measure of the predictive power of credit assessments;

- competent authorities placing emphasis on quantitative data where it exists, but also taking into account qualitative factors such as an ECAI's definition of default, methodology compared to the benchmark; and
- in cases where only limited quantitative data is available, competent authorities placing greater emphasis on qualitative factors, with appropriate conservatism being adopted in areas where uncertainty remains.

Going forward, we aim to be actively involved in the CEBS work to determine how the mapping of credit assessments concerning securitisations and CIUs will be undertaken, given that they may not fit neatly in the framework proposed by the Basel Committee for 'fundamental' credit assessments.

7 The internal ratings based approach to credit risk

Introduction

- 7.1 In CP05/3, we set out our proposals for implementing most aspects of the Internal Ratings Based (IRB) approach. Our proposals represented an advanced stage in the development process. However, they were subject to ongoing improvement and development in several respects.
- 7.2 Firms continue to be largely supportive of the IRB approach, which introduces significantly enhanced risk sensitivity and includes capital incentives reflecting this increased risk sensitivity and the improved risk management and measurement systems required by the IRB approach.

EU developments

- 7.3 Given the fluid nature of the ongoing negotiations between the European Parliament and the EU Council of Ministers, we do not make assumptions in our feedback as to what amendments may be made to the text of the draft CRD. Our proposals will need to be updated as necessary to reflect any further changes to the directive.
- 7.4 In addition to changes arising from differences between the proposed and eventual final CRD, the proposals in the February 2006 CP will take account of work produced in international groups aimed at reaching enhanced convergence on implementing the new regime. We are participating actively in the relevant work of both CEBS and the AIG. Our proposals may need to be amended to reflect the outcomes of discussions in these forums. Of particular relevance here is CEBS CP10 'Guidelines on the implementation, validation, and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches'²⁸ (CEBS Validation CP).

28 CEBS Validation CP10: www.c-ebs.org/pdfs/CP10.pdf

FSA-Industry expert groups

- 7.5 Since publishing CP05/3, we have been working with industry expert groups to develop further proposals on those areas the industry considers a priority for further guidance. Developments in those areas are indicated under the relevant headings in this chapter. We will continue to discuss with industry other areas to prioritise.

IRB General Issues

- 7.6 Respondents raised a number of general issues about our proposals for the IRB approach. We have set out our responses to individual questions on this and other issues according to the specific aspect of the IRB approach to credit risk being discussed.

Further guidance

Q38: Is the level of additional guidance to the IRB appropriate? Are there areas where you would like to see additional guidance?

- 7.7 As we have noted, respondents generally welcomed the copy-out approach proposed in CP05/3. In relation to the IRB approach, however, respondents expressed concern that, in view of the limitations of the CRD text, the copy-out approach does not help interpret the underlying requirements. At the same time, respondents were strongly in favour of a principles-based and pragmatic approach. They were also concerned that further prescriptive guidance would reduce the individual integrity of each firm's systems and processes and believed that further guidance would help only in some specific areas.
- 7.8 Related to this issue, respondents also highlighted the issues of fairness and transparency. They indicated that there must be a transparent common approach to the treatment of each firm with all firms treated fairly, recognising the risk profile of each individual firm.

- 7.9 **Our response:** It is our view that respondents accurately identified the important interests at stake in this issue. We agree that confirming a correct balance between these interests is one of the key challenges in finalising the IRB regime.

We agree with respondents that undue prescription about how firms comply with the CRD requirements should be avoided. At implementation we will still be at a relatively early stage in the life-cycle of a capital framework based more closely on firms' own systems. Both we and industry will be continuing to deepen knowledge, improve systems and develop further the relevant analytical tools. Over-prescription could have material untoward effects on how firms go about their business with potential adverse consequences both for competitiveness and prudential soundness.

We also agree, however, that the establishment of a shared interpretation as to the meaning of the many generally worded CRD requirements can have important benefits. This would help both in terms of providing the degree of certainty that firms' seek in order to develop their systems and in reducing the potential for divergent application of those requirements between firms leading to competitive inequalities.

Moreover, in moving to a framework where regulatory capital requirements are based on a firm's own estimates of risk parameters, it remains essential that our rules and guidance are formulated to ensure adequate quality of those estimates and to avoid understatement of capital requirements.

Our sense is that in general terms respondents feel that CP05/3 strikes a reasonable balance on the general level of additional guidance. Specific comments are dealt with further below. As respondents requested, we continue to work with industry in relation to several areas to determine whether further guidance is desirable and to develop such guidance where it is.

Rules versus guidance

Q39: Is the structure of the draft BIPRU text sufficiently clear?
Do you have any suggestions on how it could be improved?

- 7.10 Respondents said it was difficult to understand the separation between those provisions which would apply as rules and those which would apply as guidance once a firm has received a waiver to use the IRB approach.
- 7.11 **Our response:** We agree that there is some lack of user-friendliness on this issue. We will seek to make the distinction clearer in the February 2006 CP and other future published documents on our approach to IRB waivers, and are considering how this might be best reflected in the Handbook.

Narrowing timeframe to implementation

- 7.12 Respondents expressed two concerns about the fact that the date for implementing the new framework is becoming imminent.
- 7.13 The first concern related to firms' difficulty in adjusting to changes introduced into the proposed rules at a late stage. They called for 'a more realistic and reasonable extended timetable for introducing standards and levels of sophistication that go beyond what is absolutely required for implementation by firms in 2007/2008 to meet the CRD requirements'.
- 7.14 More generally, respondents were interested in our general approach to implementation. They asked us to confirm that we will be looking for minimum standards initially and not best practice 'as the application of the IRB approaches over the short term will evolve and improve as firms develop and refine their Internal Ratings Based systems'.

7.15 **Our response:** We acknowledge the challenging nature of the timescale for implementation required by the CRD and reinforced by legitimate competitive concerns. For this reason, it is not our intention to introduce at this stage unexpected additional requirements to the material disadvantage of firms' CRD-compliant preparations for implementation in 2007/8. As an example, our proposed interpretation of the ECOFIN changes to the 'experience requirement' provisions of the CRD, as they apply to retail portfolios, is consistent with this approach (see paragraphs 7.115-7.116).

On this, we are subject to a number of external constraints. These include the need to comply with the CRD itself and with any further provisions introduced during the final stages of the EU legislative process. We also intend to appropriately reflect the outcomes of the ongoing work of CEBS and the Basel Committee to enhance convergence in implementing the CRD across the EU and more generally. We will continue to consider the need for additional guidance and/or clarification with regard to these aspects and to paragraphs 7.11-7.12 above.

More generally, we agree with respondents' proposition that we should not demand compliance with best practice in all aspects at the start of the new framework and that we should integrate in our approach an expectation of evolution and improvement over time. As we stated in CP05/3, it is appropriate to proceed with fit-for-purpose solutions reflecting the current limitations of data and techniques, while setting clear expectations of what is required as these limitations diminish. We expect that during the period after implementation the robustness of firms' rating systems will continue to be enhanced, benefiting from deepening experience, further improved data, and continued development of techniques of estimation and validation. As we stated in CP05/3, we will be looking for evidence that firms have carefully thought-through plans for improving systems, which for many will imply a step-change in performance.

It is important to emphasise that the waiver process will be in no respect a formality and will involve vigorous challenge from supervisors. We will be looking for firms to acknowledge their shortcomings frankly and to take a conservative approach while improvements are made. If necessary, we will not agree waiver applications where insufficient progress has been made in important qualitative areas such as the use test or governance, or where there are clear shortcomings in modelling parameters – which have a significant impact on capital levels – without appropriate conservatism proposed to compensate.

Levels of conservatism

7.16 General concerns were expressed in the responses about the level of conservatism inherent in the proposed IRB framework. Respondents cited the calibration of the framework; requirements for the use of long run data and estimates of downturn loss given default (LGD); and the need for stress testing. Respondents also pointed to the tension between the requirements of

the use test and the imposition of conservatism. They argued that the floors in place following implementation should make it unnecessary for conservatism to be applied at this stage.

7.17 **Our response:** On the question of the overall level of conservatism of the framework, it is correct that we will require firms to base estimates of probability of default (PD) on long-run data and estimates of LGD and conversion factors (CFs) to reflect economic downturn conditions. These aspects are integral to both the CRD and the Basel frameworks. As is the calibration of the framework to a 99.9% confidence level. Incorporating these requirements in our domestic rulebook is important to avoid undermining the overall calibration of the framework – which will provide significant capital benefits for many firms – and to ensure the appropriate capitalisation of individual firms.

On general stress testing (Q55 of CP05/3), respondents acknowledged that stress testing at the portfolio level can be an important tool used selectively. However, they argued against a requirement to stress test where their estimates already capture economic downturn effects. The ‘general stress testing’ discussed at paragraphs 7.77-7.78 of CP05/3 represents one method of providing Pillar 1 risk parameter estimates in line with what is indicated in the previous paragraph. This is not a separate requirement but a methodological option. In relation to ratings-migration stress testing, see paragraphs 7.162-7.165 below.

The question of the overall confidence level of the framework and its calibration to downturn conditions should be distinguished from the question of how to address the issue of uncertainty – in relation to risk parameter estimation due to an absence or material scarcity of data. This is the issue addressed in the CRD, Annex VII, Part 4, paragraphs 49 and 54. It forms an important aspect of the debate on low default portfolios – see paragraphs 7.42-7.45 below.

In general terms, we agree that the accuracy of estimates should be the driving consideration and that a general requirement for conservatism would not be appropriate. Nonetheless, we continue to believe, in line with the requirements of the draft CRD, that to the extent that scarcity of data or methodological constraints impedes accuracy of estimation, this should be reflected in firms’ estimates so that capital requirements for the portfolio are not understated.

Materiality

Q40: Do you agree with our approach to materiality?

Q41: What would you find helpful to have as guidance on materiality included within the Handbook text?

- 7.18 The draft CRD occasionally refers to materiality. We proposed that we would set absolute levels of materiality in only a limited number of cases, for example in relation to partial use of IRB. More generally, we would not do so as it should be the responsibility of senior management to determine appropriate levels of materiality in most situations.
- 7.19 Responses in this area were somewhat mixed. The industry generally supported our proposal. The Joint Industry response suggested that no specific guidance would be needed provided that we accepted firms' definitions of materiality if they were risk-based and proportionate. In this respect, the industry proposed that measures of materiality should be focused on the materiality of outcome rather than the existence of a specific number of exposures. However, in contrast some individual respondents said they would welcome some guidance from us in specific areas, including requests for additional guidance on issues raised elsewhere in CP05/3.
- 7.20 **Our response:** We propose to maintain our general approach in this area. We will continue to work on the principle that it will typically be the responsibility of firms' senior management to determine and justify appropriate levels of materiality in most situations. However, in specific instances, as indicated in CP05/3, we have provided guidance on what constitutes material within a particular context.

Status of CP189

- 7.21 The Joint Industry response observed that firms interpreted paragraph 7.8 of CP05/3 as a statement that CP189 was no longer valid and should not be relied upon.
- 7.22 **Our response:** As regards the IRB approach, we confirm that our thinking has indeed moved on since CP189 and that the content of CP05/3 and the draft BIPRU replaces that of the earlier consultation paper. This is unambiguously the case in most areas, and so firms should not rely on CP189 for work planning. A clear exception to this is the chapter on Governance Issues – which applied to operational as well as credit risk. CP05/3 does not include proposals in this area. Work is ongoing both in the FSA and international groups in several areas. In addition, we referred in CP05/3 to further work being done on validation standards under international supervisory groups. And, domestically, we referred to 'drill down' visits to firms and discussions with the industry on low default portfolios. In the light of this, we may discuss further the benefits of maintaining some of the CP189 guidelines in this area.

Estimates and validation – general issues

- 7.23 In this section, we summarise respondents' comments – and provide our feedback – on several general aspects of the proposals relating to estimating and validating risk parameters.

Validation of estimates

Q51: Do you believe that the guidance on validation in the draft BIPRU text is appropriate? If not, how should it be amended?

Q52: Do you support our approach to validation?

- 7.24 CP05/3 included draft guidance on what we would expect firms to consider in developing their validation practice. This included independent input, appropriate senior management involvement, discriminative power, and accuracy of estimates. There were some mixed views among respondents. The Joint Industry response, while lacking detailed comment, appeared to seek changes. It suggested that we should implement the AIG Validation Principles, published by the Basel Committee.

- 7.25 **Our response:** The CEBS Validation CP on guidelines regarding validation issues is a relatively wide-ranging paper, extending beyond the requirements for validation by firms. However, it does incorporate the AIG Validation Principles which we support and propose to implement. As far as the proposed guidance on this issue put forward in CP05/3 is concerned, we do not consider it inconsistent with these principles. We will review the guidance presently in the draft BIPRU after the CEBS' consultation finishes.

Adequate discrimination

Q53: Do you agree with our proposed approach to adequate discrimination? If not, what alternative approach do you think would achieve a broadly consistent outcome?

- 7.26 The CRD requirement for IRB approaches to meaningfully differentiate risk requires supervisors to be satisfied regarding the discriminative power of a rating system. We proposed that firms should, in general, be able to explain the performance of their rating system(s) against a chosen measure (or measures) of discriminative power – with alternative approaches possible in cases where default experience is scarce.
- 7.27 Respondents were generally supportive of our proposals, welcoming the flexibility. Some respondents expressed reservations about the clarity of the objectives or of the level of prescription. One response indicated the need to distinguish between the use of benchmarks. They said, on the one hand, these are used to produce target measures of discrimination performance on a

commonly accepted measure such as Gini. And, on the other hand, they act as a more direct comparison – with the risk ranking of the internal model being compared against that of the benchmark. This respondent also noted the more challenging validation context of LGD and CF estimates.

- 7.28 **Our response:** We welcome the general support for our approach to the question of the discriminative power of models and rating systems. The CEBS Validation CP calls for firms to have policies and standards covering acceptable levels of discriminative power, where relevant. But it does not propose any further guidance on what might constitute acceptable methods or standards. As the proposals included in BIPRU 4.3.28 are by way of guidance, these should be seen as examples of methods that a firm may use, and are not mandatory. We recognise that benchmarking as outlined in 4.3.28 is going to be less relevant for EAD and LGD. We agree with the comments regarding the different use of ‘benchmarking’ and will take these into account in the February 2006 CP.

Data reconciliation and accuracy

Q42: Is this explanation of the required standard of reconciliation sufficient? Can you suggest any additional comparisons that might be relevant?

- 7.29 In CP05/3, we indicated our view that the integrity of data used is of central importance. In response to CP189 comments, we indicated that we no longer intended to use a scorecard approach but to include additional guidance. We indicated that reconciliation needed to be reasonably fit-for-purpose. Some respondents stated that they found the guidance clear and that it formed a good set of general principles. Others expressed concern that the guidance was excessive and did not seem to allow for evolving standards over time. The responses frequently referred to the importance of taking into account the specific circumstances of each firm.

- 7.30 **Our response:** We agree that our guidance in this area should be sufficiently flexible to take into account the circumstances of the individual firm and to allow its processes to evolve. We think that our proposed guidance achieves this aim. In particular, reconciliation does not need to be absolute. Instead, it should be fit-for-purpose in the sense that it forms part of the evidence that a firm would need about the accuracy, completeness and appropriateness of the data. Accordingly, we are inclined to maintain the guidance as proposed in CP05/3.

Guidance on rating systems

Q75: Is the guidance in the draft Handbook text on rating systems appropriate? If not, how could the guidance be improved?

- 7.31 We proposed including guidance on some areas that we expected firms to address as part of the minimum criteria for borrower rating systems. These included:
- controls over when it was appropriate to use a particular model;
 - controls over the review of a model;
 - internal guidance for staff to help them allocate exposures appropriately and consistently; and
 - how firms ensured that novel or narrow rating systems were appropriate.
- 7.32 Respondents described the guidance as appropriate and helpful. However, there was a comment in the Joint Industry response that these points would be more helpful in relation to the governance of rating systems generally, as opposed to assignment of ratings.
- 7.33 **Our response:** We welcome the positive comments received on our proposals. We propose to maintain the draft BIPRU text. However, we will consider whether – given its more general applicability – it might appropriately be moved to another part of the BIPRU. This will be reflected in the February 2006 CP.

Material drivers of default, loss given default (LGD), and exposure at default (EAD)

- Q68: What additional guidance on the identification of material drivers of LGD would it be reasonable for us to give, within the constraints of the Draft Directive?
- Q72: Do you agree with this approach to identifying material drivers of default risk?
- Q73: What guidance should be included in the Handbook text on the material drivers that we have identified so far?
- Q74: What other material drivers of default risk are there?
- Q77: Are there any other drivers of LGD that should be considered?
- Q78: Do you agree with the overall approach and the particular factors put forward as material drivers of EAD? Can you suggest factors which are more important than those we suggested?
- Q79: What guidance on EAD drivers should we give in the Handbook text?

- 7.34 The draft CRD requires estimates of each of Probability of Default (PD), LGD and EAD to be based on the material drivers of the risk parameter in question. In CP05/3, we put forward proposals on how we would approach this for each of the risk parameters. These were broadly similar but with some differences that largely reflected the different state of development for PD, LGD and EAD.
- 7.35 For PD, we felt it was feasible to identify a limited number of widely-accepted drivers of default for different types of portfolios. These could be included in a firm's rating system either individually or in combinations. Or they could be included either as explicit factors or indirectly, for example through an external measure that included such a factor or through controlled over-ride criteria. We said we would expect firms to be able to explain how they had arrived at the drivers they had used.
- 7.36 For LGD estimates, we accepted that it was too early to draw up meaningful lists of drivers. We were able to identify a number of factors that firms were using or considering. We would expect, as part of the application process, firms to discuss their drivers and how they determined them.
- 7.37 We were aware that there was relatively little evidence from existing practice of drivers being used to derive EAD estimates.
- 7.38 In each case, we stressed that we had not identified a definitive list of drivers and encouraged firms to consider a wider or more appropriate set. We also acknowledged that in some areas it may not be possible to develop an approach based on drivers of the risk parameter. For example, in retail unsecured lending it may not be feasible to identify factors that differentiate LGD before default takes place. In such cases, the burden would be on the firm to demonstrate that its models were appropriate for the circumstances in which they were applied.
- 7.39 Although there were differences in the detail of the responses to the various questions, it is clear that concerns remain on this question. Respondents were concerned that we were developing definitive lists of material drivers that firms would need to either use or explain why they were not using them. It was felt that this would impede the process by which firms would develop their own drivers appropriate to their portfolios and based on experience. In general, further guidance on our views on drivers was not welcomed. In the case of EAD, the Joint Industry response suggested guidance might be helpful if it was based on transaction characteristics, as well as relevant factors of default. It was suggested that research be done on this by the industry in consultation with us.
- 7.40 **Our response:** The CRD requires supervisors to be satisfied that the estimates of the three risk parameters are based on the material drivers of that parameter. However, it is clear that concerns about our proposals are still felt. We will give further consideration to this aspect in light of the comments received. The merit of

including indicative lists is that they give both firms and supervisors a starting point and contribute to a more consistent approach to our approval and review across firms and portfolios. Particularly where data is scarce – and there is therefore heavier reliance on qualitative factors in assignment – we think that such an indicative approach could be helpful. We understand, however, the concerns of industry that indicativeness may be interpreted as prescription and that may impede recognition of approaches based on compendium or proxy factors. As suggested by respondents, our consideration will include whether and how the approach should be varied between the three parameters of PD, LGD and EAD and with the richness of data. We note also that the CEBS Validation CP has identified possible drivers for LGD and EAD.

Low Default Portfolios

- 7.41 Low default portfolios (LDPs) is not a term defined in the draft CRD (or Basel). However, it can broadly be taken to mean exposures for which a firm is unable to validate its estimates of PD, LGD and EAD to a proven level of statistical significance based on its internal default experience. The industry has been concerned that our supervisors would not be prepared to accept ‘LDPs’ under IRB; or alternatively that they would only be prepared to accept them if the estimates were at a level firms considered unacceptably high. In CP05/3, we expressed our willingness to work with the industry on ways to include such exposures in IRB and an expert group was formed to address the issues.
- 7.42 The group has produced a framework – addressing only PD estimates at this stage – which sub-divides LDP exposures into those which:
- can be assigned PD estimates based on methodologies outlined in the draft CRD;
 - can be assigned PD estimates based on other forms of hard data; and
 - those which cannot be fitted into these two categories.

The last are the most problematic LDPs. The group produced proposed guidance for the first two categories. We are considering how the contents of this paper can be reflected in Handbook rules and guidance in a manner which appropriately addresses industry concerns about excessive conservatism on the one hand, and the greater possibility of underestimating capital requirements where data is scarce on the other.

- 7.43 The expert group has now further considered treatments to be applied to the third category of LDPs and plans further work on LGD and EAD in due course. The results of this will be communicated through the CRSG and in the February 2006 CP.

- 7.44 The CEBS Validation CP includes a section on low default portfolios, which proposes that such exposures should not necessarily be excluded from the IRB approach simply because of the absence of sufficient data to validate PD, LGD and EAD on a statistical basis. We agree with the contents of the CEBS consultation paper, which is consistent with our approach.

Use test

Q44: Do you support our approach to the use test?

- 7.45 The use test embodies the concept that both supervisors and industry senior management can more confidently rely on the validity of IRB estimates where they are integral to the way in which a firm measures and manages the credit risk in its business. That is, as opposed to being used for regulatory capital purposes only. The CRD requires that the internal ratings and parameter estimates used for IRB must play an essential role in the risk management and decision-making process. It also requires them to be used in the credit approval, internal capital allocation and corporate governance functions of the firm.
- 7.46 In CP05/3, we said we would not proceed with the use test ‘scorecard’ proposed in CP189, as it could place an unnecessary burden on firms. We clarified that the need for IRB estimates to play an essential role did not mean that the IRB system needed to have an exclusive or even primary role in all risk management and relevant decision-taking functions. However, the information the IRB estimates are based on must also inform the firm’s standards and policies; and where firms use different estimates, they need to be able to demonstrate the reasonableness of the differences to their supervisors.
- 7.47 Respondents generally welcomed the recognition that there are circumstances in which the models a firm uses for internal and regulatory capital calculation purposes might not be exactly the same. However, they felt that the draft BIPRU text was insufficiently clear in this regard. The Joint Industry response asked whether a firm might demonstrate it complies with the use test by mapping its existing business policies and practices into different areas of use. Reservations were expressed about the lack of clarity on what firms needed to do to comply with the use test, and with the changing scope of the use test requirements between CP189 and CP05/3. In addition, concern continued about provisioning and the use test in view of the differing requirements between IRB and accounting standards. Respondents asked for further guidance in this area, including on mark-to-market treatments.
- 7.48 There was also some concern at the level of detailed and technical knowledge that we would expect senior executives to have – in particular, the requirement that they should have a good understanding of a ratings system’s designs and operations.

7.49 **Our response:** We reiterate the importance of the principle underlying the use test. It remains one of the key components of the new framework that firms are able to demonstrate their confidence that the estimates they produce do not result in an understatement of risk parameters. They do this by using the test for internal risk-management and decision-making processes.

We recognise that there may be justifiable differences between models as they are used for the firm's internal purposes and for regulatory capital calculations. However, these differences should exist around a common core and the firm must be able to explain and demonstrate the reasonableness of differences. The answers to the question 'what (if any) differences and why?' will clearly be a central aspect of the approvals process. Mapping can be an important part of such an exercise.

As we stated in CP05/3, while IRB estimates must play an essential role in risk management and decision making, this does not necessarily mean an exclusive or primary role. For example, where estimates are based on the life of the asset rather than on the one-year CRD period.

Industry continues to find useful the distinction between core and broader activities set out in CP05/3. We propose to maintain this. Some respondents felt that the wording of draft BIPRU 4.2.6 could be clarified. We will look further at this wording to see whether it can be further improved.

We note this latter concern more generally and also the concern expressed as to 'how the FSA will ensure consistency of the application of the use test' to individual firms. As we proceed with the implementation process between now and the February 2006 CP, we will consider whether there may be additional guidance which can helpfully be provided to firms.

In the area of provisioning, we have acknowledged that there may be justifiable differences between the estimates of loss used for the IRB approach and those used for internal purposes such as accounting. In this respect, we do not expect numbers necessarily to be the same, but we do expect that inputs to the accounting calculation accord with the IRB system outputs where relevant. We expect to see appropriate links between provisions and the Expected Loss (EL) numbers produced by rating systems and for firms to have a good explanation of why different inputs are being used.

On the issue of mark-to-market treatments, we will consider this aspect further including the desirability of further guidance. Our starting expectation is that mark-to-market approaches should gain a corresponding acknowledgement within the framework. But there is a need to ensure that their treatment is considered in the context of recent IFRS changes. We will revert in this respect in the February 2006 CP.

On the issue of senior management understanding, please refer to chapter 1, paragraphs 1.4 to 1.8, and to chapter 18.

Estimates and validation – specific aspects

- 7.50 In this section, we summarise respondents’ comments – and provide our feedback – on several *specific* aspects of our proposals relating to estimating and validating risk parameters.

Use of external data and external models

Q54: Are the standards for the use of external measures of risk set at an appropriate level?

- 7.51 In CP05/3, we indicated our awareness of a range of uses to which firms put external data and models. We said that firms must understand external risk measures or models, assess their fitness for purpose, and be sure that they are being used appropriately. We indicated that we would not explicitly approve external models. Respondents thought our position was clear but several expressed concern about constraints in meeting the requirements that might be imposed by commercial confidentiality.

- 7.52 **Our response:** An industry expert group has been working on the further development of guidance for using external models and data.²⁹

We are considering these recommendations and intend to develop further guidance having regard to them. This guidance will recognise that the maintenance by model vendors of a certain degree of commercial confidentiality is not *in itself* incompatible with firms fulfilling the requirements of the CRD and BIPRU. Firms must, of course, continue to ensure they have sufficient knowledge and understanding of external models to be able to satisfy the requirements of BIPRU 4.3.46 (2).

Within Europe, the CEBS Validation CP considered how firms should interpret the need for external data to be ‘comparable to’ or ‘representative of’ their own portfolios. And it also contemplated how to interpret the need for data to be accurate, complete and appropriate. We intend to follow the CEBS approach to these issues.

Guidance on the use of rating agency experience or statistical models

Q76: How could our guidance on the use of rating agency experience or statistical models be improved?

- 7.53 We included guidance based on our CP189 proposal and asked how it could be improved. This required firms to consider adjustments for other information – such as internal experience, conservatism and cyclical effects – when using rating agency experience or the output of a statistical default model as the primary component of PD estimation. Respondents made no suggestions, describing the guidance as appropriate.

²⁹ CRSG expert group papers: www.fsa.gov.uk/pages/library/other_publications/eu/other_documentation/crsg/index.shtml

7.54 **Our response:** We propose to maintain the position set out in CP05/3.

Comparability between external data and the firm's own experience

Q65: What do you think are the key elements in ensuring comparability between external data and the firm's own experience?

7.55 In CP05/3, we spoke of the need for the population base for external data to be comparable and relevant. Respondents acknowledged the importance of ensuring that portfolios were similar. But they suggested that statistical 'proof' should not be required particularly in the case of low default portfolios. They also said that they should not be required automatically to seek external data.

7.56 **Our response:** The CEBS Working Group on Validation has considered this topic and its suggestions are in the CEBS Validation CP. In essence, the group suggests that comparability should be based on:

- analyses of the population of exposures represented in the data;
- the lending standards used when the data was generated; and
- other relevant characteristics in relation to the corresponding properties of the firm's own portfolio. These might include the distribution of obligors across industries; the size distribution of exposures; and similarities in the geographic or demographic distribution of the exposures.

We intend to adopt an approach consistent with this.

We also intend to clarify BIPRU 4.3.76 (1) (a), which requires that if a firm uses pooled data, it must be able to demonstrate that the rating systems of other firms in the pool are similar to its own. This is not intended to constrain the use of pooled data where that data is unaffected by rating system differences.

We confirm that there can be circumstances where firms do not need to have regard to external data in their estimation processes, such as where firms' internal data is sufficiently rich to meet the requirements of the CRD and BIPRU. Where available, though, external data should play a part in the validation process.

Provision of data and services by other members of a group

Q43: Do you support our approach to the provision of data and services by other members of the group?

7.57 Although generally content with our proposals, the responses raised some questions about the treatment of different legal structures within a firm's group and the interpretation of our outsourcing policy in this context. The industry also questioned the limitation on the ability to rely on a rating system provided by another group member to EEA groups.

- 7.58 **Our response:** We do not think it is necessary to expand on our existing policy on outsourcing. This already acknowledges that the level of assessment required when the supplier is another group member may be reduced. The limitation to EEA groups derives from Article 84 (2) of the draft CRD, which does not give us the discretion to extend the permission to other jurisdictions.

Exposures to members of a group of connected clients

Q58: Do you think that this is an appropriate approach to the rating of exposures to a group?

Q59: What impact would our approach to rating exposures to a group have on the costs to firms?

- 7.59 Our proposal was to continue with the approach we had put forward in CP189, which treated as a single common default all exposures to third party borrowing entities given a common group rating. We also referred to work, which we had started and discussed with some industry representatives, on when it would be acceptable to give common or notched ratings to members of a borrowing group.

- 7.60 All respondents agreed with our approach and none were aware of any significant cost implications arising as a result. However, the Joint Industry response did ask that we complete the work on acceptability of common/notched ratings.

- 7.61 **Our response:** We welcome the supportive comments received and propose to maintain this treatment. Subject to discussions in the CRSG concerning priority areas of work, we intend to continue with the work on common/notched ratings later in the year.

Downturn LGDs

- 7.62 One aim of the IRB framework is to measure capital requirements with reference to losses that firms might incur in a period of stress – the unexpected losses. For the PD parameter, this is achieved by the use of set formulae – described as risk-weight functions – which convert expected average PDs into PDs appropriate for unexpected losses. There are no parallel formulae for LGDs. Instead, the CRD requires that firms use LGD estimates which are appropriate for an economic downturn if these are more conservative than the long-run average.
- 7.63 The industry, both in response to CP05/3 and more generally, has raised a number of different concerns about this approach. First, there is some opposition in principle to using downturn LGDs at all in the IRB framework, given that more common industry practice has been to use average LGDs. Partially linked to the previous point, there is no consensus on how LGD varies with the cycle. In addition, some are concerned there has been insufficient guidance for the downturn LGD requirement to be implemented on a consistent and equitable basis, and that it will result in excessive levels of conservatism imposed by supervisory prescription.

7.64 **Our response:** The use of downturn LGDs remains an integral part of the framework. The requirement is to use downturn LGDs unless it can be shown that these should not differ from averages. The Basel Committee published in July 2005 a document on recommended approaches to the use of LGDs appropriate for an economic downturn³⁰. The CEBS Validation CP also contains more general material related to LGD; and CEBS plans to include implementation of the Basel downturn LGD guidance in the next stage of its work plan. The guidance is based on several principles aimed at ensuring firms using own estimates of LGD have systems in place for identifying downturn conditions and incorporating these conditions into LGD estimates where appropriate.

We have established two expert groups – one focusing on residential mortgages and the second on other exposures – to consider the implications of these documents and to develop further guidance as necessary.

Non-zero LGDs

Q67: Do you believe that our approach to non-zero LGDs is appropriate? If not, how could the guidance be improved?

7.65 In CP189, we proposed that firms' estimates of LGD should always be greater than zero. This would allow for cases where full recovery is not achieved because of a deficiency in documentation or more simply because the value of collateral at time of realisation is below the expected value and no security 'top up' is achieved. In CP05/3, we proposed that – pending progress on this issue in the Basel and CEBS groups – we would start our discussions with firms presuming that LGDs are non-zero, but would not specify any guidance on this point.

7.66 There was a mixed response, with some in favour and some against our approach. Particular concern was expressed about the lack of a zero LGD on Low Default Portfolios, and some sought clarification on the type of risks covered under Pillar 1 or Pillar 2.

7.67 **Our response:** The CEBS Validation CP considers this issue and we intend to follow the approach set out in that paper, subject to the results of that consultation process. The CEBS paper distinguishes between realised LGDs on exposures, which have defaulted in the past, and the estimated LGDs used for current portfolio – including in the IRB capital calculations. The data on the realised LGDs is the basis of the calculations for the estimated LGDs. Realised LGDs may be zero, for example if an exposure is returned to performing status ('cured') without incurring material costs. Or they may even be positive if the value of the collateral rises and the firm does not need to return the surplus to the borrower. Estimated LGDs may be zero but only in exceptional cases, with a higher burden of proof that all factors have been taken into account.

30 Basel Committee LGD document: www.bis.org/publ/bcbs115.pdf

Our ongoing work with expert groups will consider the particular application of low or zero LGDs to Low Default Portfolios. We will further consider whether to include in the February 2006 CP a diagram that identifies which risks should be covered by Pillar 1 or Pillar 2. We confirm that if a firm is taking residual risk into account under Pillar 2, it need not include that aspect of the possible loss in its LGD estimate.

LGDs on defaulted assets

- 7.68 In CP05/3, we explained that our previous CP189 proposal – that estimates of LGDs on defaulted assets needed to include an additional buffer based on potential volatility over their recovery period – had been superseded by subsequent changes in the IRB framework. This now required the total capital charge on defaulted assets, as well as performing assets, to be based on an economic downturn LGD.
- 7.69 The Joint Industry response suggested that the guidance in CP05/3 on how to calculate capital requirements for defaulted assets was confusing. For example, it was not clear whether firms should use downturn LGD applied to defaulted assets with charge-offs added back and asked for clarification. Also it was noted that the BIPRU text had not yet changed to reflect the estimate, no longer needing to be based on a best estimate of economic loss.
- 7.70 **Our response:** To clarify, as respondents requested, we can confirm that for defaulted exposures firms are required to calculate a downturn or default weighted average LGD in the same way as for performing assets. They must also produce a best estimate of expected loss for these exposures given current economic circumstances. In line with the normal treatment of EL, this best estimate – net of provisions or charge-offs – should be deducted from actual capital held in the numerator of the capital ratio. Any positive difference between the estimate based on downturn/default weighted assets and the best estimate of expected loss should be multiplied by 12.5 to convert the figure into a proxy for weighted risk assets and included in the denominator of the capital ratio.

Choice between adjusting EAD or LGD

Q66: Do you agree with our suggestion as to when to adjust EAD or LGD? What further guidance relating to adjustments to EAD or LGD should we include in the Handbook text?

- 7.71 In some situations, it is ambiguous whether a cash flow should be used to adjust estimates of EAD or LGD. Our proposal indicated that, where there was ambiguity, it was more appropriate to adjust EAD for items that occur before default and LGD for items which occur after default. However, we would not be prescriptive about what firms should do and were not proposing to provide guidance in the Handbook.

7.72 Respondents were content with our proposals and generally did not want further guidance.

7.73 **Our response:** We intend to maintain our position, and we will not be including any guidance on this point in the Handbook.

Direct estimates of LGD and EAD

7.74 The Joint Industry response included concerns that firms would be required to build facility rating systems for LGD and EAD, instead of being able to use direct estimates of LGD and EAD values. It was also critical of language in the copy-out text which discouraged concentrations within a facility grade, arguing that where these were based on accurate direct estimates, it should be acceptable for these to be concentrated.

7.75 **Our response:** We can confirm that direct estimates are allowable. This is the intention of BIPRU 4.3.24. As regards LGD, this is also explicitly stated in the CEBS Validation CP. It is permissible for such estimates to be highly concentrated, provided they are accurate.

Coverage of EAD estimates

Q69: Do you have any comments on the coverage of EAD estimates?

7.76 We proposed that firms using own estimates should consider all facility types that may result in an exposure when a borrower defaults – including settlement exposures and uncommitted lines – although we noted that the Trading Book Review might exclude some exposures from the scope of regulatory capital. We proposed that the starting point for including a facility should be the earliest date at which a customer might make drawings under it. Where firms made multiple facilities available, we proposed that firms needed to understand how exposures under one facility may be transferred into exposures under another on which the losses are ultimately incurred. We wished to avoid double-counting but expected to discuss with firms how this interaction affected capital requirements.

7.77 Respondents expressed some reservations on these proposals. One respondent asked for confirmation that the treatment of settlement exposures will be consistent with the outcome of the Trading Book Review (TBR). One respondent asked us to clarify when a 0% conversion factor might be applied to unconditionally cancellable undrawn retail credit lines. In the Joint Industry response, it was suggested that it should be up to firms how they estimate EAD for corporate overdrafts. And it should also be a firm's decision to consider the impact of other exposures on the overdraft facility and whether it adopts assumptions that potentially double count and overstate its capital requirements.

7.78 **Our response:** We can confirm we intend to treat settlement exposures in line with the output of the TBR, as reflected in the EU legislation³¹. Although quite complicated, the key elements are that:

- there is generally no capital charge for non-DvP (Delivery versus Payment) transactions (i.e. free deliveries) until after settlement date; amounts owing are generally deducted from capital, if these are not settled within five days of settlement date;
- the capital requirement for DvP transactions will not be substantially different from that currently required by the CAD; after five days from settlement date the capital charge will increase over time and deduction from capital will occur after forty-five days; and
- this treatment applies to securities, foreign exchange and commodities transactions.

It is unlikely that firms would be prevented from double-counting their exposures if they want to. However, it is important, in such cases, that a firm has sufficient knowledge of the interaction between its various facilities to be sure that the exposures are indeed being double-counted.

We suggest that the work programme for the proposed expert group on EAD should consider the treatment of any settlement-related exposures not covered by the Trading Book Review. It should also include issues related to the treatment of overdrafts and the starting dates of commitments. This will enable us to better understand the issues respondents have about our proposals.

The reference to a 0% CF for undrawn retail credit lines was an error in the draft CRD, which has now been corrected. Under the Retail IRB approach firms need to produce their own estimates of conversion factors, based on experience. There is no automatic 0% CF based on ability to cancel these lines.

EAD no less than current balance

Q70: Can you suggest any alternative interpretations of the Directive that we should consider regarding minimum EAD?

7.79 We sought to clarify that, although active management of problem accounts can in practice result in decreases in their balances prior to default, the framework in the draft CRD required EAD to be no less than current drawings including interest accrued to date, unless a provision has been taken. We asked whether any alternative interpretations of the CRD could be suggested.

31 TBR proposals: www.bis.org/publ/bcbs116.pdf

7.80 Most respondents opposed the basic proposition that EAD cannot be less than current balance, for example arguing that experience demonstrated that exposure amounts did frequently reduce in the period prior to default. However, no respondent suggested how an alternative interpretation could be drawn from the draft CRD. The Joint Industry response suggested that accrued interest should be included in the EAD calculation, but not necessarily in current drawings, due to the cost of implementing the latter approach.

7.81 **Our response:** While we appreciate the arguments put forward by respondents, the CEBS Validation CP has clarified that the exposure amount cannot be less than the current balance. As this is in line with our previous conclusion, and no alternative interpretations of the draft CRD text have been put forward, we propose confirming this treatment in the Handbook. We suggest that the work programme for the proposed expert group on EAD should include consideration of how accrued interest might be included in the EAD calculation in a proportionate way, consistent with the CRD requirements.

Time period for EAD calculation

Q71: Should we provide more guidance on an explicit time period for calculating EAD, and if so, what do you think is appropriate?

7.82 The notion of applying capital against undrawn lines implies the need to identify an explicit period over which drawings may increase before default. However, the draft CRD does not prescribe a specific time horizon. So we proposed not to mandate such a period in the Handbook, but to leave it to firms to choose what period is most relevant having interpreted the information provided by their 'reference' data.

7.83 Respondents were generally against prescription on the time period. They argued, for example, that it would not be appropriate across different types of portfolios, that it would devalue firms' own internal ratings process and ignore risk management experience for different exposure types. The meaning of reference data was also queried.

7.84 **Our response:** The CEBS Validation CP proposes that the time horizon for estimating EAD should be 12 months, unless an institution can prove that a different period would be more conservative and more appropriate. We intend to adopt this approach. We suggest that the work programme for the proposed expert group on EAD should consider how the test of 'more conservative and more appropriate', necessary for a different time horizon, might be met. As regards 'reference' data, this is data on realised EAD on defaulted loans that is the basis of the calculations for estimated EAD used for the IRB calculations on the current portfolio.

EAD on contingent exposures

Q80: Do you support our approach to EAD on contingent exposures?

7.85 Where firms are extending contingent exposures such as guarantee facilities, EAD could potentially be considered as the amount of the facility, the amount expected to be outstanding under it at the time of default, or the amount expected to be claimed. We proposed that it would be acceptable to calculate EAD on any of these bases. All respondents supported our approach.

7.86 **Our response:** We propose to continue with the approach set out in CP05/3 subject to review in light of the final guidelines of CEBS. However, firms should be aware that the CEBS Validation CP notes that the question of whether own estimates may be used for all contingent exposures is the subject of discussion and has been referred to the European Commission. We expect the issue to be clarified in the final CRD. If own estimates may not be used for contingent exposures, then EAD will be based on facility amounts and the conversion factors set out in Annex II of the draft CRD.

Definition of Default

General

Immaterial amounts for inclusion in the definition of default

Q60: What level of total amounts due would firms consider to be immaterial for inclusion in the definition of default?

7.87 The CRD allows immaterial amounts to be excluded from the days-past-due leg of the definition of default. In CP05/3, we modified our position as set out in CP189, which required that all overdue amounts be considered material. Instead, we proposed permitting firms to exclude insignificant amounts in line with a policy to be agreed with us.

7.88 Most respondents agreed that firms should be left to formulate their own policy in this area. They did not believe it would be appropriate to set a formal threshold limit of what constitutes a material credit obligation to include in the definition of default. However, some respondents did ask us whether they should measure significance against potential loss or the amount outstanding against the loan.

Use of time versus money measures

Q61: Are there any practical difficulties arising from the approach to the treatment of a 'money measure' of days-past-due?

- 7.89 Two common interpretations in the industry of days-past-due are a ‘time’ measure (meaning the number of days with some arrears) and a ‘money’ measure (where the amount outstanding is equated to monthly payments). Since we published CP189 – in which we said both measures were acceptable – the draft CRD has included a requirement for days-past-due to be calculated on a time measure. In CP05/3, we explained that a money measure could be used, provided firms’ procedures are such that no payment can be past due for more than the maximum number of permissible days. We asked if this approach would give firms practical difficulties.
- 7.90 The Joint Industry response did not raise any major concerns with our proposed approach to the treatment of a ‘money measure’ of days-past-due, believing that it could be applied to both time and money measures. The response from individual firms was more mixed with some respondents noting that they were already able to meet the requirements concerning the use of a money measure of past due. Others expressed concern about the practicalities in blending their own approaches in this area with those required by us.

Realisation of collateral

Q62: Do you support our approach to the realisation of collateral element of the definition of default?

- 7.91 We said we would generally consider realisation of collateral to indicate default but clarified that this did not extend to cases (such as commodity finance) where sale of the collateral is the normal source of repayment. A further exception was in markets such as margin lending. Here, it is established practice for collateral to be sold if its value falls below a certain percentage of the loan, provided it has not fallen below the amount outstanding.
- 7.92 The Joint Industry response did not support our view that the sale of collateral should generally be considered an indicator of default – especially in non-retail markets, where it was felt that such a sale did not always signal default.

Considerations for assets which are close to default

Q63: Do you believe our approach to assets which are close to default is appropriate? If not, how should it be amended?

- 7.93 We reminded firms that, although they may use watch-list approaches for exposures which are in greater danger of defaulting, for IRB purposes these exposures needed to be assigned to grades which complied with the CRD, including homogeneity of default risk of the borrowers. We also highlighted the need for firms to have clear policies on the re-rating of exposures returned to performing status.

- 7.94 Respondents were comfortable with our proposals concerning assets close to default. They did not wish to receive guidance on how to monitor assets with early indications of going into default, as they had already created their own bespoke risk management procedures in this area that are compatible with their business needs.

Transitional period for the definition of default

Q83: What practical problems will arise if days-past-due is set at 90 days during the transitional period until 2011?

- 7.95 We proposed not to take up the national discretion under the CRD to set days-past-due for corporate exposures at a figure between 90 and 180 days for the transitional period up to 2011. Instead it would remain at 90 days.
- 7.96 Respondents saw no problems arising from the adoption of the 90-day past due definition during the transitional period until 2011. Some argued that any change from this assumed position now would have major systems and costs implications.
- 7.97 **Our response:** We welcome industry's generally positive response to our proposals and intend to maintain the position we took in CP05/3 on all these aspects of the default definition. We note industry's concerns that the sale of collateral in margin lending does not always signal default and re-iterate the stance taken in CP05/3. That is, collateral sales on margin lending would not normally be considered to be a default for regulatory purposes, unless the value of collateral has fallen below the amount outstanding.

On using time versus money measures, we would clarify that any money measures used in the way outlined in CP05/3 should be included as indicators of 'unlikely to pay', as opposed to under 'days-past-due'.

We do not propose to issue any guidance on defining insignificant amounts to be excluded from default calculations. We believe that the precise approach taken is one for firms themselves to determine, against the backdrop that insignificant refers to items having a *de minimis* effect in terms of capital requirements.

Retail Portfolios

Formulaic provisioning in retail portfolios

Q64: Do you agree with our proposed approach to formulaic provisioning in retail portfolios?

- 7.98 We proposed taking forward the guidance in CP189, that the employment of a formulaic approach to portfolio provisioning, based on the number of days-past-due, will not necessarily be taken as an indicator of default for the exposures concerned. Respondents supported the approach proposed.

Considerations for days-past-due

Q93: Is this an appropriate treatment of days-past-due for retail portfolios?

Q94: Should we include guidance on the point from which days-past-due should be counted?

- 7.99 We proposed continuing with the approach set out in CP189, where days-past-due for retail exposures are set at 180 days, except for 90 days in the case of SMEs. These were proposed on the basis that days-past-due is intended to act as a backstop for the definition of default. Where firms have exposures in other EEA states, they would be able to use the definition used in that country. We also retained our preferences for the start date set out in CP189: date at which limit breached for overdrafts; billing date for other revolving credit facilities; and payment date for fixed repayment loans. However, we would allow firms to use different bases if they have estimated the impact of the different method and can make an adjustment if this is material.
- 7.100 Respondents generally supported our approach. In contrast, most respondents did not favour additional guidance on the point from which days-past-due should be counted.
- 7.101 **Our response:** We propose to maintain the stance that we advocated in CP05/3 in all areas concerning definition of default for retail portfolios. In line with industry requests, we do not propose to issue any additional guidance on the point from which days-past-due should be counted.

Retail

Data windows

Q87: Do you agree with our approach to data windows and the use test for retail exposure?

Q88: What guidance should we include on data windows and the use test for retail exposures?

- 7.102 In CP05/3, we set out our proposed approach in relation to the tension that could arise between the CRD requirement that the estimation of loss characteristics must be based on an observation period of at least five years and the fact that in firms' practice for retail portfolios credit scoring models are often built with a significantly shorter 'data window' (12 to 15 months) for pricing and approval purposes. A number of respondents were uncomfortable with the draft CRD requirement to use five years of data for their retail estimates. They felt this not to be in line with best practice. Some suggestions as to how the intent of the requirement could be achieved more effectively were made, for example by the weighting of data, the use of out-of-time validation or reference to external data.

7.103 **Our response:** The draft CRD states that the historical observation period used for estimating retail loss characteristics must be at least five years for at least one source. However, it also states that firms need not give equal importance to historic data if they can convince us that more recent data is a better predictor of loss rates. We think that, other things being equal, longer runs of data are likely to produce more robust risk estimates, especially as they are more likely to include a full range of experience over an economic cycle. But we also recognise the greater value of up-to-date data, where market conditions or customer behaviour are changing. Where firms' models have been developed using shorter runs of data, they will need to convince us that the calibration of these models nevertheless reflects experience over at least a five-year period and expectations of future performance.

We recognise that there is potential for tension between the needs of internal management and the regulatory capital requirements, and we noted in CP05/3 that this was prompting some firms to consider separate models for the two purposes. We think it is very important that firms should believe in the quality of the models that they use for regulatory capital purposes and to this end those models must play an essential role in risk management and decision making. Where firms have built separate models for the two purposes, they will need to explain how this requirement is achieved. The draft CRD does of course permit the use of different estimates for calculating risk-weights and internal purposes. Any such differences must be documented and their reasonableness able to be demonstrated. For our interpretation of 'essential role' and the use test generally, see our feedback on the 'use test' generally at paragraphs 7.46-7.50.

Retail definition

Q89: What practical difficulties remain in meeting the aggregation requirement for retail exposures? What other interpretations could we consider, within the constraints of the Draft Directive?

Q90: Do you think it would be beneficial to add guidance around the use of exchange rate parameters in determining the €1m retail/corporate boundary? If so, what guidance should we include?

Q91: Is the guidance on individual management of retail exposures appropriate? How could it be improved?

7.104 The definition of 'retail' exposures in the CRD limits the amount of total exposure to an SME and any connected counterparties to €1million and requires the firm to take reasonable steps to confirm this. Respondents expressed strong disagreement with the CRD requirements in this area, referring to 'immense practical difficulties' and fearing conflicts between what was required by the qualifying criteria and the way that they would normally manage customer relationships.

7.105 **Our response:** An industry expert group has prepared a set of recommendations for implementing the aggregation requirements which can be found on our website³².

We are considering these recommendations and also monitoring discussions within the EU parliamentary process where several amendments on this issue have been proposed. While we support the principle that firms should know the totality of their exposures to each customer, we also recognise both the practical difficulties of meeting such a requirement in full and the cost-benefit aspects of this issue. Accordingly, we will be seeking to develop as pragmatic an approach as possible within the constraints of the directive and having full regard to the concepts of reasonableness and materiality of potential breach.

Concerning our guidance on the individual management of retail exposures, respondents thought our guidance was broadly fair.

Refreshing risk parameters

Q92: What are your views on our proposals for refreshing risk parameters? What other means of implementing this requirement could be used?

7.106 In meeting the CRD requirements on the annual update to the review of risk parameters, we indicated in CP05/3 that we did not intend to require this to be done by means of a full rerun of a credit scoring model. Respondents were mainly in favour but also suggested that an annual review might not be needed if firms adopted appropriate trigger values for a review instead.

7.107 **Our response:** Our draft guidance would permit firms to propose alternative ways of meeting the CRD requirement provided they are appropriate to the materiality of the portfolio concerned. We propose to maintain this draft guidance.

Definition of default

7.108 Feedback on respondents' comments on defining default in the retail portfolio is dealt with in paragraphs 7.100-7.102 in response to questions 93 and 94.

Default on other facilities – 'all relevant information'

Q95: Is our revised proposal for all relevant information within the retail portfolio appropriate?

Q96: What guidance should we include on the application of the requirement to consider all material relevant information?

32 CRSG expert group papers: www.fsa.gov.uk/pages/library/other_publications/eu/other_documentation/crsg/index.shtml

7.109 In CP05/3, we stated that we would consider proposals from firms to exclude from the ‘all relevant information’ concept defaults on other facilities than the one in question. This is where the firm could demonstrate that the additional information would not make a material difference to their capital calculations or to achieve compliance within a reasonable timescale. While generally supportive, some commented on the need to take into account materiality when applying the guidance.

7.110 **Our response:** We propose to maintain our present position, which recognises that materiality should play a part in determining the timing and completeness of compliance.

Segmentation

Q100: Should we be more specific in our expectations regarding segmentation?

7.111 In CP05/3, we indicated our approach to the CRD requirement that exposures be allocated to homogenous pools (or segments) based on their risk. We asked whether we should specify further our approach to this aspect. Respondents indicated that they did not seek further guidance on this issue.

7.112 **Our response:** In light of the comments made, we propose to maintain our current position.

Qualifying Revolving Retail Exposures (QRRE)

Q97: What do you consider to be a low volatility of loss rates?

Q98: What evidence do you have on the volatility of losses in the portfolios that you would wish to see treated as QRRE?

Q99: At what level (portfolio/sub-portfolio) do firms currently assess the volatility of loss rates?

7.113 The CRD definition of QRRE includes the requirement that the portfolio in question exhibits low volatility of loss rates. In CP05/3, we asked respondents about their practice and views in relation to this aspect. The responses did not bring to our attention a significant amount of additional information.

7.114 **Our response:** We have begun discussions with some industry members on how the draft CRD requirements in this area could best be met. The CEBS Validation CP has also made proposals for the exact calculations that need to be made. We will be developing our view, in consultation with industry, in the next few months.

Experience requirement

Q45: Do you support our approach to applying the experience requirement? If not, how could our concerns on the embedding of IRB within risk management and the production of robust capital requirements be addressed?

7.115 In CP05/3, we set out our approach to the experience requirement contained in the CRD. We indicated the main elements – operating a system of a type set out by the directive, complying with the requirements for senior management knowledge and complying with the use test requirements. We indicated that we would expect firms to improve their systems in light of experience over the period so that they more fully met the requirement in the final year. We also indicated our approach to the national discretions to reduce the period during the initial period of CRD implementation. We indicated that the CRD text was itself likely to change and that we would review our position accordingly. Responses were mixed, with some favouring our approach while others questioned our decision not fully to adopt the national discretion to waive the requirement during the transitional period.

7.116 **Our response:** CP05/3 was based on the 14 July text of the draft CRD. In general terms, we maintain our approach as set out in CP05/3. However, an amendment has been proposed to the draft directive that would change the application of the experience requirement during the transitional period. Under this amendment, the experience requirement for firms wishing to use Retail or Foundation IRB approaches can be reduced to one year until the end of 2009 and for the Advanced IRB approach it can be reduced to two years until the end of 2008. Subject to any further amendments to the draft CRD, we intend to adopt these transitional arrangements. Further details of our proposed approach are contained in a FAQ response on our website³³.

Partial use

Impact of an acquisition on a firm's roll-out plan

Q46: Do you believe that the guidance relating to how an acquisition would impact a firms' roll-out plan is appropriate? If not, how should it be amended?

7.117 We suggested that while firms' entry into new products and markets may require revisions to previously agreed roll-out plans, in many cases they could be accommodated within existing waiver conditions. We would be prepared to discuss extensions regarding major acquisitions and proposed guidance on how this might be applied.

33 FAQ response: www.fsa.gov.uk/pages/About/What/International/basel/faq/faq_1.shtml

7.118 Most respondents agreed that the approach we proposed was reasonable. However, the Joint Industry response noted that further guidance was needed on how divestments and sales of business would impact a firm's roll-out plan.

7.119 **Our response:** We intend to maintain the approach to roll out that we proposed in CP05/3, including the guidance about incorporating acquisitions into a firm's roll-out plan. As regards the impact of divestments, there is a possibility that the divestment of a business on an IRB approach will take a firm above its 15% threshold for immaterial exemptions. Where this is the case – which we anticipate being unusual – we would expect to discuss with a firm what actions it would take, and over what time frame, to restore its compliance with the 15% maximum. We will consider including guidance to this effect in the February 2006 CP.

Permanent exemption for exposures to sovereigns and institutions

Q47: Are our proposals for implementing the permanent exemption for exposures to sovereigns and institutions clear and appropriate?

7.120 The draft CRD's requirements for these exemptions are that exposures are to a limited number of material counterparties and that it would be unduly burdensome for firms to implement an internal ratings system for these. We proposed that these tests would be likely to be met by firms with total outstandings to higher-risk sovereigns or institutions that were less than both £1bn and 5% of total assets, and which did not have a trading book.

7.121 Most respondents believed that our proposals for implementing the permanent exemption for exposures to sovereigns and institutions were clear and appropriate. However, the Joint Industry response did not think that firms should have to establish a policy setting out which exposures they intended to keep on the standardised approach. Instead, it said this should be agreed as part of the application process.

7.122 **Our response:** We are pleased by the industry's generally supportive response in this area and so we intend to maintain the approach to permanent exemptions outlined in CP05/3, which remains consistent with the CEBS Validation CP (paragraphs 112-4). We still propose that firms formulate a policy concerning the exposures they intend to keep on the standardised approach. This is because we believe it will help ensure that firms can justify permanent exemptions on an ongoing basis following the application process and in cases where there have been changes in portfolio and/or business strategy.

Exemption from IRB on grounds of immateriality exemption

Q48: Could BIPRU 4.2.27 be made clearer regarding the 15% immateriality exemption? If so, how?

7.123 In CP05/3, we proposed continuing with the basic approach set out in CP189 of allowing a 15% exemption from IRB on the grounds of immateriality. We gave further clarification in a number of areas. The industry raised a number of concerns with the draft BIPRU text, namely that:

- intra-group exposures would be included within the 15% calculation;
- they required confirmation that the calculation of RWA for the 15% threshold is gross, not net of any credit risk mitigation; and
- internationally active banks should be afforded greater flexibility if they operate in non-EU jurisdictions where the IRB approach is not available.

7.124 In addition, the specialist trade associations argued that money market funds should not count towards the 15% limit. This is to provide equal treatment between such funds and inter-bank deposits (which are treated as claims on institutions).

7.125 **Our response:** We note respondents' concerns that intra-group exposures will be included in the 15% threshold and propose to issue guidance – possibly including flowcharts and worked examples – once the general framework for the treatment of intra-group exposures has been finalised (see chapter 2). However, we expect the broad elements of this to include the following:

- to the extent that the calculations for partial use are at the level of a group rather than an individual firm, intra-group exposures will usually not be relevant; and
- to the extent that intra-group exposures are relevant, then those exposures subject to the permanent exemption will not be included in the numerator or denominator of the calculation, in line with our general approach as indicated in CP05/3 paragraph 7.39.

We can clarify that calculations should be net of credit risk mitigation to the extent that this reduces the firm's capital requirement.

We do not believe it is necessary to give further flexibility as regards non-EU operations. This is because the calculations are on a group basis, and firms will have the option of adopting an IRB approach at a consolidated level even if IRB is not offered by the local supervisor of a subsidiary.

Regarding the treatment of money market funds, we note that such funds can be eligible for permanent exemption if they are treated on a look-through basis and the underlying exposures are claims on institutions or sovereigns. However, it is not possible to grant such exemption when a look-through approach is not taken. This is because the CRD only provides for permanent exemptions for explicit claims on sovereigns and institutions.

Intra-group exposures

Q49: Are our proposals for exempting the intra-group exposures from the IRB approach clear and appropriate?

- 7.126 The draft CRD (Article 89.1(e)) provides for the permanent exemption of certain intra-group exposures. In CP05/3, we proposed that a firm may choose permanently to exempt from the IRB approach exposures that comply with certain conditions.
- 7.127 Once transferred from the IRB approach to the standardised approach an exposure is risk-weighted using standardised approach risk-weights. Exposures held in the standardised approach are potentially eligible for inclusion in a firm's UK integrated group and to be risk-weighted at 0% if they meet the relevant conditions.
- 7.128 We proposed that firms exempting exposures from the IRB approach include details of these in their IRB waiver application and have policies in place for identifying and transferring exposures.
- 7.129 Some respondents thought the proposals both in CP05/3 and the draft CRD were unclear. A number of respondents wanted to be able to include exposures on IRB in their integrated group. Other respondents thought the proposals were clear.
- 7.130 The Joint Industry response stated that the proposed requirement for exposures permanently exempted from the IRB to be included in a firm's IRB waiver application was impractical and burdensome. It would be simpler to require a statement of those entities not included in the integrated group rather than those that are included.
- 7.131 **Our response:** This is linked to our response to questions 112-114 of chapter 8 on the concentration risk treatment of intra-group exposures.

We still think it is appropriate to require IRB firms to have a documented policy for identifying intra-group exposures which they intend to deal with under a standardised approach calculation. We do, however, acknowledge that this has implications for our requirements on the availability of preferential concentration risk treatments. This is dealt with further in chapter 8.

Application of partial use across groups

Q50: Are there any additional factors we should take into account with respect to partial use across groups?

- 7.132 We confirmed the proposal in CP189 which states that for UK groups our approach applies at a group level. For UK subsidiaries of foreign groups with a supervisor deemed 'CRD equivalent', we rely on the partial use provisions of the home supervisor and set no additional ones ourselves. And for other UK subsidiaries, we apply our partial use provisions at a sub-group level.

7.133 The industry stated that while it was sensible to rely on the partial use provisions of the home supervisor as a general principle, it remained unclear whether such exemptions only applied to 15% calculation (set out in BIPRU 4.2.27) or would also be applied to other situations such as the exclusion of intra-group exposures. Industry argued that it would be inappropriate if the exclusion for intra-group transactions were unavailable to local subsidiaries of groups supervised at the consolidated level in third countries.

7.134 **Our response:** In general terms, we propose to maintain the approach set out in CP05/3 which is consistent with CEBS Validation CP (paragraph 117). We will consider further the issues raised by respondents in the context of ongoing work with the industry.

Explicit maturity adjustment

Q81: If you are intending to apply for the Foundation IRB approach, how significant will the implications be of collecting and monitoring maturity data?

Q82: What are the implications for firms of not implementing the maturity carve out for exposures to smaller borrowers?

7.135 In CP05/3, we restated our view that maturity is an important driver of credit risk. For this reason – and to make it a level playing field for firms on the Foundation and Advanced IRB approach – we proposed to exercise the national discretion to introduce the explicit maturity adjustment in the Foundation IRB approach. We also indicated our intention not to take up the national discretion to use the fixed maturity adjustment for exposures to non-large counterparties. Respondents did not oppose our position, although they pointed out that changes being introduced as a result of the Trading Book Review (TBR) would need further consideration. Responses expressed some desire for a carve-out for small borrowers but flagged the potential systems cost of implementing such an approach.

7.136 **Our response:** We still believe that our proposals are well founded and appropriate. Accordingly, we intend to maintain our position on maturity adjustment issues.

The TBR, which includes proposed modifications to the measurement of maturity in the IRB approach, remains under discussion in the EU. We shall make appropriate modifications to our proposals in light of the final outcome.

Purchased Receivables

7.137 In the Joint Industry response, concern was expressed that the ECOFIN changes to the draft CRD had reduced the flexibility in the treatment of with-recourse purchased receivables.

7.138 **Our response:** Our preliminary view is to agree with the interpretation put forward by the industry – namely, that the text requires such assets to be treated as Purchased Receivables, and does not allow for the alternative of treating these as secured lending to the party they have recourse to. We also believe that secured lending is in principle a more appropriate treatment for exposures where this reflects the economic substance. The economic substance of with recourse purchased receivables is the same as for secured lending; and we view the purchased receivables approach as an alternative to be used only when the more conventional IRB cannot be applied. We are, however, aware that an amendment to the directive has been proposed which would provide the requested flexibility. If this amendment does not get passed, we will give further consideration to the treatment of these exposures.

Specialised lending

Q84: What are the practical implications of adopting the Basel Framework approach to specialised lending and slotting?

Q85: Do you agree with the proposal not to include a high volatility commercial real estate category?

Q86: Is this an appropriate approach to the preferential weightings for specialised lending? If not, what alternatives should be considered?

7.139 Respondents were generally supportive of our proposal to adopt the Basel Framework approach and the Joint Industry response did not identify any significant implications. One respondent commented on the size of the task to keep up-to-date and accurate all components of the slotting methodology within the Basel Framework.

7.140 However, the Joint Industry response did raise concerns around maintaining a level playing field approach to specialised lending and suggested that CEBS would have a role to play in ensuring that this was the case.

7.141 Respondents also commented on the conservative nature of the risk-weights associated with specialised lending exposures when compared to other exposures, for example residential mortgage exposures under the standardised approach.

7.142 Respondents agreed with our proposal not to include a high volatility commercial real estate category and accepted our proposal for allowing the preferential weightings.

7.143 **Our response:** We intend to maintain our position and adopt the Basel criteria for slotting within the relevant risk-weight categories. We understand respondents' concerns about the consistency of application throughout the EU and we will work to ensure that UK firms are not disadvantaged in this respect. However, we cannot confirm that CEBS will discuss the issue of specialised lending.

We do not share the view that keeping the slotting criteria up-to-date will be onerous. We think the criteria are sufficiently flexible to ensure their relevance to future specialised lending projects.

We confirm our belief that the risk-weights associated with these exposures are proportionate to the risks involved. We note that the table of risk-weights will only be applied when a firm is not able to demonstrate that its PD estimate meets the minimum IRB requirements.

Assuming that these options remain available in the final CRD, we will be implementing our proposal not to include a high volatility commercial real estate category and our proposal for allowing the preferential weightings.

Credit risk mitigation in IRB

Flow diagrams

Q101: Would a flow diagram, illustrating the CRM requirements for IRB, be helpful? What material would you like covered?

7.144 Respondents suggested a flow diagram would be helpful, but did not suggest what specific material they would like to be covered.

7.145 **Our response:** We propose including flow diagrams in the February 2006 CP as appropriate, and will work with industry representatives to agree on a useful format and content.

Guidance on PD versus LGD approaches for unfunded credit protection

Q102: Do you think that it would be beneficial to add guidance on the use of PD versus LGD adjustment for unfunded protection in the Handbook text? If so, should our comments in paragraphs 7.200 and 7.201 be included or are you able to provide alternative suggestions?

7.146 We had noted – without proposing official guidance – that good practice in firms was to adjust PD where unfunded credit protection reduced the possibility of default and to adjust LGD where it merely provided a higher recovery to a lender. We also indicated that differing approaches for internal

and regulatory purposes was an acceptable divergence in assessing compliance with the use test. Respondents had mixed views, but mostly felt that there should not be guidance.

- 7.147 **Our response:** In line with the majority of views expressed, we do not intend to include guidance on these issues.

Residual risk

Q109: Is the additional guidance regarding residual risk in LGD helpful? In what ways could it be improved?

- 7.148 Respondents had mixed views, but mostly felt that the guidance – which clarified that if residual risk was taken account of in LGD estimates it need not be reflected again as part of its ICAAP – was helpful.

- 7.149 **Our response:** We intend to maintain the position set out in CP05/3.

CRE/RRE discretions

Q106: What are the implications for firms of not adopting the discretion to waive the requirement for repayment to depend on cash flow for CRE?

Q107: What impact will the lack of availability of a 50% risk-weight for RRE and CRE have on firms?

Q108: Is loss data available to support the use of the 50% risk-weight for RRE and CRE?

- 7.150 The industry questioned whether the loss history of Commercial Real Estate (CRE) in the UK justified non-adoption of the discretions that would allow for a 50% risk-weight. As elsewhere (see paragraphs 5.17-5.19), industry proposed working with us to secure data that they believed would support the use of a 50% risk-weight for exposures secured by CRE. No indication was given of the implications for firms should we not adopt discretions allowing for a more favourable treatment of CRE.

- 7.151 **Our response:** We continue to consider that the loss history of exposures backed by CRE implies that it would not be prudent to risk-weight such exposures at 50%. However we remain open to any data that industry may provide to demonstrate that CRE exposures deserve a more favourable treatment. Unless conclusive data is forthcoming in this area, we will continue to adopt the stance outlined in CP05/3.

Physical collateral

Q103: How should eligible physical collateral be included in the application process? Should we give guidance of those types generally acceptable in the Handbook text?

- 7.152 The Joint Industry response agreed with our proposal not to include a list of eligible physical collateral, and did not support us including guidance on the types that would generally be included.
- 7.153 Respondents also suggested that some types of non-financial collateral (i.e. rights to operate) should be included in the LGD estimate and treated in the same way as eligible physical collateral.
- 7.154 **Our response:** We will not be adding a list of eligible physical collateral, or adding guidance on the types that would generally be included. The criteria for eligibility of such collateral are clearly defined in the CRD and will be copied out in the draft Handbook.
- We do not agree that other types of non-financial collateral can be included. The CRD is clear about those types of collateral that are eligible. We do not consider there to be sufficient examples of other forms of collateral to justify extending the CRD eligibility. For the example given of rights to operate, we would question whether an accurate valuation could be obtained that would be sufficiently robust under conditions of collateral realisation.

Eligibility requirements for collateral recognition for exposures where own estimates of LGD are being used

- 7.155 In the Joint Industry response, concern was expressed that the applicability of the minimum requirements for collateral for such exposures was unclear and/or that non-compliance with the requirements should not preclude firms from including recovery from such collateral in their LGD estimates.
- 7.156 **Our response:** We agree with respondents that it is more appropriate – under the own estimates approaches – for non-compliance to result in adjustments to estimates. However, we are constrained by the provisions of the draft CRD the effect of which seem likely to exclude the recognition of collateral in these circumstances. Our current view, therefore, is that firms using own estimates are likely to need to comply fully with the appropriate provisions of Annex VIII of the CRD, as reflected in BIPRU 4.10.

Leasing

- Q104: Is the performance of leasing transactions in these markets significantly different to that of secured lending?
- Q105: What do you think will be the impact of not taking up the discretion to reduce the LGD for leasing transactions?
- 7.157 Respondents did not support our proposal not to exercise the discretion allowing for a transitional reduction in supervisory LGDs for senior Commercial Real Estate and equipment leasing exposures.

- 7.158 They did not agree with our view that the discretion would introduce an unwarranted distortion between leasing and secured lending. They felt that it would not be inappropriate to have a different treatment for the two products. This is because leasing arrangements revolve primarily around the security offered by the asset concerned, while secured lending can involve other forms of collateral.
- 7.159 Concerning our view that the risk profile of leasing transactions was not materially lower than that of comparable secured lending transactions, respondents stated they were collating data on this issue and would present their findings to the CRSG.
- 7.160 Respondents raised a concern about possible implications for international competitiveness given that overseas trade associations were lobbying their own competent authorities to take up the discretion to reduce the LGD for leasing transactions.
- 7.161 **Our response:** We continue to believe that exercising the discretion in this area is not justified by the risk profile of leasing transactions relative to secured lending. So we would introduce an unwarranted distortion between the two markets. We remain open to further data on this issue.

It should be noted that we are currently working with leasing associations on a small number of remaining issues about the treatment of leases under the CRD that were not raised in CP05/3. These include concerns about the treatment of security and residual values under the CRD and a general concern that the regulatory treatment of leases will not be consistent with the treatment for financial accounting purposes.

Ratings-migration stress-testing

- Q56: Do you agree with our proposed approach to ratings migration stress testing? If not, what alternative scenario or approach would achieve a broadly consistent outcome?
- Q57: What would be practical implications and costs associated with our approach to ratings migration stress testing?
- 7.162 In CP05/3, we proposed that firms conduct a stress test on the impact of a mild recession scenario on their IRB capital requirements, as required by the draft CRD, and hold additional capital equal to the shortfall, if any, between the amount required under that scenario and the current amount of their IRB capital requirement. We said we would specify a macro-economic scenario to be covered by the stress test, and suggested two consecutive quarters of zero growth as indicated in the Basel Revised Capital Framework.

7.163 Most respondents did not accept the need for a ratings migration stress test. Reasons given varied, but focused largely on our requirement that firms conduct the test and, where a deficit was indicated, hold additional capital. Respondents felt this went beyond the CRD, which requires a stress test to be carried out, but does not explicitly state the scenario which should be taken as a mild recession; nor what to do with the results. So these respondents rejected this and the proposed guidance on constructing a macro-economic scenario for the purposes of the test. They also requested the freedom to develop individual approaches to the test without perceived prescription on form or the capital consequences. For example, the Joint Industry response pointed out that the suggested scenario of two quarters of zero growth would indicate a severe shock, and not a mild downturn in some countries.

7.164 On the results of implementation, most respondents stated that our approach to stress testing would incur significant costs for firms. However, most concluded that the quantum was difficult to calculate. They also feared that reporting based on frequent stress testing requirements would lead to processing delays and in some cases a delay in publishing Pillar 1 quarterly reports. It was also suggested that firms' excess of actual capital over regulatory requirements should remove the necessity for frequent stress testing.

7.165 **Our response:** The ratings migration stress test has been the subject of ongoing debate between us and industry for more than two years. It seems clear that the range of options for ratings approaches available to firms under the CRD does allow for potentially very significant cyclical volatility in capital requirements. Our proposals reflect the view that it is important that firms can measure this volatility. Also, additional capital should be available up-front in order to reduce the effects of the downturn – both on the solvency level of the firm and of the credit cycle itself. This is reflected in the Revised Capital Framework that: 'a bank should ensure that it has sufficient capital to meet the needs of Pillar 1 requirements and the results (where a deficit has been indicated) of the Credit Risk Stress Test'. We acknowledge that the requirement to hold additional capital up-front is superequivalent to the draft CRD.

The responses also suggested there was some misunderstanding of our proposals and the reasoning behind them. For example, the Joint Industry response suggested that our approach would undermine the use test requirement. This is not the case: our approach is designed to allow firms to continue to use the rating systems they choose, with the possible consequences in terms of the additional capital impact reflected separately as a more macro adjustment.

This response also suggested that the requirement for estimates to be based on long-run experience with a forward-looking element built in would result in sufficient capital over the course of a downturn. This is not the case unless a firm is using a rating approach in which there is no net migration to lower grades in a downturn, as it is this migration that causes the volatility in capital requirements. A very important feature of the stress test is to measure the extent to which rating systems have this characteristic, which will directly affect the cyclical volatility of the firm's capital requirements.

In CP05/3, we committed to the provision of additional guidance on the stress test. To this end, we invited industry members to participate in this exercise via the expert group process. They concluded that they did not agree with the policy to hold additional capital and did not want to provide additional guidance on operationalising our proposed policy. In addition to cost/benefit considerations, the group's reasons for disagreeing with the policy included:

- opposition to the appropriateness of a policy which encouraged firms to be less prudent in a downturn;
- doubts whether supervisors would in practice operate the approach in the way envisaged, so that it would rather result in a constant additional capital requirement;
- level playing field concerns, given that other countries do not seem to be adopting the same approach; and
- suggestions that consideration of the issue should wait until the consequences of the new capital framework were clearer.

Instead, the group argued that cyclicity of capital requirements can be managed through the capital planning measures of individual institutions³⁴.

We are interested in exploring further industry concerns regarding both the superequivalence and cost of our proposals. To date, the impact of this has been difficult to assess given firms' difficulty in quantifying the impact of the requirements. In response to this, we have decided to subject our proposals to further cost-benefit consideration. This work is already under way and the results will be published in the February 2006 CP. Once the results are known, we will publish any remaining operational guidance on the frequency and application of the test. Further discussion of the issues is also likely in international implementation forums.

34 www.fsa.gov.uk/pages/library/other_publications/eu/other_documentation/crsg/index.shtml

8 Concentration risk

Introduction

- 8.1 Our proposals in relation to concentration risk in CP05/3 were based on the ‘harmonised’ framework proposed in CP97 – with amendments in light of the comments received previously – and developments in the draft CRD. The latter remains to a significant extent unchanged, but contains proposed amendments to achieve necessary consistency with the new credit risk capital requirements rules.
- 8.2 In addition to the responses received on the specific questions in our consultation exercise, respondents also provided comments on the proposed text in the draft BIPRU10 chapter on concentration risk. We are considering these comments in our review the draft text.

Our proposed treatment of OTC and credit derivatives

- 8.3 We have noted that in a small number of respects the draft Handbook text is unclear and not in line with the requirements of the draft CRD. This is the case with the definition of exposure amount and the treatment of OTC derivatives, including credit derivatives.
- 8.4 We intend to bring the provisions of BIPRU10 into line with Article 106 and related provisions of the draft CRD. This means that in respect of OTC derivatives generally our proposals for the implementation of Annex III of the CRD will apply in the calculation of exposure values for concentration risk purposes. However, in the context of the banking book credit derivatives purchased to hedge risk and sold credit default swaps will receive a guarantee-type treatment in line with the proposals emerging from the Trading Book Review.
- 8.5 The approach outlined above also means that, as far as the general netting of long and short positions for arriving at the exposure value is concerned, this applies to long and short positions in the financial instruments in question held in the trading book. This is, of course, without prejudice to the application of relevant CRM techniques in the banking book as indicated in BIPRU 10.5.16-21.

Responses to individual questions

Draft Handbook chapter on concentration risk

Q110: How clear is the draft Handbook text on concentration risk?

- 8.6 The majority of respondents agreed that the Handbook text on concentration risk had been drafted in a clear and concise way. One area where respondents thought we were being less than clear was the section relating to the integrated groups regime. The Joint Industry response commented that while the chapter was clear in most aspects, elements relating to our position on integrated groups and the subsequent interactions remained unclear. Respondents also requested that more guidance generally be included in this chapter.

- 8.7 **Our response:** For the most part, we consider that the Handbook text for concentration risk is drafted in a clear and coherent manner. In the area where respondents needed us to explain and communicate our proposals in a clearer fashion – namely the integrated groups section – we are currently working with industry through an expert group and our Credit Risk Standing Group (see feedback on questions 112-114).

More generally, our orientation is not to include further guidance in the concentration risk chapter of the Handbook. This is in line with our approach across the Handbook to restrict the level of additional guidance and is consistent with industry calls for a principles-based approach.

Q111: Is our approach to national discretions clear and appropriate?

- 8.8 In general, respondents stated that our approach to national discretions had been outlined clearly. Some respondents, including the Joint Industry response, wished to see a more liberal approach in our exercise of national discretions. They noted that we had failed to adopt a number of discretions which would have had the effect of reducing requirements on firms. One respondent expressed general support for our approach of leaving rules deriving from CRD ‘white text’³⁵ unchanged but, asked why we had not adopted this approach in relation to the concentration risk chapter.

- 8.9 **Our response:** As we explained in CP05/3, the rationale for our differentiated approach to ‘white text’ in this area is that the new concentration risk rules represent a harmonisation of the separate regimes previously put in place by us and our predecessor organisations. To achieve this necessary harmonisation, it has been appropriate to bring those frameworks together in line with the proposals in CP97, as amended in light of comments made, and subsequent amendments in the EU framework.

35 White text is explained in the overview chapter of CP05/3 at 1.32

Subject to some exceptions – dealt with further in this chapter – respondents did not in general provide specific examples of where they consider our exercise of national discretions to be unduly conservative. We still consider that the manner of our exercise of the large number of national options and discretions contained in the draft CRD is appropriate and contributes to a well-balanced and proportionate concentration risk framework. We are, however, giving further consideration to our exercise of the national option relating to exposures to collateral issuers (see feedback on question 122). We are also engaged in ongoing work with an industry expert group concerning intra-group exposures (see feedback on questions 112-114).

Wider integrated group

Q112: Is the proposed application of the integrated groups regime for concentration risk purposes sufficiently clear? How might we clarify it further?

Q113: Would you seek to apply for a waiver for a wider integrated group?

Q114: Would it be appropriate to include in our Handbook a flow chart similar to that in Annex 8 to illustrate the application of integrated groups?

What we consulted on in Q112-114

- 8.10 In CP05/3, we proposed to use the national discretions contained in the draft CRD at Article 111(2) and Article 113 to give effect to an integrated groups regime within the concentration risk framework.
- 8.11 Where a firm was eligible to form a UK integrated group we proposed that the concentration risk rules applicable to the firm may be modified to recognise the group context and the nature of the management of the firm's intra-group exposures. We proposed that exposures between members of a UK integrated group may be exempt from large exposure limits and the requirement to calculate a concentration risk capital component.
- 8.12 A firm that had formed a UK integrated group may also seek to form a 'wider integrated group', the successful formation of which would result in further modification to the large exposure limits that were applied to exposures to group counterparties incorporated outside the UK.

Responses to Q112-114

- 8.13 Some respondents thought the concentration risk elements of the integrated groups regime were clear. The Joint Industry response commented that it appreciated the enhanced explanations that were included in CP05/3. However, there were requests for additional guidance in a number of areas

including: the operation of limits applicable to the trading book; reporting requirements; and treasury concessions. In particular, the operation and rationale for 'diverse blocks' was not well understood.

- 8.14 Several respondents argued that the distinction between domestic and cross-border intra-group exposures was not well founded. They believed that where the other criteria for the formation of an integrated group were met, the fact that the counterparty was outside the UK was not significant. They believed that the integrated risk management of the group was the most significant aspect. Respondents called on us to explain further our rationale in this regard.
- 8.15 The Joint Industry response noted that the concentration risk elements were excessively complex and likely to be costly to implement and maintain. Respondents argued that it was inappropriate to make major changes to the intra-group concentration risk requirements when the underlying large exposures framework in the draft CRD is largely unchanged. In particular, they referred to the forthcoming EU Commission review of the large exposures regime. They felt that once the large exposures review had reported its findings it was likely that these would lead to changes in the large exposures regime and would also affect firms' integrated groups arrangements. Firms would have to change their arrangements not only to meet the proposals for an integrated groups regime as set out in CP05/3, but would also have to revisit and reorganise their arrangements to comply with any revised requirements that grew out of the forthcoming EU review of the current large exposures regime.
- 8.16 Many respondents thought the proposed integrated groups regime was not conducive to an international playing field and went against the EU Treaty's freedoms to provide services and establish business operations in other Member States. They noted their concern that the current wording of the draft CRD does not permit zero risk-weighting of intra group exposures to non-UK group companies.
- 8.17 Some respondents asked us to clarify whether, to obtain the preferential treatments in relation to concentration risk, it would be necessary for an IRB firm to use the standardised approach for the intra-group exposures in question. If this was the intention, respondents felt that it was an unnecessary and unhelpful requirement and should be removed.
- 8.18 There were very few responses to question 113. Of the individual respondents, some said they would apply and others said they would not apply for a wider integrated group waiver. The Joint Industry response said it believed that virtually all UK banking groups with international activities would wish to apply for a wider integrated group. It stated that the situation was less clear for non-UK banking groups and noted that these may prefer to grandfather in their current large exposure regime.

8.19 For question 114, there was general support for the inclusion of flow charts and examples to illustrate the integrated groups regime.

8.20 **Our response:** The question of the appropriate treatment for cross-border intra-group exposures is receiving close consideration in the context of the work of an FSA-industry expert group and the CRSG. We will be reviewing our proposals in the light of the outcomes of the work of these groups.

In general terms, we consider that there is a risk of default by counterparties to intra-group exposures, and that in the context of large exposures the impact of such default on the lending entity can have a significant impact. We accept, however, that in certain circumstances – e.g. consolidated supervision; integrated risk management and control; the counterparty being subject to prudential requirements, etc – this risk can be substantially removed to the extent that a 0% risk-weight can be applied and/or exemption from large exposures limits permitted.

In the context of cross-border intra-group exposures, the situation is more complex. Even where the risk-mitigating circumstances indicated above are present, concerns remain about the protection of UK depositors and creditors resulting from the overseas location of the funds. In particular, in a time of stress it is – in our view – unlikely that these funds will be repatriated. There are also concerns around the interaction of different national legal and insolvency regimes.

However, we acknowledge that the risk surrounding intra-group exposures between firms that are managed on an integrated basis is less than that associated with exposures to non-group third parties. This is the basis for the proposals set out in CP05/3. The effect of the ‘diverse blocks’ proposals is to provide a significant, preferential treatment for such exposures. This allows firms to have not just one limit for its exposures to the connected parties constituting its non-UK group, but to have a number of separate limits reflecting a reduced level of correlation between the identified diverse blocks.

We continue to think there is significant merit in this proposal. This includes its consistency with the approach for risk-weighting which is, as we have indicated elsewhere in this document, in line with the provisions of the draft CRD. However, we will be reviewing the proposal further in light of the work of the expert group and the CRSG.

We agree that there are level playing field issues surrounding the current EU large exposures legislation. This derives from the large number of national discretions written into the large exposures framework and the need for Member States to create a consistent regime. We have no evidence that our proposals will have a significant impact in this regard.

We see some merit in the arguments of respondents concerning the forthcoming European Commission review of the large exposures regime. However, there are also several important countervailing considerations. These include, in particular, the fact

that a key driver in developing our proposed framework has been to harmonise the rules applying to banks, building societies and investment firms. Given the unknown timetable for further legislation, if any, in the EU context, we feel that there would be significant downsides to continuing indefinitely with the current situation.

The uncertain timescale would be troubling in relation to the outstanding prudential concerns indicated above. As part of our ongoing discussions with the expert group and the CRSG, we will be interested to know in more detail the additional administrative burdens that are envisaged from introducing the proposed rules for the concentration risk element of the integrated groups regime at this stage. We would also be concerned that not introducing the harmonised framework could disadvantage firms that have already made preparations in view of the long-standing existence of the integrated groups regime proposals.

Concerning the issue of whether an intra-group exposure must be treated under the standardised approach for risk-weighting purposes in order to benefit from preferential treatment for concentration risk purposes, we can confirm that this is a possible reading of the proposal as it stands in CP05/3. However, in view of the approach that is taken in relation to the exemption of such exposures from the IRB treatment – in particular that the firm must identify such exposures and adopt a documented and consistent policy for its approach – we consider that there is strong merit in the arguments made by industry that there is a conceptual inconsistency here. So we are minded to amend our proposals on this.

Intra-group sale and repurchase and securities lending and borrowing transactions

Q115: Is the proposal for exemption from concentration risk limits for exposures arising from sale and repurchase and securities lending and borrowing transactions appropriate?

Q116: What would be the impact on financial resources of extending this proposed treatment to other types of secured intra-group exposures?

- 8.21 Respondents showed a strong level of support for the appropriateness of exempting from concentration limits exposures arising from intra-group sale and purchase and securities lending and borrowing transactions.
- 8.22 While welcoming our approach to this national discretion, the Joint Industry response sought clarification of two issues about how the policy would operate. Firstly, in relation to the condition of 90% collateralisation at all times, they wanted to know if the collateralisation would be assessed on a counterparty basis rather than by transaction, since this is the way in which collateralisation is considered by firms in their business. Secondly, they wanted to know whether the concept ‘at all times’ had any flexibility to its interpretation or was strictly interpreted.

8.23 Respondents were generally in favour of making the same preferential treatment available to a wider range of transactions, in particular prime brokerage/margin lending.

8.24 **Our response:** As we indicated in CP05/3, this preferential treatment was proposed specifically to address the difficulties faced by investment firms in respect of certain aspects of their intra-group activities. In particular, we felt that a preferential treatment was appropriate in view of the nature of the business, the impact of the new draft CRD rules on the measurement of exposure value, and the inconclusive state at the time of the Basel/IOSCO Trading Book Review (TBR).

The TBR has now been completed. Work is under way to incorporate its outcomes in the draft CRD. It looks likely that the new internal models approach to calculation of exposure values for repurchase etc transactions will be incorporated into the large exposures provisions of the draft CRD.

Assuming that the internal calculation method is incorporated for these exposures, it would then seem likely that there will no longer be a need for the specific preferential treatment for intra-group repurchase, etc transactions set out in CP05/3.

If the new calculation method is not incorporated in the CRD for these purposes then we will maintain our CP05/3 proposals.

We intend to consider the above aspects further – together with the issues raised by respondents – and to discuss them with the CRSG before finalising our proposals in this area.

Concerning the suggested extension of the proposed treatment to intra-group margin lending, it was not made clear to what extent this represents a significant intra-group activity justifying a preferential treatment. We note, however, that the internal models approach to calculating exposure amounts emerging from the TBR is likely to apply also to margin lending (subject to the uncertainties indicated above concerning its application in the large exposures framework).

Treatment of options

Q117: In what circumstances would it be appropriate to use a delta-weighted value of the underlying to calculate the issuer exposure generated by options?

Q118: Are there any circumstances where it would not be appropriate to use a delta-weighted value to calculate the issuer exposure generated by options?

8.25 Respondents were generally in favour of the use of delta-weighted value for options and of our consulting on the use of model outputs. Beyond this, respondents did not provide further input.

- 8.26 **Our response:** We will proceed now with a review of the interaction of internal models with the large exposure regime. We will discuss our thinking with the CRSG and include appropriate proposals in the February 2006 CP.

Financial collateral on Advanced IRB approaches

Q119: If you intend to use an Advanced IRB approach, what additional guidance in this area would you require?

- 8.27 The few respondents who indicated their intention to use the Advanced IRB approach stated that they did not require additional guidance from us on this issue.

- 8.28 **Our response:** In line with our general principles-based approach and with the views of respondents we do not intend to include further guidance on this aspect.

Q120: How do you intend to meet this requirement for stress testing? What guidance would be necessary in this area?

Q121: What factors should be considered in determining the extent of reduction required in collateral values for concentration risk purposes to reflect the results of stress tests?

- 8.29 In general, respondents were supportive of our approach to stress testing and recognised the value of a robust risk management of concentration risk and the part stress testing plays in this. However, many opposed a direct impact of the stress-testing results on the Pillar 1 calculations. They considered that the impact should more appropriately be addressed under Pillar 2. There were no requests for additional guidance. There was minimal input on the question of the factors to be considered in determining the extent of reduction in collateral values to reflect the results of stress tests. One respondent thought that consideration of a minor downturn would be more appropriate than a full disaster scenario.

- 8.30 **Our response:** In our draft rules on this issue we have adopted a copy-out approach to the draft CRD provisions. They make it clear that where the Article 114 options are exercised, the results of stress tests do directly impact the value of collateral to be recognised. We do not intend to include further guidance on this aspect at this stage.

Other national discretions

Reporting of exposures to issuers of collateral

Q122: What frequency would be appropriate for reporting of collateral concentrations?

Q123: Would it be appropriate to apply a de minimis threshold to collateral concentrations to be reported?

8.31 Most respondents did not support our proposal to require firms to report their collateral concentrations. Many also asked how we, as the regulator, intended to use the information provided so they could understand how it was justified on cost-benefit grounds.

8.32 Respondents indicated the difficulty many firms would face in obtaining collateral concentration information. They also highlighted the system implications for firms if this proposal was implemented.

8.33 **Our response:** Having listened to industry views, we have now revisited our proposals on this aspect. We accept that there are likely to be non-trivial systems costs and difficulties. Given the other administrative costs faced by firms in implementing the new capital requirements framework, we agree that it is appropriate to modify our proposals in this regard – at least in advance of the forthcoming review of the large exposures regime by the European Commission. We intend to address the prudential concerns involved – that firms will find themselves at risk due to heavy concentrations to single or connected collateral issuers – by requiring firms to have a documented policy for addressing these risks.

Application of limits when firms have collateral

Q124: Is our approach to exposures secured by a third party's collateral securities appropriate?

8.34 While the Joint Industry response supported our proposal on this issue, one respondent wished to see the recognition of LME warrants as representing customary banking collateral.

8.35 **Our response:** In terms of the range of eligible collateral that may be recognised for concentration risk purposes, we are constrained by the provisions of the draft CRD. We do not intend to recognise a wider range of collateral.

We continue to consider that, in general terms, it is sensible to adopt an approach to collateral in the context of the concentration risk framework based on exemptions and/or reduction of exposure amounts. We do not consider that there are strong arguments for adopting a substitution approach in this context.

Exemptions for collateralised exposures

Q125: Are there any circumstances where the above exemptions would not be covered under the new CRM rules?

8.36 We received no responses from industry on this question which referred to the collateral-related discretions in Article 113(3) of the draft CRD.

- 8.37 **Our response:** Despite the absence of comment, we think that the text of paragraph 8.43 of CP05/3 may be misleading if it is taken to indicate that we do not intend to exercise the collateral-related discretions in Article 113(3) of the draft CRD. The Financial Collateral (Simple Method) is not available under the draft CRD for large exposures purposes. Accordingly, we intend to use the options under Article 113(3)(f), (g), (h) and (o) for those firms which are using the Financial Collateral (Simple Method) for their credit risk capital requirements calculations, as indicated in Annex 4 to CP05/3.

Exposures backed by commercial real estate

Q126: In quantitative terms, what would be the competitive impact of our not exercising this national discretion?

- 8.38 In general, respondents did not support our intention to not exercise the national discretion to allow firms to adopt a partial exemption of 50% to exposures secured by commercial real estate. Respondents did not offer any quantitative data.

- 8.39 **Our response:** In general terms – and consistent with our approach in relation to credit risk capital requirements given the lack of quantitative data – we propose to maintain our position not to exercise this national discretion.

For competitive fairness reasons, however, we are now proposing to allow a 50% exemption of such exposures where they receive a 50% risk-weighting under the standardised approach – e.g. commercial real estate loans in other EEA Member States which apply the 50% risk-weight.

Partial exemption of certain exposures

Q127: In quantitative terms, what would be the competitive impact of our not exercising the partial exemption for certain exposures?

- 8.40 Respondents would wish to see the exercise of further national discretions for exposures to other institutions. While impact data was not provided, they noted that there would be adverse impact and competitive implications.

- 8.41 **Our response:** As stated in CP05/3, a key purpose of the proposals was to harmonise the existing framework for investment firms, banks and building societies. We believed the balance of exemptions adopted to be proportionate and fair. Having reviewed the comments received, we still have this view and propose to maintain our approach.

9 Interest rate risk in the non-trading book

Introduction

- 9.1 In CP05/3, we considered two main aspects of the Pillar 2 framework for interest rate risk in the non-trading (Non-TB) or banking book: the concept and calibration of a supervisory shock or stress scenario; and reporting the shock output. We also considered how to develop a test to define material interest rate risk for identifying the right population of investment firms to include within the scope of the framework. Feedback comments specific to Pillar 2 and the SREP are set out in chapter 4.
- 9.2 In response to feedback, we will retain the concepts of supervisory shock and basic indicator reporting. We will consider the interaction of the Non-TB interest rate risk framework with the SREP as part of our work to develop the SREP. In common with our general approach to Pillar 2, we will rely in the first instance on firms' internal systems and controls.
- 9.3 We have been represented at the meetings of an expert group of CEBS. The group is in the process of finalising its proposals for common implementation standards for Non-TB interest rate risk. They will be issued as part of a wider CEBS consultation exercise for Pillar 2 expected later in the year. The proposals will form the basis of our policy framework. They are expected to be consistent with the outline framework described in CP05/3.
- 9.4 We have also participated in several meetings of an industry expert group hosted by the BBA. The group has discussed the concepts of standard shock and basic indicator reporting. We will continue to work with this group as we develop Handbook rules and guidance ahead of any further consultation.

Responses to individual questions

Q128: Do you think we should specify a fixed interest rate shock such as 200 basis points or should firms be able to calculate an appropriate shock, per currency, based on 1st or 99th percentile changes over a specified period?

9.5 Most respondents supported a shock specified by a fixed basis point value. A minority preferred to give firms the discretion to use a percentile measure, although some noted that this method may be unsuitable for certain firms to calculate and apply. One respondent suggested that the shock should be calibrated through discussion between different European regulators.

9.6 Some respondents noted the benefit of a standard shock for peer group comparison, but also the risk that firms may rely on the standard shock as the internal risk management guideline.

9.7 **Our response:** We will specify the shock, or shocks, per currency in basis points rather than percentiles. Initially, we expect to specify 200bp, in line with other European regulators, but we will review this level in light of prevailing market rates nearer to the time of implementation. We will apply the shock to firms' existing systems and controls. There will be a clear expectation that internal risk management practices include consideration of alternative shock scenarios in addition to that prescribed by us.

Q129: Do you have any comments about the proposed concept of a basic indicator supervisory return?

Q130: Our proposed approach to the basic indicator approach is a sensitivity gap analysis. Do you think this technique is appropriate? Within this framework, how do you think we could aggregate the different results for each currency?

Q131: Where you have an internal system, are you already capturing the information required for the basic indicator approach in some form?

9.8 Many respondents supported the general concept of basic indicator reporting. The difficulties of constructing a report to provide meaningful data were noted, with several respondents referring to the format proposed in our Discussion Paper DP05/1 on Integrated Regulatory Reporting. One respondent suggested that a basic indicator report should consist only of the output of the shock and expressed concern that we intended to use basic indicator reporting to specify risk management guidelines to firms.

9.9 Respondents recognised the benefits of sensitivity gap analysis, but some also considered that it may be too simple to meet our data needs for the SREP. One respondent noted that gap analysis could pose costs to firms that use more

sophisticated internal risk management techniques. One respondent stated that freely convertible currencies could be converted to sterling for aggregation, but that this may not be suitable for less freely convertible currencies.

9.10 Respondents suggested that firms were capturing the necessary information to complete a basic indicator report, but many may be using risk management techniques other than sensitivity gap analysis. Basic indicator reporting may pose additional costs to firms and one response suggested that internal risk management reports would be enough to meet our data needs.

9.11 **Our response:** We intend to retain the discretion to ask for some standardised or basic indicator reporting of at least the output of the standard shock. We recognise that this may overlap with our project on Integrated Regulatory Reporting. Where there is an overlap, we do not intend to require duplicate standardised reporting of interest rate risk. Our general approach to Non-TB interest rate risk under Pillar 2 will be to rely on firms' internal systems and controls.

We will consider the relative costs and benefits to firms and to us of sensitivity gap analysis, along with other options for the basic indicator report. Our general approach will be to rely on firms' internal systems and controls.

Q132: Do you think a threshold test is necessary? Do you have any comments about the proposed threshold test? Do you think that this threshold would reflect those firms that have got material interest rate risk?

9.12 Some respondents considered that any firm experiencing a decline in economic value greater than 20% as a result of the supervisory shock should be considered to have material Non-TB interest rate risk. One respondent stated that the proposed threshold test – based on the ratio 'Non-TB: total adjusted assets' – was a pragmatic and risk-sensitive way to isolate the relevant population of investment firms. However, this respondent also noted that there may be investment firms with material Non-TB interest rate risk below the proposed *de minimis* threshold. Another respondent stated that the threshold test should act to exclude very small credit institutions from the scope of the Non-TB interest rate risk framework.

9.13 **Our response:** The threshold test is intended to capture those firms that incur Non-TB interest rate risk which is material to the individual firm, regardless of the firm's overall size. The main use of this is to identify that population of investment firms with material Non-TB interest rate risk, when it is clear that many investment firms have only negligible non-trading books (and therefore negligible Non-TB interest rate risk). We believe that the ratio 'Non-TB: total adjusted assets' is a reasonable basis on which to define the relevant population of investment firms. The Non-TB interest rate risk framework will apply to all credit institutions because Non-TB interest rate risk will be material to such firms regardless of their size.

Q133: Is our approach to interest rate risk in the non-trading book reasonably clear and appropriate?

- 9.14 Respondents were supportive of our approach. One respondent offered feedback on how the framework should inform the setting of individual capital guidance under the SREP. Another offered to provide feedback on a suitable format for a basic indicator return as part of the response to DP05/1.
- 9.15 **Our response:** Comments on the SREP can be found in chapter 4. See 9.8, 9.9 and 9.10 above for comments on basic indicator reporting.

10 Operational risk requirements

Introduction

- 10.1 CP05/3 dealt with our proposals to use national discretions and areas of superequivalence in respect of the operational risk requirements. It also identified the major Basic Indicator Approach (BIA)/ Standardised Approach (TSA) issues on which we are awaiting finalisation of the draft CRD.
- 10.2 We are reassured by the level of positive feedback that we received in response to the proposed exercise of the national discretions. As a result we intend to exempt limited licence and limited activity investment firms from the OR capital requirements. We also intend to make the Alternative Standardised Approach (ASA) available to UK firms and apply a transitional 15% percentage to the business line 'trading and sales'.
- 10.3 We are aware of the difficulties some firms are experiencing in navigating the Handbook and we are currently exploring a number of ways of making the text easier both to navigate and interpret. Clarification of the risk management standards and requirements in MiFID should help firms prepare for implementation.
- 10.4 An expert group has been established under the umbrella of our Operational Risk Standing Group to consider several operational risk issues. These include: partial use; use test; loss data; independence; and documentation. We have also asked an expert group to help us draft examples and guidance for firms undertaking the BIA/TSA income indicator calculation. The views of the expert group will help shape our policies when drafting the February 2006 CP.

Responses to individual questions

Proposed use of national discretions

Q134: Do you agree with our proposal to use the national discretion and exempt certain types of investment firms from OR capital requirements? Do you agree with our view that applying the OR capital requirements to investment firms captured by Article 20 (2) and 20 (3) of CAD would result in these firms having disproportionately burdensome requirements?

10.5 Most respondents agreed with our proposal to exercise this national discretion, as a requirement to hold capital against operational risk would be unduly burdensome and disproportionate for such firms. A number qualified their agreement by noting that exempt firms should implement the same level of general risk management standards required for other firms. Several queried whether it was appropriate for the status of such firms to change automatically when part of a group.

10.6 **Our response:** In view of the overwhelming agreement with our proposal to exercise this national discretion, we will exempt limited licence and limited activity investment firms from the OR capital requirement. These firms may – if they can justify to us that an OR capital requirement would be more appropriate – apply for a waiver from the fixed overheads requirement. This may be the case if a firm wishes to manage its operational risk on a group-wide basis or a firm has sufficient data to show that the OR risk capital charge is more risk sensitive.

Q135: Do you agree with our view that there are no UK firms falling within Article 20(3)(b)?

10.7 Respondents indicated that either they did not believe there were any such firms in the UK or that they were not in a position to comment. No respondent said it was such a firm or had such a firm in its group.

10.8 **Our response:** We agree that, under current rules, no UK firms should be able to fall within Article 20(3)(b). However, in a copy-out approach the possibility should be available in the Handbook.

Q136: Do you agree with our proposal to use the national discretion and allow the Alternative Standardised Approach (ASA) to be permitted? Do you consider many firms will adopt this approach?

10.9 All respondents agreed with our proposal to use the national discretion in allowing firms to adopt the ASA; none had any view about the number of firms which might implement it. However, several respondents – particularly smaller firms – were concerned at the requirement for a firm to be on an IRB approach before it could use the ASA.

10.10 **Our response:** Based on the responses received, we will exercise this national discretion and allow firms to use the ASA. We will not require ASA firms to adopt the IRB approach. However, ASA firms must be able to demonstrate that the ASA provides an improved basis for assessing the operational risk.

Q137: Do you agree with our proposal to use the national discretion and allow a transitional reduction in the percentage used for Trading and Sales business line in TSA?

10.11 Most respondents agreed with the proposal to permit a reduction in the Trading and Sales beta, saying that this would provide a greater incentive for firms to move from the BIA to TSA. One respondent argued that the problem lay in calibrating the BIA, and that this should therefore be adjusted.

10.12 **Our response:** In view of industry support given, we will exercise this national discretion. While a good argument could be made to increase the percentage of the relevant income indicator used to calculate the BIA capital requirement, we do not believe this would significantly change the incentive structure and we do not believe that being superequivalent with a higher beta charge would be justifiable.

Other issues

Q138: Do you believe the proposed treatment of intra-group income flows is a potentially significant issue? If so, are there any other intra-group income flows that would have the same distorting effect as dividend income?

10.13 Industry felt that the proposed treatment of intra-group income flows is a significant issue that results in potential double counting of intra-group income streams, which generates a higher operational risk capital charge. This distortion affects all intra-group income flows including fee sharing arrangements.

10.14 **Our response:** The CRD, as originally drafted, resulted in the double counting of intra-group income. However, ECOFIN has proposed an amendment to resolve this problem. The amendment limits the income from securities that must be included in the relevant indicator (BCD annex X, part 2, paragraph 5 and table 1) solely to income from shares and other variable fixed-yield securities. We believe that excluding income from participating interests and shares in affiliated undertakings from the income calculation removes the need to include intra-group income flows in the relevant income indicator.

Q139: Do you believe that the divergence between the Basel Framework and the draft CRD in the treatment of negative income under TSA is a potentially significant problem?

10.15 Respondents fully supported the convergent application of Basel 2 and the CRD. But they noted that the divergence between the Basel Framework and the draft CRD in the treatment of negative income under TSA was not a

significant issue: unless, perhaps, for a firm embarking on a start up situation. In this case, the difference could stifle product ideas and innovation. The general consensus was that it would be more prudent to set the negative capital to zero as proposed by the CRD, than to allow it to reduce capital on another business line as proposed by Basel 2.

10.16 **Our response:** We acknowledge the views of respondents and so do not propose any changes to the treatment of negative income under TSA in the Handbook, unless this element of the directive changes.

Q140: Do you agree with the areas where we are proposing to provide additional guidance such as calculation of income indicator? Are there other areas where you think further guidance should be provided? If so why?

10.17 Most investment firms and building societies supported us providing further guidance in calculating the BIA/TSA income indicator, particularly for those firms that are not currently covered by the Bank Accounts Directive. These respondents also favoured us giving examples of the indicator calculation.

10.18 The consensus view was that if guidance reflected our expectations then it should be communicated to the appropriate audience, preferably in the form of high-level guidance.

10.19 Other Operational Risk areas where respondents noted that further guidance should be provided were:

- the definition of operating expenses and the treatment of outsourcing;
- the definitions of activities that fall within the TSA's business lines and interpretation of the principles for business line mapping; and
- the calculation of the relevant indicator for operating leasing, particularly the use of gross rental income as a proxy for gross income.

10.20 **Our response:** In June, we formed an industry expert group to help us further understand:

- the issues that are concerning firms undertaking the BIA/TSA income indicator calculation;
- the possible contents of any guidance; and
- assist in the preparation of examples.

We will publish this expert group paper on our website once completed, in the form of 'frequently asked questions'. As with the other expert group papers it should not be taken as definitive FSA guidance.

11 Advanced Measurement Approaches to operational risk

Introduction

- 11.1 In CP05/3, we consulted on Advanced Measurement Approaches to operational risk. We outlined our latest thinking on the AMA qualitative standards – including the use test and data integrity, completeness and accuracy – and our latest thinking on the AMA quantitative standards. These included expected loss, soundness standards and correlations.
- 11.2 On 11 July 2005, CEBS issued its consultation paper on ‘Guidelines on implementation, validation and review of AMA and IRB approaches’³⁶ (CEBS Validation CP). This was in the form of high-level guidance, and, as we input into this work, the intention is to make our proposals consistent with it. CEBS intends to explore the more technical, AMA quantitative issues in the second half of this year to see if any convergence of supervisory practices can be achieved between Member States. This may therefore have implications for the Handbook text we propose in our February 2006 CP.
- 11.3 We welcome the feedback we received for this chapter. Operational risk methodologies are still evolving and the AMA provides a framework which leaves significant scope for further development. So we consider it important to maintain an active dialogue with industry as we move towards finalising our policies, and we see output from our expert groups with industry playing an important role in policy development.

Responses to individual questions

Qualitative standards

Q141: Do you agree with our thinking on the use test?
Should we provide further guidance?

11.4 Most respondents supported our preference for communicating expectations on the use test requirement (Annex X, part 3, paragraph 2) through guidance in the form of high-level principles. This reflected a general concern that adopting a prescriptive approach could take the initiative away from firms. Our proposed high-level principles – outlined in paragraph 11.8 of CP05/3 – were generally well received. However, respondents raised concerns about the requirement to use an operational risk measurement system, which we said provides ‘tangible’ benefits. This reflected some respondents’ belief that some of the benefits from the operational risk measurement system could be intangible, and therefore difficult to quantify. Several respondents also considered that the use test should be applied to the operational risk management framework, rather than just the operational risk measurement system.

11.5 **Our response:** Having considered feedback received from CP05/3 and the views of the relevant expert group, we do not intend to make significant changes to our previous proposals. We intend to include principles as guidance in our Handbook to support the requirement to demonstrate that the risk measurement system is closely integrated into day-to-day risk management processes.

We propose to remove ‘continually’ from the second principle, but we propose adding to it ‘adapts these to changes in the firm’s business’ as we believe firms need to adapt changes in risk management techniques to the business, rather than purely reflect experience. We propose to delete ‘solutions’ from this principle because solutions imply more finality than the use test can ever be.

We propose to amend the third principle adding ‘This does not imply that the operational risk framework must manage the systems and controls requirement a firm has in place’ as we believe the previous wording can imply that an operational risk unit needs to be directly involved in the mitigation of operational risks. Finally, we propose to amend the final principle from ‘tangible benefits’ to ‘demonstrable benefits’. We believe this should provide additional flexibility, yet not undermine the principle’s intent.

The expert group queried the use of economic capital – as opposed to regulatory capital – for managing operational risk in the organisation. Our view is that the risk measurement system could also be used for determining economic capital, and this could be different than the regulatory capital. Differences may be the result of using an alternative confidence level, or modifying assumptions for diversification or insurance. However, we would expect that, if economic capital is used for managing operational risk in the business, this should be easily reconcilable to the regulatory capital figure. Ultimately, to have a risk measurement system which calculates regulatory capital and does nothing else is contrary to the spirit of the first guideline (below).

The following wording is intended as a summary of what we propose to incorporate into our Handbook text (BIPRU):

- The purpose and use of the risk measurement system is not limited to determining regulatory capital.
- Both the operational risk measurement system and operational risk framework (including the operational risk policies, tools, processes and practices) should evolve as the institution develops experience of risk management techniques and adapts these to changes in the firm's business.
- The operational risk framework should bring together the measurement and management of operational risk within an organisation. This does not imply that the operational risk framework must manage the systems and controls requirement a firm has in place.
- The use of the operational risk framework and measurement system should provide demonstrable benefits to the organisation.

Q142: Do you agree with the need to issue guidance for data integrity, relevance and sufficiency? Do you consider the high-level principles in 11.13 [of CP05/3] to be appropriate?

- 11.6 While some respondents welcomed the proposed guidance for data integrity, relevance and sufficiency, and considered that it would benefit business by providing clarity, others thought that guidance in this area could undermine the principles of AMA. Some respondents considered that firms using an AMA should be sufficiently sophisticated not to need guidance in terms of data integrity, relevance and sufficiency. Concerns were also raised that any guidance by us for data integrity could become superequivalent.
- 11.7 Most respondents agreed that we should not go beyond the principles that we outlined in paragraph 11.13 of CP05/3, as they considered most of these to be sensible and well thought out. However, specific comments were made that some of these principles needed refining to ensure their purpose was clear.
- 11.8 **Our response:** We would consider that, generally, AMA aspirants should be of sufficient competence to determine appropriate data standards. That said, the importance that we place on the quantity, quality and reliability of data being input into the risk measurement system means we still consider it important to clarify our expectations. We do not consider that clarifying our expectations on data standards could be superequivalent, because any such communication will be in the form of general guidance. We will also align any proposals with the CEBS guidance on data in CP10.

So we continue to favour a broad principles-based approach to clarify our expectations for data integrity, relevance and sufficiency. We are now finalising these, having taken into consideration respondents' comments and the need to minimise differences with our approach to credit risk. We intend to propose high-level principles and consult on these in our February 2006 CP.

Q143: Do you agree with our proposed approach not to issue guidance for documentation issues until after the relevant CEBS consultation?

- 11.9 Respondents generally agreed that consistency within the EU is vital and considered that we should be a leader in forming regulatory policy through dialogue with other supervisors.
- 11.10 Respondents queried the scope of the documentation issues section, as they considered that it was unclear whether this related solely to operational risk management or throughout the firm.
- 11.11 **Our response:** We acknowledge industry comments that firms should be able to operate in a 'level playing field' across EU boundaries.

CEBS is not proposing to give detailed guidance on general documentation issues, and, following discussions with one of our expert groups, we are of the view that we should not propose any specific guidance on documentation in our Handbook. However, it is likely that we will propose some guidance on data documentation under data standards in the February 2006 CP. While we consider that any well managed organisation should not require specific guidance in terms of documentation issues, the CRD requires that the institution's risk management system be well documented. So institutions will have to consider the type of information that should be documented and have this readily available. Not only will this enable us to obtain a better understanding of the methodology surrounding the system, it will also enable institutions to retain corporate memory and to demonstrate that their AMA intentions are serious.

Each firm should be expected to deal with documentation in a manner which satisfies its own needs and culture and is appropriate to the operational risks it takes and its operational risk management and measurement processes.

In any event, all AMA aspirants will have to provide, as part of the application process, detailed documentation supporting their application. The onus will be on these aspirants to explain and justify any assumption they are making, in supporting documentation. We would expect such documentation to be kept 'live' as the risk measurement system evolves and to be updated and retained as appropriate.

Quantitative standards

Q144: Do you believe that expected loss can be adequately captured in internal business practices other than provisioning? If so, how should we require that this be demonstrated?

- 11.12 All respondents noted that expected loss can be adequately captured in internal business practices. The majority stated that the most appropriate methods of doing this were budgeting and pricing. Most respondents welcomed our proposals in paragraphs 11.21-11.24 of CP05/3. These allow institutions to take the initiative and indicate what expected loss means to them and how they would assess and evaluate it for calculating operational risk capital requirements.
- 11.13 Respondents also queried the definition of expected loss and whether we would require an accounting or statistical definition of expected loss or would allow a more pragmatic business/management definition.
- 11.14 **Our response:** The industry clearly feels that expected loss should be deducted from the operational risk capital charge, if it can be justified that expected loss is adequately identified and captured in internal business practices.

In line with the industry, we think that it is for institutions to demonstrate to our satisfaction that they have adequately forecast and captured expected loss in internal business practices. Having discussed expected loss in detail with one of our expert groups, and taken respondents' comments into consideration, our current view is that we will only accept a business management style definition for expected loss. This could be, for example, 'what do we expect to lose over the coming 12 months'. This would restrict any expected loss reduction to high-volume business and we believe that this is more appropriate for capturing the normalised high frequency/low severity events that are incurred day-to-day as part of the cost of doing business.

We also think that a combination of budgeting and pricing are the most appropriate methods of capturing such events, given the transparency of these practices. We would particularly want to see a robust and verifiable budgeting process based on sufficiently stable historical data. We are not proposing to allow balance sheet provisions for events that have already occurred to be deducted from the operational risk capital charge. We consider that such events are more likely to be large scale 'exceptional' events as opposed to the normalised high frequency/low severity events we would associate with a non-statistical definition of expected loss. In any event, the operational risk capital charge is forward looking, whereas provisioned events will have already occurred, so cannot be claimed to be 'expected' in the true sense. We would, of course, expect a firm to review its AMA risk measurement system for appropriateness going forward, if it would need to raise a significant balance sheet provision for an operational risk event.

As with virtually all aspects of the AMA, the onus is on the firm to justify and support any assumptions it makes. We intend to consult on our proposed Handbook text guidance for expected loss in the February 2006 CP. This is because CEBS and the AIG will look at this issue in more detail by during the second half of 2005.

Q145: Do you agree with our proposal not to provide high-level guidance on these topics at present?

- 11.15 At the time of CP05/3, we were proposing not to provide high-level guidance on the more quantitative AMA issues and respondents generally agreed with this. Some commented that operational risk was still in its infancy and considered it inappropriate at this stage to provide high-level guidance on these issues. Respondents also felt that any guidance should be drawn up in conjunction with industry participants with practical experience of the difficulties involved. Others felt that any high-level guidance would be unlikely to go any further than what was already specified within the Accord itself.
- 11.16 Some respondents commented that guidance would help TSA aspirants looking eventually to progress to AMA; while others felt that it was important that enough information was communicated before the Handbook became available to ensure that AMA aspirants were able to adequately prepare for AMA and parallel run accordingly.
- 11.17 **Our response:** We are currently exploring some of the more technical, quantitative AMA issues – such as soundness standard and correlation/diversification benefits – before deciding whether to give any guidance. The February 2006 CP will outline our final proposals.

12 Capital requirements for groups

Introduction

- 12.1 In CP05/3, we described our proposed methods for calculating group capital resources and requirements. We consulted on proposals to implement two national discretions that can only apply to investment firm groups: the exemption from consolidation for investment firm groups and the alternative group capital requirements for ‘limited’ investment firm groups.

Responses to individual questions

Q146: Are any aspects of our proposed approach to the calculations of group capital resources and group capital resources requirements unduly burdensome? If so, which? And why?

- 12.2 Most respondents agreed that our proposed approach was not unduly burdensome. However, some respondents in the investment management sector did comment here on:
- the conditions to be met for the investment firm exemption from consolidated supervision;
 - the group operational risk requirements (ORR) applying to ‘mixed’ groups ;and
 - the consequences for existing ‘limited’ groups that either cannot meet the new conditions for exemption from consolidation or seek to acquire an own account dealer or credit institution.

We have covered these points under question 148 below.

37 Groups containing 'limited' investment firms and an own account dealer/credit institution.

12.3 Some respondents asked that the conditions under which an entity in the group can be excluded from consolidated requirements be included in the final Handbook text.

12.4 **Our response:** Article 73.1 of the recast BCD sets out the circumstances in which an entity can be excluded from the calculation of a group's consolidated requirement. Only one of these – that a firm may, by notification, exclude an entity on the grounds that it is below a specified *de minimis* limit – was included in the draft Handbook text³⁸.

The other cases for exclusion are that:

- the entity is in a third country where there are legal impediments to the transfer of the necessary information; or
- the entity is of negligible interest; or
- it would be inappropriate or misleading to include the entity.

These are subjective criteria and it would not be appropriate to implement them through a notification mechanism. If a firm wants to exclude an entity on any of these grounds, it can apply to us for a waiver, and we will consider that application on its merits. In addition, a firm cannot exclude more than one entity from a group's consolidated requirement on the grounds that each of them is either of negligible interest or below the *de minimis* limit. This is unless the entities are also of negligible interest when considered collectively. If a firm wants to exclude more than one entity on these grounds, it can apply for a waiver, and we will consider that application on its merits.

We will amend the existing text in BIPRU 8.2.11 and include additional guidance to give effect to these provisions in the Handbook text. We also intend to make it clear that we do not expect such waivers to be used to exclude an entity that would make the group ineligible for the exemption from consolidation or the alternative consolidated requirement calculations for limited groups.

Q147: We will need to include lists of the non-EEA regulators whose credit, market and operational risk requirements can be regarded as equivalent to those in the CRD for the purposes of aggregation. Which regulators' requirements do you want to aggregate in calculating your group's capital resources requirement, and for which risk components (credit, market, operational)? On what basis do you think we should regard them as equivalent?

12.5 Respondents asked us to consider whether the credit, market and operational risk requirements applied in Australia, South Africa, Switzerland, Japan, the USA and other OECD countries are equivalent to those in the CRD.

38 BIPRU 8.2.9R.

- 12.6 **Our response:** The specific countries listed by respondents will be included in the list of non-EEA regulators we propose to assess for CRD equivalence in the areas of market, credit and operational risk requirements. However, it is impractical to meet the blanket request to assess all OECD countries for CRD equivalence before implementation. So it would be helpful if respondents could provide more information about which OECD countries they wish us to prioritise.

Proposals applying only to investment firm groups

Q148: Is our proposed guidance on the investment firm exemption from consolidated supervision clear enough?

- 12.7 Some respondents said that our proposed guidance on the investment firm exemption from consolidated supervision was clear. But some found the financial holding company capital condition more difficult to understand. Several respondents thought that the financial holding company would need to have enough capital to cover goodwill. Others commented that, even without a goodwill deduction, the financial holding company condition was unduly burdensome, resulting in some groups either having to raise more capital or failing the conditions for exemption.
- 12.8 A number of respondents commented on the potential consequences if the financial holding company capital test could not be met by groups that are currently exempt from consolidation. They noted that some groups had structured their business so that substantial goodwill was sheltered on the balance sheet of the financial holding company. If such groups become liable to consolidated supervision, they will have to deduct goodwill from consolidated Tier 1 capital. Respondents said this could put a ceiling on the growth of these groups by acquisition. Alternatively, it could trigger capital shortfalls leading to consolidation in the industry and ultimately less competition and less consumer choice. Respondents who raised this issue acknowledged that the deduction of goodwill was a CRD requirement but asked if we would consider introducing transitional relief for those falling within the scope of consolidated supervision for the first time.
- 12.9 **Our response:** The purpose of the financial holding company capital test is to prevent a group being excessively funded by debt, which puts undue pressure on the regulated entities in the group. So some groups may need to raise additional capital at the level of the financial holding company if they wish to retain the benefit of the exemption from consolidated supervision. As we explained in CP05/3, we intend to use the minimum allowed under the CRD as the starting point for setting the financial holding company capital test. This requires the holding company to have enough Tier 1 and Tier 2 capital, before goodwill and other deductions, to cover:

- the sum of the solo capital charges that would apply if the group were required to calculate its consolidated capital resources requirement in line with BIPRU 8.6.1R; and
- the total amount of any contingent liabilities in favour of financial services entities that would otherwise be consolidated.

For groups that do not meet the financial holding company capital test, the CRD requires that goodwill be deducted from group Tier 1 capital. We have no choice in implementing this requirement. Transitional relief is not provided for in the CRD and we think that there is sufficient time between now and implementation for groups to take appropriate action. We encourage firms in this position to discuss the matter with their supervisors as soon as possible.

12.10 Some investment management sector respondents also commented on the proposals for ‘limited’ groups. They noted that the alternative approaches to calculating group capital resources requirements were not available to groups that were mainly ‘limited’ but contained a small own account dealer or credit institution. The group capital resources requirements for these ‘mixed’ groups may be considerably higher than the sum of the solo requirements. Respondents felt that this was disproportionate to the risks that they posed to consumers and markets.

12.11 Respondents felt that we should consider:

- a *de minimis* limit for the own account dealers or credit institutions in mixed groups, below which a group could be treated as ‘limited’; or
- calculating the group ORR for a mixed group by aggregating the fixed overhead requirements (FOR) for ‘limited’ firms with the ORR for own account dealers and credit institutions.

12.12 Some respondents also commented on the step change in capital requirements for mixed groups coming into the consolidation regime for the first time. They thought that this would deter diversification of the business. For example, a limited group that acquired an own account dealing firm would no longer be exempt from consolidated supervision. So it would be required to deduct goodwill from group tier 1 capital, and to have capital to support a group ORR.

12.13 **Our response:** We acknowledge that adding a small amount of own account dealing to an otherwise limited group may cause a significant increase in group capital requirements. In developing our proposals, we carefully considered the CRD provisions as they will apply to mixed groups. We concluded that the CRD gives us no alternative to the approach we have proposed. So, if we were to implement the consolidated requirements as some respondents have suggested, we would not be fulfilling our legal obligations under the CRD.

13 Credit risk mitigation

Introduction

- 13.1 CP05/3 considered those credit risk mitigation (CRM) issues common to the standardised and Foundation IRB approaches. We consulted on several areas of national discretion, including the scope of eligible protection providers under these approaches.
- 13.2 We find it encouraging that industry generally accepted the proposals on areas of national discretion, although some of these discretions will be removed from the final CRD text during EU negotiations.

Mortgage Indemnity Insurance

- 13.3 A number of respondents raised the material issue of mortgage indemnity insurance (MII) as a recognised unfunded credit protection technique under the standardised approach. The Joint Industry response confirmed the risk mitigating effects of MII pointing out that the product, although structured differently from bank guarantees, has the same legal and economic effect as a guarantee. The product also meets the definition of ‘unfunded credit protection’ in Article 4 of the CRD, although it is well understood that MII products may have difficulty in satisfying the specific operational requirements for guarantees.
- 13.4 This overview was supported by detailed analysis from other respondents looking at the economic effect of MII products.
- 13.5 We continue to investigate the possibility of MII meeting the relevant operational requirements to be considered eligible credit protection under the standardised approach. This issue was not explicitly consulted on but remains a significant point of discussion both domestically and at an EU level. As such, we have to form our thinking with the continued uncertainty that surrounds this issue in the CRD text.

FSA-Industry expert groups

- 13.6 We have set up four CRM expert groups: E*; property valuation and insurance; collateralised OTC derivatives; and internal models for repos. It is expected that these expert groups will produce issues for consultation in the February 2006 CP.

Responses to individual questions

Funded CRM

Q149: What are your views on our proposal to adopt the full list of Core Market Participants (CMPs) contained in the Draft Directive?

- 13.7 Respondents generally supported our proposal.

- 13.8 **Our response:** We will implement the full list of CMPs – as outlined by Annex VIII, Part 3, paragraph 59 (h) – in the Handbook.

Q150: What are your views on our proposal to allow a volatility adjustment of 0% in these circumstances [where other competent authorities have permitted a 0% volatility adjustment to securities financing transactions issued by that domestic government]?

- 13.9 Respondents generally supported our proposal, although it was pointed out that CEBS would have a role to play in communicating additional CMPs eligible for the 0% volatility adjustment.

- 13.10 **Our response:** We will exercise this discretion. While we agree that CEBS may be an appropriate forum for communicating the addition of another CMP, we cannot at this stage confirm that they will take an active role in this process.

Q151: What are your views on our proposal to use the waiver process for recognition of internal models for this purpose?

- 13.11 There was general agreement that this was a sensible approach consistent with current practice for similar recognition.

- 13.12 **Our response:** We will implement a waiver application process for the recognition of internal models. Work continues to identify the precise specifications under which a waiver of this kind would be granted. This will be coordinated in conjunction with our work on the recognition of EPE models for counterparty credit risk exposure and will mainly involve communication with the Market Risk Standing Group.

Unfunded CRM and Credit Linked Notes

Q152: What are your views on our decision not to extend the list of eligible protection providers?

Q153: Are there any reasons for exercising this discretion to extend the list of eligible providers?

13.13 There was general agreement that there was no reason to extend the list of eligible providers. Some respondents commented on the work of the working group to recognise double default effects.

13.14 **Our response:** We agree that the work of the double default group would mean that some benefit may be recognised when the protection provider has a lower rating than the underlying obligor. But the scope of eligible protection providers for double default effects is likely to be only a sub-set of those already eligible for the substitution approach. Therefore, exercising this discretion would not have an effect on the double default treatment.

We will not be extending the list of eligible protection providers.

Q154: What are your views on this treatment for exposures covered by sovereign guarantees?

13.15 Respondents supported our proposal to extend the lower risk weight permitted for direct sovereign exposures to other exposures³⁹ guaranteed by the central government or central bank.

13.16 **Our response:** We will be implementing this discretion in line with our proposal.

Q155: What are your views on our decision that, in this case [non-payment of premiums], the protection provider should be entitled to cancel the credit protection contract?

13.17 Respondents supported our proposal.

13.18 **Our response:** We shall include additional guidance on this issue, subject to legal sign-off.

Q156: At what stage should this right become exercisable?

13.19 Most respondents felt that any prescription by us should not be in conflict with current market practice, which would be documented in standard ISDA agreements.

13.20 **Our response:** We do not consider it appropriate to endorse the standards of particular bodies. However, if our guidance refers to specifications on this issue, it will not be in conflict with current market practice.

39 The treatment provided for in Annex VI paragraphs 4-6, permitted by Annex VIII, Part 3, paragraph 90

Q157: What are your views on our proposal to introduce such a cap [a 60% cap on the value of the protection where restructuring is not included as a credit event]?

13.21 There was a sense of unease with this proposal and some respondents simply disagreed with our proposed policy. Some respondents questioned the validity of the 40% reduction in the value of the protection and questioned whether another number could be used, particularly for IRB banks. This was based on analysing the pricing of protection that does not include restructuring as a default event and comments that losses are generally the result of bankruptcy, rather than restructuring.

13.22 Another key message was that we should not be superequivalent to the CRD in this area.

13.23 **Our response:** Our consultation focused on the use of a cap on protection rather than a simple haircut approach – i.e. our proposed 60% cap was an alternative to a 40% haircut – not the relevant percentages. This is because these are set in the CRD and are not subject to change in our implementation.

We do, however, acknowledge the concerns of respondents, particularly because this is an area of superequivalence. We note that there is an amendment proposed that would explicitly bring the CRD text in line with our interpretation – i.e. a cap rather than a haircut. If this amendment is not included in the final CRD, then we will consider this a sufficient signal that this was not the legislation's intention – and we will not be superequivalent in this area as a result.

Q158: What are your views on our decision to require firms to consider correlation in this way for unfunded CRM?

13.24 Respondents noted that our proposal did not fully clarify what we were asking firms to consider. There was a sense that, in the right circumstances, it was appropriate to look at correlation. However, the overriding message was that we should not add layers of prescription, and that any guidance should be in the form of principles.

13.25 **Our response:** Further discussions after CP05/3 have concluded that the correlation between collateral and the underlying exposure is of much greater concern – in terms of the approaches available to take account of that collateral – than similar correlation between unfunded protection provider and underlying obligor. The substitution approach, available for unfunded credit protection, inherently assumes a high degree of correlation (i.e. 1) between the protection provider and the underlying obligor. So it seems inappropriate that to be eligible for the pillar 1 capital requirement associated with a substitution approach, a firm must ensure that there is no material correlation between protection provider and obligor.

Where the capital requirement takes account of a 'double default' element – as permitted under the Trading Book Review proposals – a firm must ensure that there is no excessive correlation between the protection provider and the underlying obligor. However, this is reflected in the operational requirements for the double default treatment.

We will therefore not be extending the requirements to consider correlation for firms using unfunded credit protection.

Q159: What are your views on the need to clarify the eligibility criteria in relation to protection provided under cash funded Credit Linked Notes?

13.26 The responses were wholly in favour of this and also suggested we extend this clarification to fully collateralised credit derivatives.

13.27 **Our response:** We will add some guidance in this area.

Q160: What are your views on our decision to extend the legal review requirement to unfunded CRM?

13.28 There was general agreement that the legal requirements for all credit protection should be uniform. However, there was a slight concern about superequivalence. A strong message was delivered that there should not be a requirement for external legal opinion to confirm enforceability and that, in many cases, firms' internal counsel would be sufficient.

13.29 Furthermore, respondents suggested that we needed urgently to indicate whether, in the post-CRD world, the (superequivalent) UK requirement for investment firms – but not banks – to have netting opinions to avoid reporting gross derivatives will continue. It was noted that the CRD and the Trading Book Review consultation paper do not impose any constraint on our ability to review our current position in this matter.

13.30 **Our response:** We will draft text to make clear that legal reviews are required for all types of credit protection. We also believe that our stance on when an external legal opinion would be required is well known and so we will not repeat it in this area.

We confirm that, under the CRD, both banks and investment firms will be subject to the same requirements for the legal opinions relied upon for netting agreements.

14 Securitisation

Introduction

- 14.1 The main policy issues we consulted on in CP05/3 were: the principles around scope of application; implicit support including sanctions; significant risk transfer; and buy-back. Other issues included the implementation date; the approach to unrated exposures under the standardised approach; the use of the simplified approach for retail exposures under the Supervisory Formula Method (SFM); eligible liquidity facilities; early amortisation triggers; and draft BIPRU rules.
- 14.2 The industry comments we received were extremely helpful and generally supportive. Of the points raised, we can resolve many by clarifying the policy in our feedback. However, some issues will result in policy being changed – most notably the ‘known at all times’ requirement for unrated exposures under the standardised approach and the legal certainty requirement.

FSA-Industry expert groups

- 14.3 We have discussed the Internal Assessment Approach (IAA), grandfathering and Handbook restructuring in our CRD securitisation expert groups. The IAA has been discussed in some detail and there is now general agreement on how to progress policy in this area. As stated in CP05/3, we will consult on the IAA in the February 2006 CP.
- 14.4 There will be no grandfathering of waivers or guidance on securitisation. The expert group discussed regulatory calls and it was concluded that they should expire once the regulatory regime is certain. A call still exercisable several years after the final rules are published will not be considered a regulatory call.
- 14.5 With the exception of the high-level requirements (see Q163), none of the existing securitisation regime will be carried forward, although firms will have until the end of 2005 to propose the inclusion of specific current requirements in the February 2006 CP.

Responses to individual questions

Implementation date

Q161: What are your views on the proposed implementation dates for the securitisation framework?

14.6 All respondents supported allowing firms that choose to continue applying the current framework, rather than applying the standardised approach to credit risk, to also continue with the existing securitisation regime until 1 January 2008.

14.7 **Our response:** The securitisation framework under the CRD will not apply to those firms that continue to apply the current framework for credit risk until 1 January 2008. Any firm that moves to a CRD approach before 1 January 2008 should also apply the CRD securitisation framework.

For banks and some building societies, this will mean continuing to apply IPRU (Bank) chapter SE. For other firms, notably investment firms, this means there will be no detailed securitisation regime for a further year.

Scope of the securitisation framework

Q162: What are your views on the scope of the securitisation framework?

14.8 All respondents supported a clear definition on scope of application. While they agreed that the proposed scope appropriately captured non-trading book securitisation positions, most expressed concerns about the possible capture of some trading book positions, in particular actively traded tranching portfolio credit derivatives. They also expressed concern about the requirement to transfer securitised positions from the trading book to the non-trading book. Some commented on the apparent partial application of the securitisation regime, albeit on the most significant elements of it, i.e. implicit support and significant risk transfer.

14.9 **Our response:** We agree with the comments made by respondents. The proposed scope was intended to clarify application across the trading book boundary, an aspect of the securitisation regime not specifically addressed in the CRD. The feedback from respondents has been extremely helpful, therefore, in clarifying guidance in this area.

The hypothesis that where trading book requirements are met that originators, like third-party investors, should include these positions in their trading book does not seem unreasonable and the CRD securitisation framework applies to securitisation positions only when they are held in the non-trading book. Positions held in the trading book are subject to trading book capital requirements.

What needs to be clarified is whether securitisations of trading book positions must be subject to the same operational requirements as non-trading book securitisations. We will do further work to assess the implications of avoiding either the significant risk transfer or implicit support requirements in the trading book, when deciding how this should be incorporated in the scope.

Implicit support

Q163: What are your views on the high-level requirements carried forward from the current securitisation framework?

14.10 All respondents supported the proposal to carry forward the high-level requirements of the current securitisation framework. Further observations included the regular review of draft rules by the Securitisation Standing Group and the addition of a rule requiring firms to review legal documentation on a regular basis.

14.11 **Our response:** The high-level requirements of the current securitisation framework will be carried forward. And we shall continue to consult the Securitisation Standing Group on the draft rules.

We agree that firms should regularly review legal documentation. Legal certainty for financial collateral is defined in the credit risk mitigation requirements Annex VIII Part 2, paragraph 6(b) and the substance of this requirement will be included in the securitisation rules using an appropriate cross-reference.

Q164: What are your views on our definition of implicit support to securitisations?

14.12 The definition of implicit support attracted a lot of comment, although respondents generally supported the approach being proposed.

14.13 Some respondents raised an objection on contractual support that may be given being treated as contractual support that will be given. They proposed that the requirement should instead be based on a prudent estimate of the support actually being provided. They recognised, however, that the provision of contractual support that may be given was not common.

14.14 The provision of implicit support was considered in certain circumstances to be subjective. Examples given were:

- the sale of higher quality assets into revolving structures and managed structures;
- the sale of higher discounted assets into revolving structures and managed structures;
- the provision of additional reserves to a conduit structure to protect against co-mingling or dilution risks; and

- new credit card receivables solely funded by the originator used to repay investors during the amortisation period.

14.15 As a consequence, respondents asked if discretion could be exercised in implementing the sanctions outlined in BIPRU 9.2.2, particularly where it could be shown that implicit support had been provided inadvertently.

14.16 Respondents also asked if contractual obligations to make payments would continue as acceptable forms of support, even where it was not possible to quantify the maximum amount payable at the time of initial securitisation. Examples they gave were:

- representations and warranties;
- derivative agreements;
- certain tax indemnities; and
- variations in payment priorities following various triggers.

14.17 **Our response:** Contractual support that may be given can be in the form of either waiving a right to an asset, e.g. future margin income (FMI), or having the option to add further assets, including cash, to the structure. While discretionary contractual support is uncommon, the waiving of FMI is most likely to occur. This is because FMI is excess cash generated by the structure which the firm is not allowed to account for on its regulatory balance sheet in line with Article 57 of the CRD.

The policy is based on the assumption that optional contractual support is accounted for as an obligation. This means the contractual right to assets such as FMI will be accounted for as if it will be waived (i.e. asset not recognised on the balance sheet) and the option to add further assets to the structure will be accounted for as if it will be provided (i.e. the liability fully recognised on balance sheet).

This assumption is based on a prudent estimate of the support actually being provided. This will be a product of the need to provide support – due to the performance of a securitised asset pool – and the intention to provide such support. Since it is implicit support which is being considered, it is only the intent to provide such support which is an issue. Where a firm has seen fit to include such a clause, it seems reasonable to assume that the intention is to provide such support as and when required. Any other estimate seems unlikely to be a credible assessment of intent.

For firms wishing to include optional contractual support in the form of waiving FMI, the regulatory capital cost is zero since FMI is already prohibited from being recognised. Since this is by far the most likely form of discretionary support, the policy is not viewed as unduly burdensome.

To meet CRD requirements, this optional contractual support must be clearly set out in the contractual terms governing the structure; otherwise such support will be considered as going beyond the firm's contractual obligations (i.e. implicit

support). Including such a clause is consistent with BIPRU 9.1.8, which requires all parties to a securitisation to fully understand the risks assumed or retained.

We do not agree with the proposition that implicit support can be subjective. We accept that deciding on the fair value of assets is a matter of judgment, but where fair market value has been adequately determined – within acceptable materiality limits – it is a given whether or not implicit support has been provided.

If it is not possible to determine the fair market value, it is then not possible to prove whether implicit support has been provided. So such securitised assets should not be bought back. For example, selling assets to an SPE at par and routinely buying them back at par several years later is not risk transfer.

For revolving structures, we accept that for asset replenishment it is not always possible to replicate exactly the credit quality of the pool; however, if transactions are always done at fair market value this should largely mitigate the risk of any material change. It should be noted that this is already a requirement of the existing securitisation regime for banks. The same principles apply to the other examples provided.

We have concluded that it would be prudentially unsound to effectively waive the implicit support requirements because a firm is unable to fair value assets.

We will consider each instance of implicit support on a case-by-case basis. However, it does not seem appropriate to draw an explicit distinction between intended implicit support and that which is provided inadvertently – perhaps due to inadequate systems and controls – as if it should, as a matter of course, be treated less seriously. It seems highly unlikely that inadvertent support can be provided. This is because support is only an issue when a firm is transacting with the structure precisely when the issue of implicit support is of prime consideration.

Implicit support is when a firm provides support beyond its contractual obligations, with a view to reducing potential or actual losses to investors. If this is achieved by using representations, warranties, derivative agreements and variations in payment proprieties following various triggers and certain tax indemnities, this will not be an acceptable form of support. This is even when the amount payable cannot be quantified.

Q165: What are your views on the guidance on internal controls around buy-back?

- 14.18 Respondents supported the guidance on internal controls around buy back. One requested confirmation that the right to buy-back would not require any capital, even where it was intended that all exposures would be bought back. Another respondent questioned the need for auditor sign-off.

14.19 **Our response:** We can confirm that no capital is required even where it is the intention to buy-back all exposures at a future date. This is as long as the buy-back requirements are met, for example assets bought back at the fair market value prevailing at the time of purchase. We can also confirm that there is no requirement for auditor sign-off.

Q166: What are your views on our consideration of early action to respond to instances of implicit support?

14.20 Respondents supported us taking action where there had been implicit support. They emphasised that any instances of implicit support should be considered on a case-by-case basis and any action taken proportionate. Respondents argued that where implicit support was unintended and immaterial, no action should be taken. But they agreed there was a need to see how this aspect of the regime would work in practice.

14.21 Some respondents noted that the proposed policy was superequivalent to the CRD in that action would only be required on the second instance of implicit support. However, this was not considered an issue if action taken was always proportionate.

14.22 **Our response:** We consider that respondents' comments are consistent with good practice. The proposed policy is based on the view that it would be prudentially unsound to effectively allow firms one 'free go' at implicit support. We agree that the policy could be considered superequivalent to the CRD. However, this is not the case in the context of our wider statutory duties, which would not allow us to grant firms immunity from regulatory action in this way.

Q167: What are your views on the disclosure requirements for implicit support?

14.23 Respondents were supportive of our proposal that disclosure of implicit support should only occur when it is proportionate to do so. One respondent, however, felt that disclosure should not go beyond that already required by prevailing accounting standards.

14.24 **Our response:** We support the view that any rule breach should be treated proportionally and that this should include our approach to instances of implicit support and any disclosure under Pillar 3. However, the CRD does appear prescriptive on this point and requires all instances of implicit support to be disclosed, regardless of the amount. We will give further consideration to this issue.

We do not, however, agree that disclosure should be limited to the prevailing accounting standards. While it is certainly possible that accounting standards will meet the disclosure requirements, it cannot be certain that this will always be the case or that accounting disclosure will be sufficiently timely.

Significant risk transfer

Q168: What are your views on our interpretation of significant credit risk transfer?

- 14.25 The Joint Industry response fully supported the proposed wording, but one respondent did not.
- 14.26 One respondent questioned one of the minimum requirements for significant risk transfer. BIPRU 9.5.6 and 9.5.9 requires an originator not to maintain effective or indirect control over the transferred exposure – such as having the right to repurchase from the transferee the previously transferred exposures – in order to realise their benefits. This respondent did not believe that the ‘ability’ of the originator to buy assets at less than fair value, and so derive benefit, should affect a capital measure based on exposure to risk of loss.
- 14.27 Another respondent noted that BIPRU 9.5.7 would require clean-up calls to be exercised at the discretion of the originator not the SPE; yet because of the requirements of FRS5, it was mostly the SPEs that had the discretion to exercise such options. They suggested we change the wording along the lines of an ‘originator must not be obliged to undertake a clean-up, but that it is not necessary for the originator to have the right to initiate a clean-up’.
- 14.28 **Our response:** The aim of the policy is to allow firms to recognise any amount of risk mitigation, however small, while ensuring it is not possible to arbitrage the rules. An example of a potential arbitrage is firms retaining all securitised exposures (i.e. no risk transfer) which still results in a reduction in regulatory capital.

Many transactions are structured so that excess spread covers several multiples of expected loss. However, this form of risk mitigation is not recognised for regulatory purposes. The reduction in regulatory capital can therefore ‘appear’ to exceed the amount of risk transferred. For example, where a securitisation is structured to rely heavily on excess yield as the first loss piece, the amount of risk transferred will be very low particularly when a firm retains the equity piece. It is then possible for Kirb to actually exceed the size of the retained equity piece position. To capture this effect, we will amend the guidance in BIPRU 9.4.2 to 9.4.6 to permit the choice between deduction and applying the significant risk transfer requirements. Given the equity piece is usually deducted, this should not be unduly burdensome.

We have considered alternative approaches for measuring significant risk transfer, including setting a minimum amount of risk to be transferred, for example 50% as a barrier to such arbitrage. However, the issue of whether or not to prescribe the measurement of risk remains. One option was to use the notional of the underlying (e.g. third parties should hold 50% or more of the notional). But we believe that this would not be correlated to risk. We concluded that setting a minimum in this way would be unduly burdensome, as would be detailed prescriptive methods for calculating risk for what are highly structured and innovative products. We feel the optimum is a principles-based rather than a rules-based approach.

BIPRU 9.5.6 and 9.5.9 prohibits an originator having the right, similar to a call option, to repurchase exposures at a profit due to an increase in value. To allow any form of right to buy back would be sub-equivalent to Annex IX Part 2 Paragraph 1(e) of the CRD. If such calls were permitted this would be contrary to the requirements around clean-up calls.

The clean-up call requirements have been copied directly from Annex IX Part 2 Paragraph (f) (i-iii) of the CRD; consequently, it is not possible to change the wording of the directive in this way. The treatment of clean-up calls by the SPE requires further work and may be carried forward to the February 2006 CP.

Standardised approach

Q169: What are your views on our approach to unrated exposures in the standardised approach to securitisations?

Q170: Do you intend to hold significant unrated securitisation positions under the standardised approach?

14.29 All respondents supported allowing firms to use the weighted average risk-weight for unrated exposures where the pool of securitised exposures is 'known at all times'. They considered the definition of 'known at all times' as being 'at least daily' to be unduly burdensome. It was suggested that the composition of the pool could be reported less frequently if changes are infrequent and/or do not materially affect the capital requirement for that exposure. The eligibility criteria for the pool would also provide relevant information.

14.30 **Our response:** We will exercise the discretion to allow standardised firms to use the weighted average risk-weight for unrated exposures multiplied by the concentration ratio. We agree with the comments made and will change BIPRU 9.10.8 (4) to reflect this.

IRB approach

Q171: Do you intend holding significant unrated securitisation positions, to which you might benefit from the ability to use the SFM?

14.31 The majority of respondents stated they would make use of the SFM.

14.32 **Our response:** We will exercise the national discretion to allow firms to use the SFM.

Q172: What problems will you face to meet the minimum IRB requirements to calculate Kirb and LGD for your unrated securitisation positions?

14.33 Respondents commented that firms using models not based on PD and LGD inputs would have problems. There was also a general lack of dissemination of this type of data. Another respondent mentioned the use of scoring based systems as a possible solution.

14.34 **Our response:** We will review these and other Standing Group comments as part of our ongoing work on credit risk implementation.

Q173: Do you intend using the simplification $h = 0$ and $v = 0$ for securitisations of retail exposures under the SFM?

14.35 The majority of respondents intend using the simplification.

14.36 **Our response:** We will exercise the national discretion to allow firms to use these simplifications for securitisations of retail exposures under the SFM.

Q174: What are your views on the waiving of the requirement to use a publicly available ECAI methodology under the IAA?

14.37 Respondents supported the proposal and further discussion on the IAA.

14.38 **Our response:** We will, as planned, consult on the IAA in the February 2006 CP.

Q175: What are your views on our proposed waiver approach for eligible liquidity facilities?

14.39 Respondents supported the proposed waiver approach for eligible liquidity facilities, subject to these facilities not being included within the 15% materiality exemption described in BIPRU 4.2.23G (4) and 4.2.27G. Respondents also asked if unrated warehouse loans would be included within the definition of eligible liquidity facilities.

14.40 **Our response:** Eligible liquidity facilities will not be included within the 15% materiality exemption. Unrated warehouse loans which meet the requirements for eligible liquidity facilities can be treated accordingly.

Q176: To inform the development of our proposals, please provide examples of any early amortisation triggers based on a quantitative value other than three-month average excess spread.

14.41 Two examples were provided: seller's share and size of trust. By far the most common early amortisation trigger remains those based on excess spread.

14.42 **Our response:** Firms must obtain a waiver to use early amortisation triggers based on a quantitative value other than the three-month average excess spread. Where such triggers become commonplace, we shall give consideration to changing the rules.

Q177: What are your views on the proposed structure of the draft rules and guidance for securitisations?

14.43 Respondents supported the proposed structure of the draft rules and guidance for securitisations. One respondent recommended that the securitisation requirements should be contained within a standalone chapter, thus avoiding the need to navigate between chapters across PRU.

14.44 **Our response:** We agree with the comments made and our aim, where possible, is to keep the securitisation regime within a standalone chapter. While there may be a need to cross-refer to definitions (e.g. on legal certainty, see Q163) in other chapters, there will be no cross-references to material outside of BIPRU.

15 Rules of disclosure

Introduction

- 15.1 In CP05/3, we outlined our proposals for implementing the market discipline disclosure requirements in the draft CRD, Pillar 3 of the Basel Framework. We stated our intention to adopt a risk-based approach to monitoring and enforcing firms' compliance with the requirements. We did not include draft Handbook text with CP05/3, as we wanted to consider how the relevant International Accounting Standard (IFRS 7 Financial Instruments: Disclosure), then still under negotiation, would interact with the draft CRD.

Summary of responses

Q178: Do you agree with our intended approach to the implementation of the disclosure requirements (Pillar 3)?

- 15.2 Less than a quarter of CP respondents answered this question. All agreed with our risk-based, high-level approach.
- 15.3 Respondents' primary concern was about the validation/auditing of disclosure, where they stated they would like further clarification. The interaction between IFRS 7 and the disclosure requirements of CRD Annex XII (Pillar 3) was highlighted.
- 15.4 Respondents suggested that we undertake a pre-consultation exercise on disclosure with industry and trade associations before we issue draft Handbook text.
- 15.5 **Our response:** In September, we plan to meet representatives of industry, trade associations and professional bodies to discuss 'in roundtable' the implications of Pillar 3, including verification and the interaction with IFRS7.

We intend to copy out CRD articles and annexes to create Handbook text for Pillar 3 provisions. Where appropriate, we shall include additional guidance in the Handbook.

16 Summary of cost-benefit issues

Introduction

- 16.1 For CP05/3, we appointed LECG, an economics consultancy firm, to prepare a fit-for-purpose market impact analysis on UK implementation of the CRD. This work included an interim cost-benefit analysis. A more detailed CBA will appear in the February 2006 CP.

Responses to individual questions

Q179: Do respondents share LECG's tentative conclusions that market impacts (that is, on pricing, volumes, competition, market structure, pro-cyclicality, etc.) will be small and, overall, positive? If not, can they explain why and make specific reference to cases, and markets, where this is not the case? Are there areas where respondents would recommend further impact analysis and, if so, why? Please provide examples and evidence, if possible covering the following aspects:

- risk management;
- costs for firms and other parties;
- the prices firms charge and the volumes they produce;
- competition in the markets in which respondents operate, taking into account the international dimension where relevant;
- the structure of the markets in which respondents operate, taking into account the impact on small firms, M&A activity, and market entry and exit;
- procyclicality; and,
- regulatory arbitrage activity.

- 16.2 Some respondents agreed that the CRD will generate a positive impact on risk management in the long-run, although some noted that this may not materialise for certain categories of firms (e.g. smaller credit institutions under the standardised approach).
- 16.3 On the magnitude of market impacts, some respondents commented that it could be more accentuated than anticipated by LECG in some markets and for some institution types. For instance, some emphasised that the CRD might materially affect the pricing of some non-core banking activities: liquidity facilities and inter-bank lending; and niche markets like social housing where, because of the high price sensitivity of demand, the impact on volumes could be greater than the one envisaged by LECG for retail markets in general. Regarding the impact on institution types, some respondents thought the analysis of market impacts on larger firms focused on major business lines activities and neglected the overall implications for the business.
- 16.4 Most respondents considered that the LECG report underestimated compliance costs for small banks and building societies under the standardised approach and the resulting effect on business viability. Since the majority of them perceived the advanced approaches as unattainable, this might adversely affect their competitive position to larger IRB firms.
- 16.5 The severity of the impact could vary depending on how IRB firms choose to use their capital advantage. The markets particularly affected would be retail banking, especially venture capital and mortgage markets (in particular some categories of residential mortgages where requirements for lower risk-weights are not met).
- 16.6 Respondents for small firms believed they might be marginalised into higher risk lending as a result of finer pricing on prime borrowers. Albeit small in terms of basis points, the resulting increase in the cost of funding could reduce their profitability in a material way.
- 16.7 Some found the LEGC report imprecise when it assessed the magnitude and direction of changes in compliance costs for some categories of firms. For instance, the analysis on investment firms failed to recognise that many investment managers would be subject to a Fixed Overhead Requirement (FOR) rather than an Operational Risk (OR) charge. Some respondents noted that the report underestimated the potential capital reduction for a minority of small firms that would be able to adopt the advanced approaches.
- 16.8 **Our response:** In the CBA for the February 2006 CP, we will analyse the benefits from CRD implementation. This will include a qualitative analysis of the incentives to improved risk management.

The CBA will focus on those markets where the effects are expected to be most pronounced. This will, in part, be determined by: (a) size of the market, having regard

to the international dimension; (b) expected changes in risk-weights; and (c) expected changes in non-credit components of the requirements (e.g. Pillar 2, OR, FOR).

The industry's comments on the impact of the CRD on the capital costs of compliance have informed our CBA plan in the February 2006 CP for assessing compliance costs for markets, categories of firms or groups of stakeholders more materially affected. We have noted the oversight on the capital costs of compliance for investment firms subject to a FOR. However, we believe that the vast majority of these firms will have reduced capital requirements as a result of the FOR.

Q180: What will be the main sources of compliance costs, both one-off and recurring? Where possible please provide estimates of these costs. We are particularly interested in costs that would not be incurred in the absence of the CRD or that would be incurred in a later year.

- 16.9 Overall, most respondents felt that one-off costs would be the most significant component of compliance costs. These would be mainly incurred through new or upgraded IT and systems. Some commented that IRB systems may need to be regularly updated after implementation.
- 16.10 Some respondents expected the one-off costs for investment managers to include:
- the costs of restructuring for any firm that relied on preference shares for Tier 1 capital, if the current proposals on the 50% limit to use preference shares were implemented;
 - the costs of requesting a legal opinion on what constitutes Tier 2 capital; and
 - the costs of formal ICAAP reporting and documenting processes.
- 16.11 Among on-going costs for credit institutions, some respondents included:
- licence fees;
 - external behavioural scoring costs for mortgage lending;
 - additional compliance staff (particularly for smaller organisations);
 - increased Board oversight; and
 - reporting costs.
- 16.12 Apart from potential large continuing costs for investment management groups deemed by us to be complex for the purposes of ICAAP, respondents believed other continuing costs would be minimal for investment managers.
- 16.13 Some categories of costs not considered by the report were mentioned, including the costs of remaining uncertainties on the way we will choose to implement CRD and the costs of parallel running during the transitional period.

16.14 On the split between CRD-specific costs and those that would have been incurred regardless of CRD, some respondents commented that this was hard to quantify. In addition, CRD-specific costs should include the opportunity costs for firms accelerating investments to ensure CRD compliance within the implementation timetable (e.g. missed development opportunities outside CRD compliance).

16.15 **Our response:** Industry feedback has informed our CBA plan to assess the capital and non-capital incremental costs of compliance arising from CRD. Given the high degree of uncertainty on the costs that will actually arise from CRD implementation, the focus of the analysis will be on total costs. A breakdown is envisaged for markets, categories of firms and groups of stakeholders that might be more materially affected. We will also consider a breakdown for the most significant areas of superequivalence and policy choice.

Q181: Respondents' views on the costs and benefits of the alternative options discussed in this CP would also be welcome where the differences are expected to be significant.

16.16 The banking industry considered the following areas to be significant from a cost-benefit point of view, in addition to those already mentioned:

- solo consolidation, integrated groups and interplay of these with connected lending and concentration risk;
- Pillar 2, especially for smaller firms;
- mapping of ECAs ratings for exposures to institutions;
- risk-weighting of residential mortgages and commercial real estate;
- data accuracy;
- use test;
- low default portfolios;
- external data models (if assumptions made are incorrect);
- stress testing, including stress testing of collateral for concentration risk;
- retail/corporate exposure boundary for IRB; and
- treatment of restructuring for credit derivatives.

16.17 **Our response:** Industry feedback has informed our plan to assess the costs and benefits arising from CRD implementation. We have consulted on this plan with representatives of the BBA, APCIMS, IMA and LIBA. While our work will be wide-ranging, the analysis may not fully capture the granularity of the issues bulleted above. But we will take the costs and benefits of all these issues into account in our continuing discussions with the industry.

17 Approvals process of IRB and AMA applications

Introduction

- 17.1 In CP05/3, we consulted on the approvals process and asked respondents to comment on whether they foresaw any problems with implementing it, especially groups with international activities. The latest information on the process for the different waves of applications for the advanced approaches is given in the responses below.

Responses to individual questions

Q182: What additional information on the approval process would firms find useful for inclusion in the Handbook?

- 17.2 Most respondents stated that more guidance and information on the approvals and assessment processes, including on home-host coordination, would be welcome. Respondents were keen to have guidance on what constituted a good state of readiness. It was also suggested that a better indication of the lengths of visits that different types of firms could expect should be provided.
- 17.3 In terms of the decision-making process, respondents were interested in whether we would issue 'yes but' or 'no because' waivers and the extent of guidance and explanation that would be provided alongside decisions.
- 17.4 Some respondents noted that they found our CRD implementation website useful. They said they would find direct dialogue helpful, with us providing additional guidance.

17.5 **Our response:** The feedback we received informed the publication, in June 2005, of an updated application pack for IRB and AMA. At the same time, we updated our dedicated webpage on Basel2/CRD implementation to give practical information to firms, in particular for those anticipating applying for the advanced approaches in Wave 1⁴⁰. This provides respondents with guidance on the approvals and home-host processes. We will keep the contents of these pages under review.

We cannot be prescriptive about the scope or length of visits as this will depend on the risk profile of both the waiver and the firm. On whether IRB/AMA waivers might include conditions, these will follow the same pattern as any other waiver, and as such may include conditions. Where appropriate, we will provide reasons for the decision we have reached.

The application pack and policy baseline⁴¹ provide firms with some indication of what the approvals process will involve and how applicants can prepare themselves for making an application. In deciding when to apply, it is important that applicants take into account that we will need to see evidence of compliance with the use test requirement during our review of their application.

We encourage firms to continue communicating their implementation plans to their relationship managers, who will be able to provide more details on particular areas of interest to individual applicants.

Q183: What problems do you foresee in implementing the approval process as set out here? In particular, do firms foresee problems in managing the approval arrangements where groups with international activities are concerned?

17.6 Coordination of approach among regulators (particularly within the EEA) and communication were raised as issues. Respondents were interested in how data consistency in submissions could be dealt with for overseas subsidiaries that may be working on different dates for implementation (due to local requirements). Clarity on the level of detail required from overseas operations was also requested. Some respondents called for more clarity on timetables for international groups. The Joint Industry response noted that the industry was anxious to understand the division of responsibilities between home and host supervisors and the extent to which we would rely on the home regulator.

17.7 Some respondents stated that it would be helpful to know how we planned to deal with late changes to the CRD text that will affect IRB applications. Respondents were also interested in how we would deal with changes in the models occurring mid-application. In addition, respondents highlighted that, in cases where IRB models will be developed from scratch, experience of such

40 Basel2/CRD implementation page: www.fsa.gov.uk/Pages/About/What/International/basel/info/index.shtml

41 CRD policy baseline: www.fsa.gov.uk/pages/About/What/International/basel/info/baseline.shtml

systems would be limited. They asked us to note that as a result there may be a considerable difference between the understanding/use/integration of such systems at the initial application submission date than at a later FSA assessment/approval date. Other respondents expressed concern that too much detail was required in the second part of the application form for IRB approval. And they felt a considerable amount of documentation would be needed to fully describe all Basel processes.

- 17.8 **Our response:** We have provided guidelines for EEA and non-EEA groups/overseas firms on the Basel 2 section of our website⁴², which should help applicants understand better the home-host coordination process. Our approach to the home-host process within the EEA will be guided by the convergence principles, as published by CEBS in CP10⁴³. It should be noted that for EEA applications, Article 129(2) states that 'competent authorities shall do everything within their power to reach a joint decision on the application within six months'. In the absence of such a decision, Article 129(2) states that the lead competent authority 'shall make its own decision on the application' We do not anticipate that these circumstances will arise very often and we will use best efforts to avoid this situation, both where we are home regulator and where we are host. We are looking at the implications of lack of alignment of implementation dates. But since the timetables for implementation dates have not yet been finalised we cannot give further guidance at the moment.
- Regarding the division of responsibilities between home and host regulators, work is being undertaken by the AIG and CEBS to produce guidelines to which we are contributing. However, we will not know how this division will function in practice until these guidelines have been finalised. This is particularly true of non-EEA regulators. We are also looking closely at the issue of reliance on other regulators and the implications that this has on resourcing levels and the amount of work to be undertaken. On the level of detail required from overseas operations, the application pack when requiring information on business lines or asset classes does not distinguish between domestic and non-domestic operations, except where specific information is required.
- The application pack has been designed to minimise the burden for firms and make the approvals process efficient. We have emphasised that, where possible, applicants provide summaries of information to reduce the volume of documentation submitted. As stated in CP05/3 (17.10), we appreciate that firms will wish to continue improving their methodology and we would not want them to delay doing so. Firms should communicate any significant changes to their relationship manager.

42 Basel2/CRD implementation page: www.fsa.gov.uk/Pages/About/What/International/basel/info/index.shtml

43 http://www.c-eps.org/Consultation_papers/CP10.htm

In terms of dealing with the delay in finalising the Capital Requirements Directive (CRD), we have revised our application Waves⁴⁴. As stated in CP05/3 and in various public announcements on our approach to implementing the CRD, we will deem valid the preparatory work undertaken in good faith by any firm in anticipation of the final text of the CRD. Firms which submit an application in Wave 1 in compliance with the policy baseline⁴⁵ articulated for that purpose will not be penalised because of changes made in the final stages of agreeing the CRD. Rather, we will discuss with such firms an appropriate, individual timetable for making any changes required by the final CRD text.

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- 44 Details of our revised timings can be found on our website in a paper submitted to the March Basel 2/CRD Implementation Advisory Group entitled 'Consequences for UK implementation plans of delay in EU agreement of the Capital Requirements Directive (CRD)': www.fsa.gov.uk/pubs/international/crd_mar05.pdf
- 45 CRD policy baseline: www.fsa.gov.uk/pages/About/What/International/basel/info/baseline.shtml

18 Senior management understanding

Introduction

- 18.1 In CP05/3, we included within the BIPRU 4 text ‘copy-out’ of the draft CRD requirements in respect of the governance of IRB rating systems.
- 18.2 This chapter summarises respondents’ comments on governance from CP05/3. Specifically, it provides further clarification on definitional issues, and the level of understanding that would be required of different parties in relation to IRB rating systems. In addition, it covers the issue of the governance requirements that should apply to operational risk approaches.
- 18.3 In developing proposals in the area of governance, it will be critical we discuss with the industry how to achieve the appropriate balance between the role of good governance in ensuring prudential soundness and the demands on firms. Our fundamental approach to regulation remains one where we look to senior management at regulated firms to take responsibility for running their businesses in line with regulatory requirements. The need for proper senior management understanding was recently emphasised in the ‘Corrigan report’⁴⁶. This included the recommendation that ‘Senior management ... should ensure that they understand the essential risk elements of the instruments their firms are buying and selling ... [and] ... understand the limitations of the pricing and risk models applicable to those instruments...’. While this report focused on the risk management of complex transactions, the general principle is widely applicable.

Governance requirements in respect of IRB rating systems

- 18.4 For IRB rating systems, we proposed that the level of understanding required should not be same for all senior executives. BIPRU 4.3.9G and 4.3.11G differentiated between the levels of understanding required by different groups of senior executives:

46 ‘Toward Greater Financial Stability: A Private Sector Perspective’, the report of the Counterparty Risk Management Policy Group II, July 27 2005. (Over-Riding Guiding Principle #23, page 127)

- the governing body or designated committee should have a ‘general understanding’ of the rating system; and
- senior management should have a ‘good understanding’ of the rating system’s design and operations.

18.5 Neither the draft directive nor the BIPRU elaborates on what a ‘general’ or ‘good’ understanding might mean in practice.

18.6 Respondents expressed concern at the proposed requirement that senior management should have a good understanding of the ratings system’s designs and operations (BIPRU 4.3.11G). They were concerned at the level of detailed and technical knowledge that this might imply, and the potential for supervisors to form unrealistic expectations of senior executives.

18.7 **Our response:** The governance of IRB rating systems will be one of our key areas of focus in assessing IRB waiver applications. We fully recognise that it would be neither appropriate nor proportionate to expect senior executives to have the same detailed understanding of rating systems as the specialists within the firm responsible for designing and maintaining them. This is particularly the case for large groups or firms with a large number of rating systems. Nevertheless, we view the role of the governing body, designated committee and senior management as fundamental in ensuring the adequacy of ratings systems.

In considering this issue, it is important to clarify definitions. The governance requirements proposed in BIPRU 4 focused on three sets of individuals: the governing body, the designated committee and the senior management. *Governing body* and *senior manager* are defined terms within our Handbook. We propose to apply these definitions in respect of the IRB governance requirements. We do not propose to provide additional guidance on who should fall within these definitions; as at present, this is for firms to determine. For example, firms currently determine the parties that should be captured in relation to the senior management requirements for CAD models. Similarly, in assessing who qualifies as senior management for IRB governance purposes, we would expect firms to focus on relevant senior management. Typically, this would be likely to include not only senior risk management and finance staff, but also heads of business units.

The term ‘designated committee’ in BIPRU 4.3.9G derives from, but is not defined in, the draft CRD; neither was it defined in CP05/3. However, if a firm were to use a designated committee as its rating system approval body, we would expect its membership to include at least one member of the firm’s governing body. We believe this to be necessary to ensure that the approval decision has input and challenge from a sufficiently senior level. We are currently considering whether we should provide additional guidance or include it within our Handbook definitions to clarify this point.

BIPRU 4.3.9G places the requirement for a general understanding either on the governing body, or, where the firm chooses to use one, on the designated

committee. However, we believe it is important that, where a designated committee is used as the approval body, a general level of understanding of rating systems would nevertheless be required within the overall competence of the governing body⁴⁷. In such circumstances, we would expect the governing body's level of familiarity with rating system issues to rise over time. We see this understanding as necessary to ensure the governing body appreciates the nature of the responsibility it has delegated to a designated committee, and the implications for the firm of the decisions taken by it. We are currently considering whether it is necessary to provide additional guidance to make this clear.

We believe the requirement for a general understanding should apply at the level of the governing body and the designated committee as a whole, rather than at the level of their individual members. We do not believe it is appropriate to define a threshold of understanding that each member of these bodies should meet. It is inevitable that the level of understanding of individual members of the governing body and designated committee will vary, depending on their level of involvement with the firm's rating systems. Our principal concern is that a general understanding of rating systems should fall within the overall competence of the governing body as a whole, and the designated committee as a whole. This understanding should be sufficient to allow for effective challenge, and enable them to take reasoned decisions on the matters presented to them. It should go beyond an understanding of the processes in place within a firm or group to ensure the adequacy of its rating systems. For rating systems which a firm considered to be material to its business, it could include an awareness of, for example:

- the nature of the rating systems themselves;
- the products and customer segments covered by the rating system;
- the materiality of the rating system to the firm or group;
- at a general level, the rating systems' key strengths and weaknesses;
- the level of performance that the firm considers to be adequate for such rating systems;
- the role of the Credit Risk Control Unit and internal audit in ensuring the performance of rating systems; and
- the process within the firm and group to monitor and ensure adequate performance on an ongoing basis.

We would expect this general level of understanding to have been reached at the time of approval of the rating systems. In addition, it should be refreshed periodically, by way of the management and exception reporting on the rating systems provided to the governing body and designated committee, and by ongoing briefings and training.

47 This includes Non-Executive Directors.

We are currently developing our thinking further on what both 'general' and 'good' understanding should mean in practice. Owing to the importance of this issue, we plan to include in the February 2006 CP greater detail on our expectations in the form of additional guidance in BIPRU 4. In developing this guidance, we will discuss our views with the industry in the coming months, as part of the pre-consultation process for the February 2006 CP.

Many firms are still developing the management information on rating systems to be supplied to the governing body, designated committee and senior management. BIPRU 4.3.9G proposed that the governing body or designated committee, and senior management should have 'detailed comprehension' of management reports (associated with the rating system). We believe it is appropriate for the frequency and level of detail of such management reporting to vary with the level of seniority of the recipient. As firms' work in this area develops, we will be keen to discuss the nature, and level of detail, of management reporting they propose to use.

Our waiver application pack requires that applications be submitted on a group basis. Nevertheless, the governance requirements of BIPRU 4 will apply at the level of the individual firm. We recognise that that in many cases the approval processes at the firm and group levels will be inextricably linked. So, in determining whether the IRB governance requirements have been met at the firm level, we propose to have regard to the governance arrangements and level of understanding at the group level. The more high-level the understanding and challenge at the group level, the greater the understanding and challenge we would expect at the firm level.

Governance requirements in respect of operational risk approaches

- 18.8 The BIPRU and the draft CRD do not include explicit requirements for senior executives to understand and approve the use of the standardised approach (TSA) or AMA models. However, the governance requirements within BIPRU that apply to operational risk approaches are implicit within the systems and controls requirements from the SYSC module that we have cross referenced in BIPRU 6, and in the qualitative standards – the use test - for AMA that have been 'copied out' of the draft CRD into BIPRU 6.
- 18.9 We believe it is important that the level of understanding and challenge required of the governing body and senior management for IRB rating systems should apply also in relation to AMA to operational risk. We are considering where – and how best – to articulate this principle within our Handbook.

List of non-confidential respondents to CP05/3

Association of Private Client Investment Managers and Stockbrokers

Aviva PLC

Barclays PLC

Britannia Group

British Bankers' Association/London Investment Banking Association/Building Societies Association/Council of Mortgage Lenders/Finance & Leasing Association (Joint Industry response)

British Vehicle Rental and Leasing Association

Building Societies Association

Chelsea Building Society

Citigroup

City Asset Management PLC

Close Brothers Limited

Collins Stewart Tullett PLC

Cornelian Asset Managers

Cripps Portfolio

Daiwa Securities SMBC Europe Limited

Economist Intelligence Unit

Fitch Ratings

Futures and Options Association

GECB Consumer Finance UK

Goldman Sachs
HBOS PLC
ICC Information Limited
Institute of Chartered Accountants in England and Wales
Institutional Money Markets Funds Association
Investment Management Association
John Thirlwell
Manchester Building Society
Merrill Lynch Europe PLC
Nationwide Building Society
Pricewaterhouse Coopers LLP
Principal Portfolio Management
Risk Reward Limited
Royal Bank of Scotland Group
Royal Institution of Chartered Surveyors
Schroders Investment Management Limited
Siemens Financial Services Limited
Smaller Businesses Practitioner Panel
Standard & Poor's

Priority issues for the February 2006 CP

| Chapter | Priority issues for consultation |
|--|---|
| Scope of application | Solo consolidation |
| Capital and valuation | Split of deductions from tier 1 and tier 2 Calculation of qualifying holdings Clarifications and extra guidance on, and re-ordering of, the existing proposals as well as new rules, following changes in policy due to CP05/3 feedback |
| Internal capital adequacy standards (Pillar 2) | Proportionality Diversification effects Stress tests and scenario analyses |
| Standardised approach to credit risk | In the area of credit risk and concentration risk, we have established several industry expert groups to examine a range of priority issues. These include the standardised approach, the treatment of Low Default Portfolios, downturn LGDs, external models, and 'aggregation'. They also include the treatment of intra-group exposures for concentration risk purposes. In addition, work is continuing on the implementation of a number of aspects of the IRB approach at European and international levels. In the planned February 2006 CP, we will take account of the outcomes of these work streams and reflect them as appropriate in the final draft BIPRU text. |
| ECAIs | |
| Internal ratings based approach to credit risk | |
| Concentration risk | |
| Interest rate risk in the non-trading book | Format and contents of Handbook text Need for Handbook guidance additional to the governing CEBS paper Format and frequency of data reporting Interaction with the Supervisory Review Process |
| Operational risk requirement | Exemption from the OR capital requirements for certain types of investment firms Treatment of intra-group income Treatment of outsourcing Income calculation examples Treatment of negative income Income indicator for a firm stopping or selling some of its entities or activities or starting or acquiring new entities or activities Extraordinary or irregular items (BIPRU 6.4.8) Income derived from insurance Income indicator for operating leases Business line Mapping |

| Chapter | Priority issues for consultation |
|---|---|
| Advanced Measurement Approach to operational risk | Data integrity, completeness and accuracy (including internal loss data) Expected Loss AMA Insurance Partial Use and its application Other qualitative issues: Independence for AMA and Validation Other quantitative issues: Soundness Standard; the four model elements; Correlation and Dependency AMA Allocation |
| Capital requirements for groups | Use of advanced approaches in calculating GRR CRD equivalence and list of equivalent non-EEA regulators Integrated group regime issues at group level |
| Credit risk mitigation | Effects of financial collateral on different exposures under the Advanced IRB approach and how it interacts with the approaches available under the Foundation IRB approach. The minimum requirements for property taken as security on mortgage loans and the issue of mortgage insurance. Collateral, both posted and received, in terms of OTC derivative contracts. Trading Book Review: Short Term Maturity Adjustment and Double Default |
| Securitisation | Internal Assessment Approach |
| Rules of disclosure (Pillar 3) | Areas of discretion Scope of application Materiality Proprietary and confidential Frequency Media and location Verification of disclosures |
| Market risk | Collective Investment Undertakings Trading book boundary Treatment of specific risks in the Trading Book Unsettled and failed trades |
| Counterparty credit risk | Changes introduced by the Trading Book Review |

Glossary

| | |
|-----------------|--|
| AIG | Accord Implementation Group |
| AMA | Advanced Measurement Approaches (for operational risk) |
| ASA | Alternative Standardised Approach (for operational risk) |
| Basel Committee | Basel Committee on Banking Supervision |
| BBA | British Bankers' Association |
| BCD | Banking Consolidation Directive (No 2000/12/EC) |
| BIA | Basic Indicator Approach (for operational risk) |
| BIPRU | Prudential sourcebook for banks, building societies and investment firms |
| BSA | Building Societies Association |
| CAD | Capital Adequacy Directive (No 93/6/EEC) |
| CBA | Cost-benefit analysis |
| CDR | Cumulative Default Rate |
| CEBS | Committee of European Banking Supervisors |
| CDS | Credit Default Swaps |
| CF | Conversion Factor |
| CIU | Collective Investment Undertaking |
| CML | Council of Mortgage Lenders |
| CMP | Core Market Participant |
| CP | Consultation Paper |
| CRD | Capital Requirements Directive (recast of BCD and CAD) |

| | |
|----------------|--|
| CRE | Commercial real estate |
| CRM | Credit risk mitigation |
| CRSG | Credit Risk Standing Group |
| DvP | Delivery versus Payment |
| EAD | Exposure at Default |
| ECA | Export Credit Agency |
| ECAI | External Credit Assessment Institution |
| ECM | Economic Capital Modelling |
| ECOFIN | Council of EU Finance Ministers |
| EEA | European Economic Area |
| EL | Expected Loss |
| EU | European Union |
| FAQ | Frequently Asked Question |
| FLA | Finance & Leasing Association |
| FOR | Fixed Overhead Requirement |
| FSA | Financial Services Authority |
| FSMA | Financial Services and Markets Act 2000 |
| GENPRU | General Prudential Sourcebook |
| G10 | Group of Ten central bank governors (Basel Committee) |
| IAA | Internal Assessment Approach |
| IAS | International Accounting Standards |
| ICAAP | Internal Capital Adequacy Assessment Process |
| ICG | Individual Capital Guidance |
| IFRS | International Financial Reporting Standards |
| IOSCO | International Organization of Securities Commissions |
| IPRU | Interim Prudential Sourcebook |
| IRB | Internal Ratings Based approach (for credit risk) |
| Joint Industry | BBA/LIBA/BSA/CML/FLA joint industry response to CP05/3 |
| LIBA | London Investment Banking Association |

| | |
|--------|--|
| LDP | Low Default Portfolio |
| LE | Large Exposure |
| LGD | Loss Given Default |
| LTV | Loan-to-Value |
| MII | Mortgage Indemnity Insurance |
| MiFID | Markets in Financial Instruments Directive (2004/49/EC) |
| Non-TB | Non-Trading Book |
| OECD | Organisation of Economic Cooperation and Development |
| OFR | Own Funds Review |
| ORR | Operational Risk Requirements |
| PD | Probability of Default |
| PIBS | Permanent Interest Bearing Shares |
| PSE | Public Sector Entity |
| QIS | Quantitative Impact Study |
| QRRE | Qualifying Revolving Retail Exposures |
| RAO | Regulated Activities Order |
| RRE | Residential Real Estate |
| RWA | Risk Weighted Asset |
| SFM | Supervisory Formula Method |
| SME | Small or Medium-Sized Enterprise |
| SPV | Special Purpose Vehicle |
| SREP | Supervisory Review and Evaluation Process |
| SYSC | Systems and Controls module of the Handbook |
| TBR | Trading Book Review |
| TSA | The Standardised Approach (for operational risk) |
| UCITS | Undertakings for Collective Investments in Transferable Services |

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