

05/3***

Financial Services Authority

Strengthening capital standards

Including feedback on CP189

January 2005



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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by **29 April 2005**.

Comments may be sent by electronic submission using the form on the FSA's website at: http://www.fsa.gov.uk/pubs/cp/cp05_03_response.html.

Alternatively, please send comments in writing to:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an e-mail message as a request for non-disclosure.

Copies of this Consultation Paper 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 This Consultation Paper (CP) is the first of two CPs planned for this year in connection with the UK implementation of the Capital Requirements Directive (CRD). It concentrates on the key areas where the UK is expected to have discretion to exercise in deciding the new prudential framework. The second CP – containing the entire draft Handbook text for implementing the CRD provisions – will be published as soon as practicable following agreement of the final text of the Directive by the EU Council of Ministers and the European Parliament. We intend to conduct a full and constructive consultation. We expect active dialogue and discussion on the basis of this CP and welcome all responses to it.
- 1.2 Exceptionally, this CP is very long, running to almost 200 pages, and is accompanied by over 300 pages of draft rules and guidance. The full set of draft rules and guidance on which we will consult later this year will be longer. Once made, however, the new rules will effectively replace much of the current, extensive Handbook regime relating to prudential controls on banks, building societies and investment firms.
- 1.3 To guide small firms in their reading of the CP, there is a box at the end of this Overview which highlights the particular issues and chapters likely to be of most relevance to them. There is a separate box on the implications of the CRD for consumers.
- 1.4 This CP supersedes CP189 of July 2003. (Feedback to CP189 is set out in Annex 3 and reflected as appropriate in the relevant chapters of this CP.) Where firms have relied on CP189 approaches in their preparatory work for implementing the CRD, we will take account of this when agreeing the timetable for their compliance with our final rules.

Relationship with the Revised Basel Framework

- 1.5 The key aim of the CRD is to introduce a modern, risk-sensitive prudential framework for credit institutions and investment firms across all Member States. It is closely linked to the Revised Basel Framework, agreed in June 2004¹ (the Basel Framework), which applies to internationally-active banks. Like the Basel Framework, the CRD is based on three ‘Pillars’:
- quantification of the risks arising from financial firms’ trading and credit businesses;
 - a stronger constructive dialogue between regulators and firms on the risks run by the latter and the level of capital which should be held to support them; and
 - a series of robust requirements on public disclosure by firms to encourage a stronger role for market discipline in ensuring that firms hold capital appropriate to their business.

Although the term ‘Pillar’ is not strictly appropriate in the CRD context, it is used in this CP as a convenient way of denoting these key elements of the Directive.

Textual Baselines

- 1.6 The European Commission published the draft text of the CRD on 14 July 2004 (the Draft Directive). This CP is in general based on the 14 July text. However, a number of changes have been made to the Draft Directive in the general conditions for political agreement as agreed by EU Finance Ministers (ECOFIN) on 7 December 2004 (the ECOFIN text). Many of the changes are helpful in the UK context and can reasonably be expected to be incorporated into the final text. Accordingly, the most substantive changes reflected in the ECOFIN text are taken into account in this CP. In each such case, we indicate that the ECOFIN text forms the basis for our consultation. At this stage, however, all the draft rules and guidance in Appendix 1 are based on the 14 July text.
- 1.7 The Draft Directive is not a single new directive. Rather it comprises the significant changes proposed to two existing Directives, the Banking Consolidation Directive (BCD)² and the Capital Adequacy Directive (CAD).³ The amendments proposed would result in a ‘re-cast BCD’ and a ‘re-cast CAD’. For the sake of simplicity, we refer to the Draft Directive and specify which of the two amended directives we are referring to only where it is necessary to distinguish between them.

1 Basel Committee on Banking Supervision: International Convergence of Capital Measurement and Capital Standards: A Revised Framework.

2 Council Directive of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (No 2000/12/EC).

3 Council Directive of 15 March 1993 on capital adequacy of investment firms and credit institutions (No 93/6/EEC).

- 1.8 We seek to provide firms and other stakeholders with as much early clarity as possible on our plans to implement the required changes to our existing capital adequacy regime. However, the potential benefits of this approach need to be balanced against the cost of possible late changes to our proposed rules if that is required by the final outcomes of the EU negotiations and/or discussions in the Committee of European Banking Supervisors (CEBS).

Pre-consultation

- 1.9 This CP benefits from a significant degree of informal pre-consultation with industry. We are grateful to the representatives of many firms and trade associations who have worked with us in Standing Groups (on credit risk, securitisation, credit risk mitigation, operational risk, and capital and groups) over the past six months as we have developed our thinking on UK implementation of the CRD. Their practically focussed insights have been invaluable.
- 1.10 We have published minutes of the Standing Group meetings and the papers discussed on our website (www.fsa.gov.uk/international/standing_groups.html) and all firms have been welcome to submit comments to us directly or through their trade association. We have also produced answers to a number of sets of frequently asked questions (FAQs) put together by trade associations and published these on our website (www.fsa.gov.uk/international/standing_groups.html). We plan to continue to use the Standing Groups and FAQs as we develop our plans for implementing the CRD and finalise Handbook changes required to implement the CRD. We are also in active discussion with the industry about planning for the practical aspects of the changeover at the level of the individual firm.
- 1.11 To help gain an understanding of firms' preferences, concerns and state of preparedness, we also commissioned a report from a firm of external economic consultants, LECG. LECG conducted a preliminary high-level market impact analysis and review of the main policy options. Through this, we have obtained insights into the views of a representative sample of firms which have influenced the proposals in this CP and will be useful in our continuing consideration of implementation choices.
- 1.12 Our implementation decisions will take account of an assessment of the costs and benefits associated with specific options. Where our propositions would be superequivalent, we try to provide our reasoning, including our initial view of the costs and benefits. As is made clear in the preliminary cost benefit analysis (CBA) in Annex 2, the costs and benefits of CRD implementation are likely to reflect some market impacts (such as changes in products, prices and competition resulting from improved risk management and capital

requirements). We would welcome feedback on any specific significant costs or benefits we may have overlooked in the context of particular proposals.

Contents

- 1.13 This CP is structured as follows. This overview provides the context of our policy choices and proposals in relation to the Draft Directive. Chapters setting out our proposed approaches in specific areas follow, with references to draft Handbook text as contained in the Appendices. A series of Annexes include a statement on how we are ensuring that our proposed implementation is compatible with the objectives and principles set out in the Financial Services and Markets Act 2000 (FSMA), give feedback to CP189 and reproduce the application packs for use by firms planning to adopt the foundation or advanced approaches for credit risk (Internal Ratings Based approach (IRB)) and/or the advanced approaches for operational risk (Advanced Measurement Approaches (AMA)).
- 1.14 Recognising the limitations imposed by the fact that the CRD is not yet finalised, this overview seeks to give as much clarity as possible on:
- external constraints and areas of continuing discussion;
 - scope of application;
 - our overall policy stance;
 - our proposed approach to exercising the national discretions;
 - our commitment to ‘copy out’ and the circumstances in which we might be superequivalent to the CRD;
 - the most significant policy proposals outlined in this paper;
 - the implementation timetable;
 - home-host issues; and
 - the next steps.
- 1.15 The consultation on this CP will close on 29 April 2005. Depending on when the final Directive is agreed and therefore the timing of the second CP, we may provide a separate feedback statement, or incorporate our feedback into the second CP.

External constraints and areas of continuing discussion

- 1.16 Current uncertainties about a number of external constraints restrict our room for manoeuvre on implementation. Successful UK implementation requires careful assessment of the challenges they pose, so that we can handle a range of possible outcomes in relation to each of them.

- 1.17 Given the long lead times for many aspects of firms' preparations, we need to make progress on implementation alongside active involvement in finalising the Directive. One uncertainty is whether Member States and the European Parliament will agree that the standardised and intermediate approaches within the Draft Directive should be implemented with effect from 1 January 2007, with the more advanced options not going live until 1 January 2008. The UK preference remains for a single implementation date of 1 January 2008. Our planning work has to take both possibilities into account.
- 1.18 On the Directive text in general, there remains considerable uncertainty about the timing of final agreement between the Council and the European Parliament. In order to allow Member States the 18 months normally allocated for implementation and to ensure that the Directive comes into force on the same date as the Basel Framework, the text needs to be agreed by June /July 2005. The ECOFIN text agreed in December 2004 (see paragraph 1.3) gives the basis for further discussion with the European Parliament. However, the Parliament is currently not expected to deliver its draft Opinion on the Draft Directive until April/May 2005.
- 1.19 Through the Lamfalussy machinery (notably CEBS) and otherwise, the FSA, together with HM Treasury (HMT), aims to promote implementation which is consistent, effective and proportionate across the EU. CEBS is working hard to ensure progress in this area, and we are fully involved in and supportive of its efforts. CEBS' continuing work on supervisory convergence, notably on Pillar 2 topics and areas of national discretion, could well lead to further revision of some of the proposals explained in the CP.
- 1.20 Firms should also be aware that the Committee of European Securities Regulators (CESR), CEBS' sister committee, is also undertaking work which will have implications for the implementation of the CRD. The two most relevant areas are CESR's input into further European rule-making on aspects of the Markets in Financial Instruments Directive (MiFID), including on scope of application and systems and controls, and on the recognition/regulation of rating agencies.
- 1.21 The Basel Committee on Banking Supervision (the Basel Committee) and the International Organization of Securities Commissions (IOSCO) announced in January 2004 their intention, through a joint working group, to review the treatment of certain counter-party credit risk and trading-book related items in the light of progress with the Basel Framework. We recognise that for large investment firms in particular, but also for major banking groups, not incorporating the outcomes from this Trading Book Review (TBR) into the CRD in a timely fashion could be problematical, particularly in terms of systems development and potential capital impact.

- 1.22 The joint working group is working to a tight deadline to publish a Basel/IOSCO consultation document by April 2005, which would enable incorporation of relevant proposals during the European Parliament's consideration of the CRD. This could allow finalisation of the necessary provisions sufficiently in advance of 1 January 2008 to allow time for them to come into force on that date. In addition, the UK has secured a transitional provision in the ECOFIN text which would permit a delayed implementation of the new CRD rules bearing on trading book positions. In practice, while we are endeavouring to implement all the rules – including those stemming from the TBR – by the beginning of 2008, that would enable Member States to continue to apply existing 'Basel 1' requirements in respect of trading book positions pending implementation of the TBR outcome, at least until January 2009. Meanwhile we are undertaking necessary work in preparation for incorporating into our rules the trading book provisions of the CRD.
- 1.23 Other elements of the Basel Framework are also subject to further change. A further Quantitative Impact Study (QIS) on the market impacts of the Basel Framework across the G10 participant countries will be undertaken this year. This will decide the calibration of the Basel model. Meanwhile, participation in QIS will help firms to assess their readiness for implementation.
- 1.24 Additionally, the Basel Committee has said that at some later date it intends to review the definition of capital to take account of market developments and innovation. This may lead to amendments to the constituent components of tier 1 and tier 2 capital and the relationship between them and would, almost inevitably, be accompanied by a parallel review at EU level. However, any changes which result from this review will not be part of CRD implementation, but will be introduced later.

Scope of Application

- 1.25 While the Basel Framework applies formally to internationally active banks only, the CRD will apply to all deposit-takers, other than credit unions, and to investment firms. We have set out what we currently understand this to mean for the various categories of UK regulated firms in Chapter 2. For most small and medium-sized firms caught by the Directive, the change will involve a move from the Basel 1 approach to the new standardised approach for credit risk (which firms may defer until 1 January 2008) and the simpler approaches for operational risk. The standardised approach is explained in this CP and does not involve firms submitting an application for approval to FSA.
- 1.26 Firms, whether large or small, seeking to adopt the IRB and/or AMA approaches face a significant challenge to undertake the necessary systems and risk management work required by the Draft Directive. The potential demands of that work and the costs involved should not be underestimated.

We are looking to develop active dialogue with all firms wishing to apply to use any of the advanced approaches. We are making considerable resources available across our policy teams, our Risk Review Department and supervisory divisions to ensure that such firms receive appropriate and timely input and feedback from us.

- 1.27 We are well aware that at one end of the scale, global financial groups and large investment banks which operate within the EU need a timely resolution of both the TBR and the home-host issues (most particularly in relation to model approval) for the CRD to be introduced effectively. More details on both these aspects are contained in this Overview. At the other end of the spectrum, some small UK investment firms and commodity firms will need to wait for the UK's implementation of MiFID, on which we and HMT plan to consult later this year, to know for sure whether they will fall within the scope of the CRD (see Chapter 2). For many of these firms, the implications of the CRD are expected to be relatively minor, given the treatment afforded to certain categories of investment firms to reflect the limited risks posed by their business.

Our overall policy stance

- 1.28 The Basel Framework, as reflected in the CRD, is a major step forward which relates capital much more closely to risks. But there is much to do through time to adjust firms' practice, and supervisory expectations. The CRD provides an improved conceptual framework but the analytical tools to secure most value from it are lacking in some areas. There is therefore a need 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. For example, firms on the Advanced IRB must make use of 'all relevant information' in their estimation of probability of default (PD). The range and content of these inputs will change over time and we will expect firms to remain alert to such developments and incorporate them into their systems and business thinking. Failure or inability to do so will cause us to review a firm's eligibility to retain foundation or advanced status. We will be particularly concerned to see that firms take a prudent view of the possibility of losses occurring in their portfolios. For example, in the area of mortgage lending, estimates of PD and loss given default (LGD) based on data that do not go back to the early 1990s will generate imprudently low capital requirements. Where firms do not tackle such issues effectively under Pillar 1, we will be obliged to set additional capital charge under Pillar 2. There is therefore a clear capital incentive for firms to improve their risk management techniques.
- 1.29 More generally, recognising the potential reduction in capital for firms that qualify for the IRB or AMA approaches, we will be looking for

evidence that carefully thought-through plans for improving systems in such firms will deliver high standards of risk management and monitoring. For many such firms that will imply a step change in performance. Our underlying objective is the development of prudent standards that properly implement the Directive. We have no interest in implementing the Directive so as to enable a pre-agreed number of firms to qualify to use the IRB or AMA approaches or in applying lowest common denominator solutions to particular policy issues. In all of this it is important to understand that the CRD, as the Basel Framework, is a tool to enable regulators to improve the risk-sensitivity of the capital standards of the industry as a whole over the next five to ten years.

1.30 These considerations are reflected in the strategic objectives set by the High-Level Advisory Group on Basel/CRD Implementation⁴ as the context within which the FSA will make its decisions:

- The FSA will interpret and apply Pillars 1 and 2 with the aim of achieving capital standards for regulated firms that are proportionate and risk-based, and that give appropriate incentives to good risk management.
- The FSA will interpret and apply Pillar 3 with the aim of achieving risk disclosures that are relevant and reasonable (in terms of costs and benefits) relative to the aim of encouraging market discipline.
- The FSA's application of the standards in the CRD should appropriately take into account how the Basel Framework is being implemented in other key jurisdictions, in part to minimise the potential for regulatory arbitrage and inequality.
- The FSA will seek to achieve early clarity on the key policy and practice choices that are project-critical to regulated firms' implementation plans. The FSA will base its policy and practice choices on an open and transparent process of both formal and informal consultation, and it will communicate regularly with the industry on key policy and practical issues.
- The FSA will base its supervisory practice in applying the CRD on its Arrow⁵ Framework.

Our approach to national discretions

1.31 In this CP we provide our views of how we will implement the principal national discretions in the Draft Directive. In each case, we have discussed

4 Chaired by Hector Sants, Managing Director, Wholesale & Institutional Markets, at the FSA. This group has met quarterly since July 2004. Minutes and papers are posted on our website at http://www.fsa.gov.uk/international/basel_tor.html.

5 Arrow is the risk-based approach to supervision developed by the FSA to facilitate our identification of risks and allocation of our resources. For more information, please refer to '*The Firm Risk Assessment Framework*', published in February 2003.

with industry representatives, through our Standing Groups, the approach we propose to take. We discuss the most significant national discretions in this paper; a full list is set out in Annex 4. (See also paragraph 1.34 (iv) below.)

Our commitment to ‘copy out’ and the circumstances in which we might be superequivalent to the CRD

- 1.32 In general, we intend to follow a ‘copy out’ approach to implementation. This means that the rules will generally be based on a copied-out version of the Draft Directive, with provision of additional guidance only where this is clearly justified. Our consultation covers the amending text in the Draft Directive which the Commission highlights in grey, but not the ‘white’ text which covers those provisions of the CAD and BCD which will continue unamended. We are also consulting on those provisions containing a mixture of ‘grey’ and ‘white’ text (see paragraphs 7.7 and 8.6 to 8.9).
- 1.33 The CRD is the first major directive to be implemented since we, with HMT, made a public commitment not to be superequivalent in our UK implementation of EU Directives unless we have a clearly justified case for requiring more than the Directive text.
- 1.34 We should comment on four classes of situation which might be thought to carry some potential for superequivalence. In our view, it is only in situations of the first kind that superequivalence arises.
- (i) Superequivalence, as commonly understood, describes implementation by a Member State which goes beyond the minimum that is necessary to comply with an EU Directive. There is a limited number of superequivalences proposed in this CP, notably in relation to capital, groups and the regulatory capital element of the integrated groups regime. In each case, we state clearly that we are proposing to be superequivalent and why.
- (ii) It is possible that other Member States may choose to implement aspects of the Directive in ways which achieve less than the EU text requires. If so, it will be those Member States whose approach is sub-equivalent to the Directive, not the UK approach which is superequivalent.
- (iii) Firms want us to be neither unduly prescriptive nor ambiguous in implementing the Directive. To help meet these sometimes conflicting expectations, we set out clarifications of certain words such as ‘material’ in the context of credit risk and ‘significant’ in the context of risk transfer where we believe that this would be helpful both for firms and for us. Such ‘elaboration’ does not in our view amount to superequivalence.
- (iv) The Draft Directive requires us to exercise a significant number of national discretions. Our approach to the principal national discretions within the Draft Directive is set out in detail in this paper. Firms may not agree with the way in which we propose to exercise the national discretions in all cases and should tell

us where and why they do not. We expect that CEBS will produce agreed guidance in relation to some of the more significant ones and where it does, we will follow that guidance unless there are demonstrable reasons why that would be inappropriate in the UK context.

Significant policy developments

Credit risk

- 1.35 We provide clarification on the entry criteria for the IRB approach. Two issues of particular concern to firms are the role of stress testing and the treatment of low default portfolios (LDPs). In this consultation we have suggested a way in which the Directive requirements on stress testing should be interpreted, including in relation to movements in the economic cycle. Suggestions on how this should be developed further are welcome. On LDPs, there are no specific references in the Draft Directive and therefore no specific treatments for them. We believe that it should be possible to include firms' LDPs in the IRB approach and are working with the industry on ways to achieve the Directive requirements, aiming to complete our work in the first half of 2005. We are also contributing to the work of CEBS in this area and will take account of its conclusions in our national implementation. (Chapter 7)
- 1.36 On the standardised approach, there are a number of key areas where we have had to make choices. One of these is the risk-weighting of loans secured by residential mortgages. Following discussions with the industry to determine the appropriateness of our proposed approach, we have revised our CP189 proposals to take account of evidence of the loss experience in the UK on higher Loan-to-Value (LTV) lending. (Chapter 5)

Operational risk

- 1.37 We outline the purpose of operational risk requirements and the operational risk measurement methodologies available to calculate these. We also describe the proposed use of the relevant national discretions, including the exemption for investment firms that do not deal on own account from the operational risk capital requirement. The various issues on the AMA still under consideration are set out in some detail, including the policy options for these issues and our preferred approaches. We focus particularly on qualitative requirements, such as the 'use' test, and the quantitative requirements. We are also contributing to the work of CEBS in this area and will take account of its conclusions in our national implementation. (Chapters 10 and 11)

Credit Risk Mitigation

- 1.38 The new credit risk mitigation framework will have a significant impact on firms' regulatory capital, in particular how collateral is recognised as a risk mitigant. The definition of eligible collateral has been broadened as has the number of different approaches for calculating regulatory capital. Firms using approaches based on the volatility adjustment may see an increase in regulatory capital whilst firms permitted to use recognised internal models may see a reduction. The proposals for credit derivatives and guarantees are more detailed than our current rules. (Chapter 13)

Securitisation

- 1.39 The CRD takes forward the current regime and develops a more sophisticated and risk-sensitive framework. A direct consequence of this is the ability to remove a number of the current restrictions. This means that firms will now be permitted to retain any tranche within the structure and not just the equity piece, buy back any tranche at fair market value, remove market-making limits and recognise any amount of risk transfer however small. Implicit support remains a key aspect of the framework and we have taken the opportunity to clarify further what is required. (Chapter 14)

Treatment of groups

- 1.40 The provisions of the CRD will apply both to individual firms and to groups. We recognise that membership of a group can, in the right circumstances, be a source of strength to firms. We are therefore proposing to take advantage of a number of the national discretions that allow us to modify the requirements for firms that are members of groups. So we intend to allow firms to include within their capital adequacy and concentration risk calculations certain subsidiaries that are, in substance, divisions of the firm. And we propose modified capital and concentration risk requirements for intra-group exposures that arise within businesses whose risks are managed on an integrated basis. (Chapters 2, 8 and 12)

Individual Capital Assessments/Pillar 2

- 1.41 The Draft Directive introduces a requirement for firms to have their own processes to assess their capital adequacy which we will review as a basis for providing individual capital guidance. This mirrors Pillar 2 of the Basel framework. We have closely followed CEBS' work in designing our proposed approach, but there will need to be extensive dialogue between firms and supervisors to understand differences between their respective assessments so as to produce a fair and

consistent regulatory standard. This will be an iterative process over several years. We therefore encourage firms to start work now on designing their internal processes based on the draft rules and guidance set out in this consultation paper. For some firms the supervisory review of such internal capital assessment processes is new, for others, it represents a change of emphasis, with their own assessment of their capital requirements now playing a crucial role in the process. (Chapter 4)

Proposed treatment of investment firms

- 1.42 We propose to implement all of the Draft Directive's national discretions that relate to 'limited licence' and 'limited activity'⁶ firms and their groups. These are: the exemption from operational risk capital requirements for such firms and for 'limited' groups; and the exemption from consolidated supervision. (Chapters 2, 10 and 12)

Implementation timetable

- 1.43 Our implementation timetable is dependent on the European timetable for finalising the CRD. Our timetable is also based on the EU's proposed implementation dates. All firms must adopt the Basel Framework/CRD by 1 January 2007. However, at that point, while firms must apply Pillar 2 and 3 as stated, they will have a number of options relating to Pillar 1. Firms will be able to choose between the basic indicator or standardised approach for operational risk, and either the standardised approach or Foundation IRB or Retail IRB for credit risk. There will, in turn, be two options under the standardised approach for credit risk: firms may move to the standardised approach for credit risk under the Basel Framework/CRD or elect to remain on Basel 1 until 1 January 2008.⁷
- 1.44 To the extent that firms opt to stay on Basel 1 for credit risk, they may have a corresponding reduction in their Pillar 1 charge for operational risk. But, from 1 January 2008, when the Basel 1 method becomes invalid, all firms must apply the standardised or IRB approaches for credit risk and either one of the simple approaches or the AMA for operational risk. A delay in the EU process could push the initial implementation date beyond 1 January 2007. The Council and Parliament might then decide on a single implementation date of 1 January 2008 or opt for two different start dates.

⁶ 'Limited licence' and 'limited activity' firms are defined in the proposed Glossary amendments in Appendix 1. Broadly, they are investment firms that do not carry on principal dealings activities, or do so only within restrictions.

⁷ BCD Article 152(7).

Home-host issues

- 1.45 For firms' compliance with prudential requirements, we continue to regard the generally accepted policy of home country control as the norm. We also recognise firms' desire for streamlined regulatory arrangements regardless of the number of different countries in which they operate. However, the changing economic landscape, in which the interactions between firms and national economies are now greater and closer than ever before, and new complexities, such as the approval of firms' internal risk models, require meaningful responses which take account of the differing perspectives of those involved.
- 1.46 We are considering the home-host relationship in all aspects of our implementation work: on the component parts of Pillar 1, on Pillar 2 and, of course, on applications to use the advanced approaches for credit risk and operational risk. We recognise that practical problems may arise for multi-national groups that have to apply the Basel Framework/CRD in several different jurisdictions - within the EU or globally.
- 1.47 In the EU, there is a legal framework for risk model approvals, as set out in Article 129 of the Draft Directive. Whatever the final detail of its wording, we are planning on the assumption that a single application will be submitted to the home supervisor. This would involve co-operation with all host supervisors, but especially where subsidiaries in host countries are considered to be systemic. It is currently intended that supervisors should co-operate in order to agree an opinion within six months of submission of the application. If this is not achieved, it would be for the home supervisor to make the decision, taking whatever account they deem appropriate of the views of the host supervisors. We see this as designed to encourage supervisors to reach agreement, rather than to default to unilateral home supervisor decisions.
- 1.48 Outside the EU, there is no legal framework for model approvals. Accordingly, the only way to proceed is by agreement. Work continues in the Accord Implementation Group (AIG) under the Basel Committee and in the supervisory colleges (meetings of relevant regulators to discuss particular international financial groups) to develop good practice between supervisors.
- 1.49 Where we are home supervisor, we will take the lead role in communicating with host supervisors on a group's implementation plans. This may include our convening colleges of overseas supervisors. Where we are host supervisor, we will rely on the home supervisor to take the lead in communication with host supervisors. If we require information from the firm or the parent (as a result of our responsibility for the capital requirements of subsidiaries on a sub-consolidated basis) we will continue with routine supervision, making information requests as necessary following liaison with the home regulator.

- 1.50 We are aware that individual G10 supervisory authorities may expect a firm to operate at a level (for example to adopt an advanced approach) which we and the UK entity concerned do not consider appropriate. Our underlying philosophy in this area remains not to compel a firm to adopt a particular approach nor to prohibit it from doing so. This would be our starting point for discussing an individual firm with another regulator. Where we have doubts over the suitability of a model reviewed by other supervisors for the UK operations of a group - or about the suitability of a model produced by a UK firm for its operations in other countries - we would also expect to explain our reasons to the other regulators involved.
- 1.51 While much practical detail remains to be resolved between supervisors at G10 and EU level, we encourage all UK firms with specific issues on home-host arrangements to raise them with their relevant supervisors.

Next Steps

- 1.52 To help firms continue to make progress with their preparations for implementation, we will:
- intensify the work in the Standing Groups, placing a clear focus on the priority policy areas of each, and fully involving firms in the production of practically-focussed recommendations and solutions;
 - continue to offer practical guidance through the FAQ process;
 - encourage firms to engage in a dialogue with their usual supervisory contacts, to ensure that their individual circumstances and implementation plans are well understood;
 - participate in conferences and seminars on Basel/CRD implementation, including attendance at seminars run by trade associations focusing on different sectors;
 - assess the UK's implementation approach against that of other EU Member States; and
 - continue to work actively in CEBS and the AIG to secure outcomes which will help to ensure consistent and proportionate implementation of the CRD across the EU and of the Basel Framework globally.

Small Firms

Implementing the CRD is a challenge for all firms within its scope. Such firms will have to implement changes to minimum capital requirements, the internal capital assessment and significant changes to their controls environment. To assist firms in this process, and to help us understand firms' intentions so that we can focus our efforts as effectively as

possible, we are in correspondence with all relationship-managed firms, asking whether they are aware of the impact of the CRD on their firm and how they will deal with implementation.

But it is important to us that we engage with small firms and fully understand the issues they may be facing in their implementation of the CRD. We plan to do so through close dialogue with the relevant trade associations, including the BBA, APCIMS and the IMA.

The CRD provisions in themselves do not discriminate against small firms. However, we recognise that in practice it may be difficult for smaller firms to aspire to the advanced approaches, not least because of the systems and compliance costs involved. In our implementation work on the advanced approaches and more generally, there is therefore a clear focus on not increasing the cost to smaller firms and on not increasing the ‘penalty’ for firms on the standardised approaches where we have national discretion.

An example of this is the risk weighting of residential mortgages. The risk weight for residential mortgages under the standardised approach is 35%, but supervisors are required to ensure that this weight is only used if there is a ‘substantial margin’ by which the value of the property exceeds the loan. It is up to Member States how to define ‘substantial’. We suggested in CP189 that the 35% risk weight should apply to the proportion of a loan up to 75% Loan-to-Value (LTV), with a marginal risk weight of 75% applied to the residual amount. As a result of the responses received to that consultation and concern about the extent of the difference between the IRB and standardised approaches in this area, we are now proposing to set the point beyond which the 75% weight applies at 80% rather than 75% LTV.

Particular chapters of this CP will have greater or lesser relevance for smaller firms depending on the type of business they do. For most small *deposit-takers*, the CRD will primarily require a move from Basel 1 to the standardised approach for credit risk and the simpler approaches for operational risk. The management of these firms should therefore focus attention on Chapter 5 (‘The standardised approach to credit risk’), Chapter 4 (‘Individual capital adequacy standards’), especially the paragraphs on self-assessment (4.9 to 4.11) and the simpler forms of operational risk treatment in Chapter 10. To the extent firms use credit risk mitigation and securitisation techniques, Chapters 13 and 14 will also be important.

The position of small *investment firms* is more complicated. Such firms will likely find it helpful to read Chapter 2 for an account of what will determine whether, and if so how, they are caught by the CRD. The other sections of the CP likely to be of most relevance are Pillar 2 self-assessment and transitional arrangements in Chapter 4 (paragraphs 4.9 to 4.11, and paragraph 4.42 to

4.45) and the simpler forms of operational risk treatment in Chapter 10 (paragraphs 10.1 to 10.11).

Credit unions are exempt from the provisions of the CRD.

Most *retail advisory firms* - IFAs and others – can expect to be exempt from the CRD, either explicitly or through an expected UK exemption of ‘advice only’ firms from the scope of implementation of the Markets in Financial Instruments Directive (MiFID).

General insurance and mortgage brokers will be unaffected unless they also do other business or form part of a larger group containing a deposit-taker or investment firm.

Consumers

The objectives underlying the CRD and its planned implementation in the UK are primarily prudential in nature. The proposals in the CP will therefore affect consumers only indirectly. However, the significant enhancements which we expect the CRD to bring to the prudential framework for banks and investment firms should make it less likely that institutions fail. This will help us to meet our statutory objective of maintaining market confidence and have indirectly positive implications for consumer protection. We are aware of two specific concerns about the possible impact of CRD implementation on consumers:

- (i) Small specialist lenders who focus on consumers with poor credit histories might be forced to leave the market because of the increased costs of capital and compliance. This could deprive such consumers of access to credit.
- (ii) Lenders may choose to market credit cards in preference to term debt because lending by that means will attract a lower capital charge. That could raise the cost of borrowing for some consumers and exacerbate concerns about consumer indebtedness.

We are using a number of tools including market impact analysis and dialogue with firms to identify the extent of such problems and the likelihood that they will occur. We will then consider whether our exercise of the policy choices open to us within the terms of the CRD could reduce any likely problems.

2 Scope of application

The scope of the CRD

- 2.1 The Draft Directive applies to all deposit-takers other than credit unions and to investment firms.⁸ It also applies to certain groups containing such firms, whether headed by one of these firms or by a financial holding company.

Investment Firms

- 2.2 Throughout this CP, we use the term ‘investment firms’ to mean the non-deposit-taking firms to which the risk-based capital elements of the CRD – and therefore the draft Handbook text in Appendix 1 – will apply. This population of investment firms is generally defined as those subject to the requirements of the Markets in Financial Instruments Directive (MiFID).
- 2.3 There is an exception for firms that are only authorised to provide investment advice and/or to receive and transmit orders from investors without holding client money or assets. They will have to hold initial capital, professional indemnity insurance or a combination of the two. Our CP later this year on implementing the MiFID will contain proposals on the prudential requirements for these firms. We will also consult at that stage on any prudential requirements for ‘locals’.⁹ The prudential rules that apply to firms in both these categories will remain within the Interim Prudential Sourcebook for Investment Businesses (IPRU(Inv)).
- 2.4 More generally, there are uncertainties about the boundary between investment firms that will be subject to the CRD and firms that will not. These will be resolved in the coming months by:

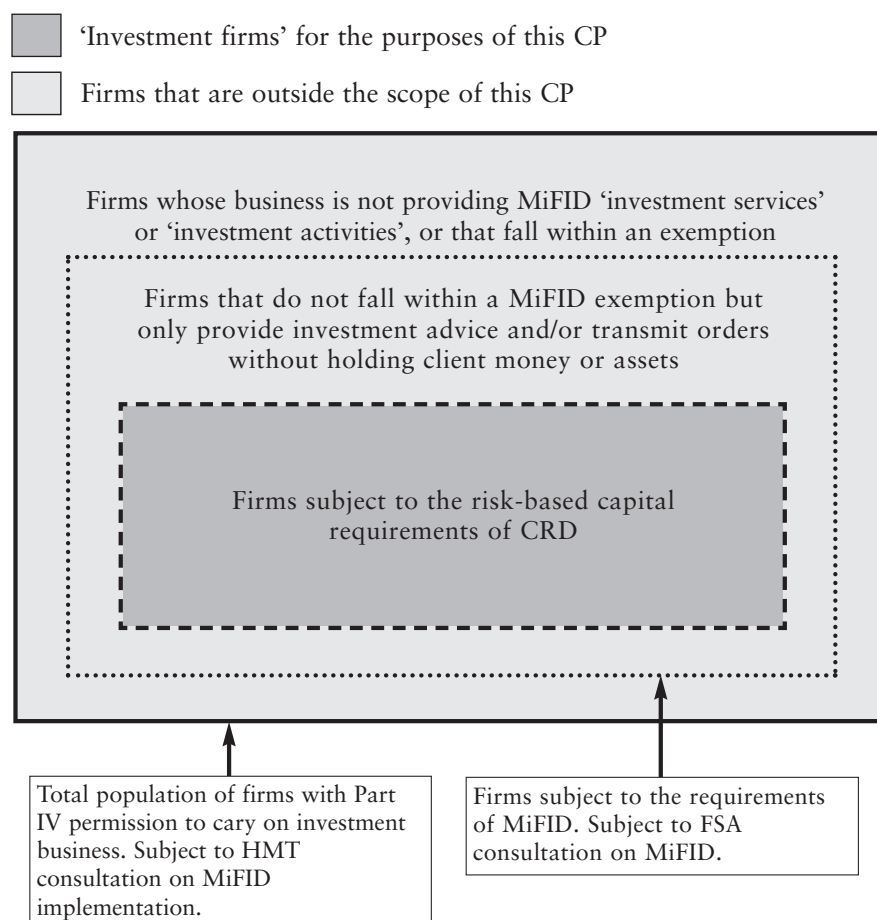
⁸ BIPRU 1.1 sets out our draft rules for determining which firms are within the scope. This assumes that the basic structure of the Regulated Activities Order will not change as a result of the MiFID implementation (see paragraph 2.4). If this assumption proves to be incorrect, BIPRU 1.1 will be amended, perhaps substantially.

⁹ Broadly speaking, a ‘local’ is a specialised trader on financial futures, options or other derivatives markets that can only undertake certain activities.

- HMT's consultation on amendments to the Regulated Activities Order as a consequence of the MiFID; and
- our consultation on MiFID implementation.

Together, these consultations will explain how the various mandatory and optional exemptions in the MiFID will apply to firms. That boundary will, in turn, define the investment firms that are subject to the CRD. So firms that are currently outside the scope of the CAD should be able to determine if they will be captured by the CRD once these consultations have been completed.¹⁰

2.5 The diagram below illustrates the various populations.



2.6 The MiFID is currently due to take effect by the end of April 2006,¹¹ eight months before the CRD. On this timetable our initial implementation of its prudential consequences will be done in the IPRU(Inv). Our second CP on implementing the CRD will take into account the investment firms that are brought into the scope of the risk-based capital requirements by the MiFID.

2.7 Firms remaining outside the scope of the CRD will continue to be subject to the IPRU(Inv). Our current presumption is that we will not change the

¹⁰ This may be of particular relevance to commodities firms, for example.

¹¹ Though there is growing recognition across Europe that this implementation date is unmanageably tight, to the extent of at least 12 months.

prudential requirements that apply to firms that are outside the scope unless there are strong reasons to do so. In that case, we will consult on our proposed changes at the appropriate time. A related issue is the treatment of these firms for the purposes of calculating the capital resources of a group the CRD applies to. We think that the Draft Directive requires the calculation of a ‘notional’ requirement as though the firm itself were subject to the CRD.

- 2.8 We do not comment on multilateral trading facilities in this CP as we will consider their treatment in our consultation on the MiFID.

Modifications to the solo requirements for a firm that is a member of a group

- 2.9 The Draft Directive applies at both a ‘solo’ (that is, individual firm) level and to groups. We describe our proposed approach to the capital adequacy of groups in Chapter 12. Here we summarise the various modifications we propose making to the solo prudential requirements for a firm that is a member of a group.

Retention of solo requirements

- 2.10 The Draft Directive contains a national discretion¹² that would permit the complete disapplication of solo systems and controls, capital adequacy and concentration risk requirements. In principle, we could apply this to a bank or investment firm whose ‘financial’¹³ parent is in the UK and whose group is subject to consolidated supervision by us provided that a number of conditions are met. Based on the ECOFIN text, these are:
- there is no current or foreseen material or legal impediment to the prompt transfer of own funds or repayment of liabilities by the parent undertaking;
 - either:
 - o the parent undertaking satisfies the competent authority regarding the prudent management of the subsidiary and has declared, with the consent of the competent authority, that it guarantees the commitments the subsidiary has entered into; or
 - o the risks in the subsidiaries are of negligible interest;
 - the risk evaluation, measurement and control procedures of the parent undertaking cover the subsidiary; and
 - the parent undertaking holds more than 50% of the voting rights attaching to shares in the capital of the subsidiary and has the right to

12 BCD Article 69.

13 That is, a parent that is a credit institution, investment firm or financial holding company.

appoint or remove a majority of the members of the management body of the subsidiary.

- 2.11 We understand that most Member States are unlikely to implement this national discretion. We have never applied the similar provision in existing directives,¹⁴ and do not propose to implement this revised national discretion. Individual firms – rather than groups – have obligations to consumers and this is the fundamental reason for setting solo prudential requirements. In principle, an enhanced form of group supervision could be a partial substitute, and this idea underpins the solo modifications described in paragraphs 2.12 to 2.30. But a complete waiver of solo requirements would be incompatible with our consumer protection and market confidence objectives because:
- there would be no assurance about the financial soundness of the individual firms that consumers deal with;
 - we could not require unregulated or non-UK entities in a group to support the obligations of firms;
 - whilst we could, in principle, require robust support arrangements between the firms in a group (and the second condition in paragraph 2.10 would require that in some cases):
 - o this could lead to customers of one firm being preferred over those of another; and
 - o all of the firms in a group would stand or fall together, which could have systemic consequences.

Modifications of solo requirements

- 2.12 We recognise that membership of a group can be a source of strength to a firm. We also acknowledge that, in some circumstances, the risks to a firm from transactions with other members of its group can be lower than those arising from business with third parties. We therefore propose certain modifications to the solo regime applying to a firm that is a member of a financial group. In summary, these are:
- solo consolidation of subsidiaries that are, in substance, operating divisions of the firm (see paragraphs 2.15 to 2.22);
 - an integrated groups regime for exposures arising from business whose risks are managed on an integrated basis (see the overview in paragraphs 2.23 to 2.30); and
 - treasury concessions for exposures arising from centralised group treasury functions (see paragraphs 8.24 and 8.25).

14 Though, in technical terms, we have historically used it to implement some of the solo modifications discussed here.

Annex 8 contains flowcharts showing the relationship between the various modifications.

- 2.13 In the Interim Prudential Sourcebooks (IPRUs), these modifications are generally available to banks and, in some cases, building societies. We now propose that all deposit-takers and investment firms should be eligible to take advantage of them.
- 2.14 On the other hand, the capital – and ‘capital-like’ funding – a firm provides to its subsidiaries or participations cannot simultaneously be used by the firm to support its own activities. We therefore require firms to deduct from capital both:
- their investments in subsidiaries¹⁵ and participations; and
 - any lending to subsidiaries and participations that is capital in nature (see paragraphs 3.17 and 3.18).

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

Solo consolidation

- 2.15 The Draft Directive¹⁶ allows solo consolidation of subsidiaries that are in substance operating divisions of their parent firm. So the parent firm’s calculations of its solo capital adequacy and concentration risk requirements are based on a partial consolidation taking into account these solo consolidated subsidiaries. And the firm’s investments in, and exposures to, those subsidiaries are eliminated in the solo consolidation.
- 2.16 The ECOFIN text contains significant changes to the Draft Directive’s provisions on solo consolidation. We describe below our current thinking on implementing these amended provisions. But the draft Handbook text in this CP does not contain proposed rules and guidance on solo consolidation. We will include this in our second CP; in broad terms, we will:
- specify the conditions to be met if a subsidiary is to be solo consolidated, as described here; and
 - require solo consolidation to be carried out by applying the provisions for consolidation in BIPRU 8.
- 2.17 In the IPRUs, solo consolidation is available to banks and building societies, but not to investment firms. We now propose to make it available to all

15 Other than those that are solo-consolidated.

16 BCD Article 70.

deposit-takers and investment firms and, based on the ECOFIN text, we will be able to do so. In addition, the ECOFIN text contains no geographical restriction on the subsidiaries that can be solo consolidated.

2.18 The solo consolidation conditions in the ECOFIN text (in bold type), and our proposed detailed criteria for this national discretion, are set out below.

- **The subsidiary's material exposures or material liabilities are to the parent;**
- **The parent holds more than 50% of the voting rights attaching to shares in the capital of the subsidiary.** We intend to require 75% ownership. This is the majority required to pass a winding-up resolution. It is also our existing policy and so should have no impact on firms;
- **The parent has the right to appoint or remove a majority of the members of the subsidiary's management board;**
- **The risk evaluation, measurement and control procedures of the parent cover the subsidiary.** In particular:
 - o 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
 - o if the parent uses an internal ratings based approach, market risk model or operational risk advanced measurement approach that is suitable for the activities of the subsidiary, we will expect its use to be extended to cover the subsidiary;
- **The parent demonstrates fully to us the circumstances and arrangements, including legal arrangements, by virtue of which there are no current or foreseen material practical or legal impediments to the prompt transfer of own funds or repayment of liabilities on demand by the subsidiary to its parent.** In meeting this test, firms will need to consider matters such as exchange controls, legal restrictions and taxation, though this list is not exhaustive. In addition:
 - o Any liabilities of the subsidiary to its parent will need to be repayable on demand;
 - o The parent should be able to initiate a prompt winding-up of the subsidiary;
 - o We think it unlikely that a regulated subsidiary could meet this condition because regulators typically impose constraints on the ability to transfer own funds;¹⁷ and
 - o For an indirect subsidiary, we propose that the parent should obtain an ongoing legal opinion confirming that this test is met.

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

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?

2.19 We had intended proposing that most eligible subsidiaries could be solo consolidated under a notification procedure, rather than by waiver. But we are re-considering that issue in the light of the new requirement in the ECOFIN text that firms should 'demonstrate fully' to us that own funds are transferable and liabilities can be repaid on demand.

2.20 We propose that solo consolidation should not be permitted if the firm's solo tier 1 capital¹⁸ after deduction of its aggregate investments in solo consolidated entities would fall below half of its solo capital requirements. This is superequivalent to the Draft Directive but we believe it is necessary to limit the extent to which solo consolidated subsidiaries could drain capital from a firm. Based on our estimates for a small sample of firms, we do not expect this condition to have a significant impact. As noted in paragraphs 10.3 and 10.4 of Annex 2, the great majority of firms interviewed by LECG had no comment on this proposal. Three of the largest firms felt that it might lead to a need for increased capital but did not identify any resulting changes in their own behaviour or that of key market sectors.

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?

2.21 Based on the ECOFIN text, we will be required to:

- Notify the competent authorities of all other Member States at least annually of the 'use made' of solo consolidation in the UK and of the 'circumstances and arrangements' described by firms under the last point in paragraph 2.18;
- Provide the same information to the competent authority of any third country where a solo consolidated subsidiary is located;

17 But this would not exclude a subsidiary that is subject to our prudential regime for mortgage lenders. The capital requirements in PRU 9.3 do not apply to a solo consolidated subsidiary of a bank or a building society (see PRU 9.3.4R(3)).

18 That is, assuming no solo consolidation

- Disclose publicly:
 - o the criteria that we apply to determine that there is no material impediment to the transfer of own funds or repayment of liabilities;
 - o the number of firms that apply solo consolidation and the number that solo consolidate third country subsidiaries;
 - o the aggregate amount of firms' capital resources that is invested in solo consolidated third country subsidiaries; and
 - o the percentage that this represents of those firms' capital resources and capital resources requirements.

2.22 Firms will have to provide the basic information needed so we can comply with these obligations. We will consult on proposed notification and reporting requirements in our second CP or in the parallel CP on regulatory reporting.

Integrated groups: an overview

2.23 This CP represents our current thinking on the integrated groups regime. This updates our proposals in CP97. Views are sought so we can deliver a final proposal in our second CP.

2.24 A form of integrated groups treatment is currently potentially available to banks under IPRU (Bank). This allows exposures between the members of a bank's integrated group to receive a 0% risk weighting. Banks may also receive large exposures concessions, exempting certain intra-group exposures from large exposures limits. An integrated groups regime is not currently available to building societies and investment firms. However, these types of firm have alternative means of achieving modified capital requirements, where warranted. In addition, they are potentially able to receive a range of large exposures exemptions for exposures to counterparties connected to the firm.

2.25 We proposed in CP97 to apply an integrated groups treatment to banks, building societies and investment firms. The rationale for applying a single integrated groups regime to banks, building societies and investment firms is to harmonise between sectors the conditions for 0% risk weight, and large exposures exemptions, for intra-group exposures. We remain committed to this harmonisation.

2.26 In our revised integrated groups proposal (see BIPRU 10), we distinguish between exposures to UK-incorporated members of an integrated group ('the UK integrated group') and exposures to other group companies. We do not propose to apply limits or require capital against exposures at the solo level in either the trading or non-trading books between members of a UK integrated group. Because of the different legal and regulatory circumstances applying outside the

UK, we proposed in CP97 to set limits and require capital against exposures to members of the group incorporated outside the UK in the same way as for non-integrated groups (in both the non-trading and trading books). But firms may apply for a waiver from these limits under specified conditions, and form a 'wider integrated group'. We propose to continue with this approach.

2.27 The risk weighting aspects of the revised integrated groups regime are discussed in detail in Chapter 5 on the standardised approach and in Chapter 7 on the IRB approach. For more detailed discussion of the large exposures aspects of integrated groups – including explanation of the wider integrated group - please see Chapter 8. Examples and flow charts showing how the regime is applied can be found in Annex 8.

2.28 The key areas in which capital and large exposures requirements are modified under the revised integrated groups regime are:

- under the standardised approach, exposures between members of a UK integrated group are exempt from large exposure limits and all capital requirements;
- as part of its IRB waiver, a firm may apply to permanently exempt from the IRB approach certain intra-group exposures to certain types of group companies for integrated groups purposes. Such exposures would be subject to the standardised approach, and potentially eligible for the UK integrated groups treatment;
- large exposures limits on exposures to non-UK members of the integrated group may be increased beyond normal limits through the waiver; and
- provided it meets the requirements in BIPRU 10.6.7R, the integrated group may use a treasury concession to increase the scope of its intra-group lending that is exempt from large exposures limits (see BIPRU 10.6.8R to 10.6.12R).

2.29 In CP97, we recognised that by relaxing our standards for firms that are part of an integrated group - without taking into account the potential impact on consumers and markets - we could potentially create competitive advantages for groups. We explained in CP97 that, even so, we have to take account of the effects on UK competitiveness of *not* accommodating integrated approaches to the management of groups. We believe that this remains the case.

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

2.30 Together with our approaches to capital deductions and solo consolidation (see paragraphs 2.15 to 2.22), the revised integrated groups regime forms part of a package of treatments of solo capital and large exposures

requirements. In defining each approach, we have considered the combined impact of the three elements. We believe the effect of the overall package to be prudentially appropriate. We are keen to receive views from firms on the clarity, proportionality and appropriateness of this package. We will be eager to discuss the substance and form of our revised integrated groups regime when we pre-consult the industry for our second CP.

Q6: Is our overall approach to integrated groups clear?

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

3 Capital resources and valuation

Introduction

- 3.1 This chapter sets out proposed changes to our requirements for the minimum amount, and definition, of capital that firms must hold as well as general rules for the valuation of assets, liabilities and income statement items.

Capital resources

- 3.2 For most firms the minimum amount of capital required is the higher of a fixed minimum amount of capital and a further amount based on a firm's individual risk profile. Most investment firms are also subject to a fixed overheads requirement (previously known as an expenditure-based requirement). A combination of these amounts is known as the firm's Capital Resources Requirement (CRR). Our draft rules for the CRR are set out in Appendix 1 at GENPRU 2.1.
- 3.3 We also propose rules concerning the types of eligible capital that make up a firm's capital resources. Capital is divided into categories or tiers which reflect the permanence and loss absorbency of that capital. These capital resources must at all times be equal to - or higher than - a firm's CRR. Our draft rules on eligible types of capital resources are set out in Appendix 1 at GENPRU 2.2.
- 3.4 The following factors have shaped our approach in developing our policy on capital resources:
- The definition of capital has not been materially changed by the Draft Directive, but will be subject to a more fundamental review by 2009 which should lead to greater convergence between Basel and EU definitions of capital. We need to include a definition of capital in this CP and, more particularly, the draft Handbook text, so that firms can assess the impact of the more substantive changes to the risk based capital

requirements introduced by the Draft Directive, and to deal with the consequential changes to the definition of capital.

- We have already consulted and issued Policy Statements on the definition of capital. Most significantly, we consulted in CP97 in June 2001 (on integrated capital rules), CP155 in 2002 (on tier 1 capital for banks) and issued the changes in PS04/16 in 2004 (insurers).
- We remain, where possible, committed to making our prudential policy consistent across sectors. To achieve this, we need to make some limited changes to the existing policy in the various Interim Prudential Sourcebooks (IPRUs). Overall, we believe that the proposed policy is proportionate and achieves a sound quality of capital for all sectors.

3.5 Following the approach in paragraph 3.4 above, we have needed to do more than simply copy-out the definition of capital in the Draft Directive in our draft Handbook text. We have therefore drafted the rules in GENPRU 2.1 and 2.2 on the following basis:

- we have carried forward the policy on capital resources for credit institutions and investment firms that we consulted on in CP97;
- we have copied out the limited changes introduced by the Draft Directive;
- we have applied the rules on core and innovative tier 1 capital for banks, that came into force in January 2004, to building societies and investment firms; and
- we have developed our rules for credit institutions and investment firms based on the structure in CP97 as updated for the rules which are now in force for insurers.

Changes to the definition of capital arising from the Draft Directive

3.6 The Basel Framework does not include the definition of capital. Therefore, most of the BCD provisions concerned with the definition of capital are unchanged by the Draft Directive. However, the Draft Directive does make some changes to the definition of capital which are consequential to the changes to the measurement of credit risk and securitisation. The Draft Directive also reverses some of the effects of international accounting standards (IAS) where firms adopt these. There are changes associated with IAS - for example, the exclusion from capital of fair value reserves related to gains or losses on cash flow hedges of financial instruments measured at amortised cost and any gains or losses on a firm's liabilities valued at fair value that are due to changes in that firm's own credit standing. We have consulted separately on these - in CP04/17.¹⁹

19 *Implications of a changing framework*, October 2004

- 3.7 We set out the proposed changes to our capital requirements below. There is further background on these changes in Chapters 7 and 14.
- Firms calculating risk-weighted exposure amounts under the IRB approach must deduct negative amounts (resulting from the subtraction of expected loss amounts from provisions and other expected loss amounts) from capital resources (50% from tier 1 and 50% from tier 2).
 - The exposure amount of securitisation positions, which would receive a risk weight of 1250% under the IRB approach, must be deducted from total capital resources (but see paragraph 3.8) unless the firm includes the positions in its calculation of risk-weighted exposure amounts.
 - In the case of a firm that is the originator of a securitisation, net gains arising from the capitalisation of future income from the securitised assets and providing credit enhancement to positions in the securitisation must be excluded from reserves.
 - For firms calculating risk-weighted exposure amounts under the IRB approach, positive amounts resulting from the subtraction of expected loss amounts from provisions may be included in upper tier 2 capital resources, up to 0.6% of risk weighted exposure amounts.
- 3.8 The ECOFIN text introduces some changes to the provisions in the Draft Directive that define capital resources. Their purpose is to improve consistency with the Basel Framework and the broad effect is to require that certain deductions, currently made from total capital, should be deducted half from tier 1 capital and half from tier 2. The relevant deductions relate to:
- material holdings;
 - investments in insurance subsidiaries and participations;
 - expected loss amounts (see paragraph 3.7); and
 - certain securitisation exposures (see paragraph 3.7).
- 3.9 This change in the location of the deductions does not affect the calculation of the limits on different forms of capital. It therefore has no impact at all on the overall level of regulatory capital. We believe that the amendment is intended to affect how firms (and groups) present their capital resources - both in the returns to us and for public disclosure purposes. We intend to consult on that basis in our second CP and in the parallel consultation on regulatory reporting.

Other changes proposed to the definition of capital

- 3.10 We propose a number of other changes to the rules in the existing IPRUs that are not required by the Draft Directive. We aim, where appropriate, to make

our rules consistent for the different sectors of the industry to create a level playing field in the capital markets, especially where the rules derive from the same directives. We consulted on this in CP97 (June 2001) followed by a Policy Statement in July 2002 (PS115). CP97 covered issues such as material holdings deductions, requirements for eligibility of subordinated debt and the components of, and limits on, the various tiers of capital. We do not revisit in this CP the changes we consulted on in CP97. So the draft rules set out in this CP incorporate policy decisions published in PS115.

- 3.11 The draft rules in GENPRU 2.1 and 2.2 also reflect the final decisions made after recent policy consultations, in particular CP155 issued in October 2002 (and related Policy Statement issued in November 2003) on banks' tier 1 capital and CP204 on implementing the Financial Conglomerates Directive, issued in October 2003.
- 3.12 We propose making some changes to the rules which we have not previously consulted on as set out below. Where these changes may impose additional costs on firms, we comment on the potential impact.

Innovative tier 1

- 3.13 The innovative tier 1 category of capital is currently only available to banks and insurers. We propose to make it available to building societies and investment firms. Innovative tier 1 is recognised under the Basel Framework but not under the Draft Directive. GENPRU 2.2 defines the characteristics such instruments must have to be treated as innovative tier 1 capital. Innovative tier 1 can be included in total tier 1 up to a maximum of 15%. Instruments which are eligible for innovative tier 1 treatment under our rules are not eligible for tier 1 treatment to meet the Draft Directive minimum requirement. However, they can count towards a capital buffer above the Draft Directive minimum requirements, including any individual capital guidance we give under our Individual Capital Adequacy Standards (ICAS) framework – see Chapter 4. Holding innovative tier 1 capital also permits firms to issue a greater amount of eligible tier 2 capital. The draft rules in this CP for innovative tier 1 capital broadly follow the guidance currently set out in IPRU (Banks) which has been considerably expanded since CP97.

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

Permanent Interest Bearing Shares (PIBS) issued by building societies

- 3.14 We propose classifying PIBS in a similar way to permanent non-cumulative preference shares issued by proprietary firms. PIBS would be subject to the same limits as permanent non-cumulative preference shares,

and so restricted to 50% of total tier 1. This is a higher limit than currently permitted in IPRU (Building Societies). Under the draft rules in GENPRU 2.2, it is not solely the legal form of the instrument that qualifies it for a particular tier of capital but also its features, particularly its ability to absorb losses and permanence. PIBS with innovative features - such as interest rate step-ups at a future call date or capitalisation of deferred interest - will be eligible to be treated as innovative tier 1 only. We propose to permit all existing PIBS issued by 18 November 2004 to count as non-innovative tier 1 until their redemption.

- 3.15 We do not think the costs of our proposed policy will be material for the building society sector as a whole, since PIBS do not currently account for a significant proportion of that industry's regulatory capital. We estimate that the requirements for fully discretionary dividends and the restrictions on the use of step-up features may result in increased costs for future PIBS issues. However, we do not consider these costs to be material, or to outweigh the benefits of ensuring building societies hold an appropriate amount of higher quality, fully loss-absorbent capital.

Deduction of material holdings from capital resources

- 3.16 In CP97 we consulted on making the rules on the deduction of material holdings consistent for credit institutions and investment firms. In summary, these changes would result in a relaxation in the current requirements for credit institutions but a slight tightening for investment firms. We need to make one change to the CP97 proposals to ensure compliance with the Draft Directive. In PS115 we said that, for individual holdings of other credit institutions' or financial institutions' capital that exceed 10% of the issuer's capital, only the amount above the 10% threshold must be deducted. We are now proposing that the full amount must be deducted.

Connected lending of a capital nature

- 3.17 We are proposing to extend to building societies the requirement, which currently applies to banks, to deduct connected lending of a capital nature. We believe this is necessary so that firms do not count - as part of their available capital resources - lending which is potentially locked up in subsidiaries and may be unavailable in times of financial stress, and, even if available, has limited value.
- 3.18 We do not consider that the costs of our proposed policy will be material due to the extensive use of solo consolidation by building societies. For firms with significant (non solo-consolidated) subsidiaries, the deduction may have a material impact if the lending supports the business of the subsidiary. However, we consider that the benefits of capital being fully

available to a firm when it needs it outweigh the potential costs associated with the deduction.

Secondary requirements

- 3.19 We have decided to discontinue secondary requirements for investment firms (see IPRU(Inv)) as a capital charge for the purposes of calculating capital resources to meet the CRR. However, where appropriate, secondary requirements may be taken into account in determining the individual capital guidance we give to an investment firm under our ICAS framework – see Chapter 4.

Dividend discretion

- 3.20 To qualify as tier 1 or upper tier 2 capital, the terms of a capital instrument must permit the firm full discretion over dividend payments made in cash. This is because, in our view, good quality capital should have no fixed costs. This is also consistent with the requirements of the Draft Directive. To clarify our requirement, we have added guidance that dividend pushers, which oblige the firm to pay a dividend in cash on a security if a dividend has been paid on a junior security, or a security ranking *pari passu*, in a preceding period, should not be included in a tier 1 or upper tier 2 instrument.

Loss absorption on a going concern

- 3.21 Banks are currently required to obtain a legal opinion from Queen's Counsel to demonstrate that a directly issued capital instrument in tier 1 or upper tier 2, where it is not a share, can provide loss absorbency to the firm on a going concern basis. We propose extending this requirement to building societies and investment firms. We believe this produces a greater degree of flexibility than other approaches such as prescribing, for innovative tier 1 and upper tier 2 instruments, a particular conversion or write down feature in times of financial stress.
- 3.22 We consider that the additional costs of a Queen's Counsel opinion represent a small proportion of the overall costs incurred to raise capital. They do not outweigh the benefits of firms obtaining greater comfort that their capital is capable of absorbing losses to an appropriate degree.

Limit on preference shares

- 3.23 For investment firms we propose limiting the proportion of preference shares in tier 1: the total amount of preference shares and innovative tier 1 capital must not exceed 50% of total tier 1. This limit already applies to banks. We believe the limit is necessary because preference shares and

innovative tier 1 capital do not provide the same level of loss-absorbency to the firm as ordinary shares and reserves.

- 3.24 We do not consider that this proposed requirement will have a material impact on investment firms' capital costs. Currently, preference shares do not make up a high proportion of the capital resources of investment firms for the sector as a whole. This requirement should ensure that investment firms maintain the integrity of their tier 1 capital by holding a predominance of the highest quality tier 1 capital.

Fixed overheads requirement

- 3.25 We are proposing to revise our guidance on the definition of 'fixed overheads' referred to in Article 21 of CAD, which has commonly been known as the expenditure-based requirement (EBR). For consistency, the new definition follows the definition of 'fixed overheads' that we apply to UCITS firms in IPRU(Inv). We have also added some guidance on the purpose of the fixed overheads requirement (FOR) and what we believe might be included as 'fixed overheads'. This should help firms calculate an appropriate FOR.
- 3.26 This change will reduce the amount of capital that firms will have to hold where they have 'other variable overheads'. In addition, firms currently subject to the rules in Chapter 10 of IPRU(Inv) will benefit from being able to exclude from fixed overheads commissions paid to employees where these meet the requirements of section (d) of the rule ('shared commission and fees payable which are directly related to commission and fees receivable, which are included within total revenue').
- 3.27 We are also proposing to change the total capital requirement for limited licence firms²⁰ from the 'sum of' the FOR and credit and market risk charges to the 'higher of' the FOR and the risk-based charges. This will bring our rules into line with minimum EU Directive requirements. It will have most impact on those firms that currently hold the sum of the two requirements where the two components are a similar amount.
- 3.28 Overall, we estimate that the change to the FOR will reduce capital requirements by between 10% and 25% for relevant firms.
- 3.29 We are consulting on the basis that the FOR will not apply to own account dealers. This is not the position outlined in the Draft Directive, but it is reflected in the ECOFIN text.

20 'Limited licence firms' are defined in the proposed Glossary amendments in Appendix 1. Broadly, they are investment firms that do not carry on principal dealing activities, or do so only within restrictions.

- Q9: Are the draft rules in GENPRU 2.1 and 2.2 understandable and is their application to your firm clear?
- 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?
- Q11: Would the proposed changes to the definition of capital resources in GENPRU 2.2 and to the 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?

Valuation

- 3.30 The general rule for valuing and recognising assets, liabilities, equity and income statement items is to apply the accounting rules firms use for public financial reporting purposes. We give further rules and guidance where firms are required to depart from the general rule. The general requirements for valuation and recognition of assets, liabilities, equity and income statement items are set out in Appendix 1 at GENPRU 1.3.
- 3.31 The following approach underlies the draft rules in GENPRU 1.3:
- we have carried forward the policy on capital resources for credit institutions and investment firms that we consulted on in CP97;
 - we have incorporated the proposed policy changes set out in CP04/17;
 - we have developed our rules for credit institutions and investment firms based on the structure in CP97 as updated for the rules which are now in force for insurers.

Valuation of trading book positions

- 3.32 The requirement to value financial instruments held in the trading book will be the same for all categories of firms. We understand that there are currently differences in the application of this requirement between categories of firms and we intend for there to be a harmonisation of practices over time. The Trading Book Review (TBR) is looking at valuation practices, and we have also undertaken some cross-firm work in this area using our Consumer and Industry-Wide Framework. We intend to address this issue fully following the TBR.

Accounting changes

- 3.33 The changes associated with the changing accounting framework (such as the introduction of International Financial Reporting Standards) have been

consulted on separately in CP04/17. As highlighted in CP04/17, a number of accounting standards are undergoing significant revisions. There is still uncertainty about how these will affect the calculation of regulatory capital. We will continue monitoring the accounting developments and plan to review the results of the CP04/17 consultation in two years' time (or earlier, if appropriate). We will announce a timetable for this review towards the end of 2005.

4 Individual capital adequacy standards

Introduction

- 4.1 This chapter describes our proposals to implement the requirements for individual capital adequacy standards reflecting the provisions of Part 3 of the Basel Framework (Pillar 2), the Draft Directive and the May 2004 CP issued by CEBS.²¹
- 4.2 Individual capital adequacy standards are intended to achieve two important goals:
- to ensure that firms hold internal capital that is consistent with their risk profile and strategy; and
 - for supervisors to review firms' processes and strategies and to determine appropriate prudential or other measures if weaknesses or deficiencies are identified.
- 4.3 We do not intend to use this framework to impose ever higher capital requirements on regulated firms or as a means of negating benefits firms may derive from changes to the prescribed minimum capital requirements.
- 4.4 While the proposed framework is new, it substantially reflects current practices and processes that more sophisticated firms have either already implemented or are currently implementing to improve their management of both risks and capital. For less sophisticated firms we aim to keep compliance costs to a minimum and are committed to developing a proportionate regime.
- 4.5 The Draft Directive²² introduces requirements for two separate processes to achieve these goals. Individual capital adequacy standards therefore require:
- firms to develop and maintain an Internal Capital Adequacy Assessment Process (the ICAAP); and

21 *The Application of the Supervisory Review Process under Pillar 2*.

22 BCD Articles 123 and 124.

- supervisors to review and evaluate firms' ICAAPs as part of their ongoing Supervisory Review and Evaluation Process (the SREP).
- 4.6 In practice, the two separate processes will be closely linked, reflecting the dialogue that must take place between firm and supervisor.
- 4.7 We have drawn heavily on the high-level principles, set out in CEBS' May 2004 CP, for our definition of the two processes and to explain the interaction between them.
- 4.8 CEBS is doing further work on the SREP to achieve an appropriate degree of consistency of approach between supervisors. We may therefore need to modify our approach as a result of further CEBS guidance.

Characteristics of the ICAAP

- 4.9 We believe that, while a prescriptive framework would provide certainty and transparency, it could undermine the emphasis on firms' ownership of, and the governing body's responsibility for, the ICAAP. However, some guidance for firms beyond the minimal provisions in the Draft Directive is appropriate - particularly for smaller and less sophisticated firms. We aim to specify certain elements, which will enable us to make a fair comparison between a firm's ICAAP and SREP, and to ensure consistency between comparable firms.
- 4.10 Our draft rules requiring firms to undertake the ICAAP are set out in GENPRU 1.2 and BIPRU 2.2 in Appendix 1.
- 4.11 We propose to supplement the high-level principles set out in GENPRU 1.2 with additional material which will:
- focus on the information we believe all firms should consider when developing their ICAAP and which we expect to discuss with firms when we conduct our review and evaluation;
 - require that firms adopt an approach which is proportionate to their size and relevant to the nature of their business - that is, whether they are large, complex organisations or small, less sophisticated banks, building societies, securities firms or asset managers;
 - require that firms carry out stress tests and scenario analyses. We think these are good management practices. They will also provide information for us about the sensitivities in a firm's assessment and assist our judgement as to the appropriate level of capital;
 - give examples of the risks firms in different sectors may be exposed to and how they might assess the extent of their exposure to those risks;

- require that a firm's assessment provides information not only on the amount of capital it considers appropriate, but also on the composition of that capital (for instance, which amounts would be classified as tier 1, 2, or 3 under our rules or fall outside our definition of capital); and
- require that groups break down their group-level ICAAP so we can evaluate the extent to which diversification benefits have been incorporated into the underlying assumptions (see paragraphs 4.34 to 4.36).

The draft material does not:

- prescribe particular methodologies to quantify risks;
- list exhaustively the risks a firm needs to consider;
- set any particular calibration parameters for stress tests;
- require particular scenarios to be examined; or
- define any overall confidence level (see paragraphs 4.37 to 4.40)

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?

Characteristics of the SREP

4.12 The SREP is the process which we will use to:

- review and evaluate firms' exposure to risks (a firm's risk profile);
- review and evaluate the adequacy and reliability of firms' ICAAP;
- review and evaluate the adequacy of firms' capital resources and internal capital in relation to their overall risk profiles;
- monitor ongoing compliance with standards laid down in the Draft Directive; and
- identify any weakness or inadequacies requiring a regulatory response, including giving Individual Capital Guidance (see paragraphs 4.22 to 4.27).

4.13 The SREP will be delivered through the Arrow process, which will be modified to encompass the evaluation of the ICAAP as described above. We think this approach is consistent with the requirements of the Draft Directive and the CEBS high-level principles.

4.14 The reconciliation of the supervisor's view of firms' regulatory capital with the firms' own capital adequacy assessment, delivered through its ICAAP will be an important challenge. A firm is likely to make its assessment in terms of

internal or economic capital, and may use different assumptions from those the Capital Resources Requirements (CRR – see GENPRU 2.1) are based on, such as diversification or asset valuation assumptions.

- 4.15 The CRR will continue to provide supervisors with a frame of reference, while the ICAAP will help to inform firms and supervisors about risks for which no standard measurement methodology has been defined. But supervisors will inevitably have to make judgments.
- 4.16 The review and evaluation of the ICAAP will be performed consistently and systematically. As such, the dialogue will be structured so that supervisors can assess whether the capital held is adequate to cover:
- basic risks covered by the CRR;
 - risks not fully captured by the CRR;
 - other risks specific to the firm; and
 - risk factors external to the firm.
- 4.17 For firms applying for advanced model approaches, the approval process will be used to identify relevant aspects of the firms' approaches which cannot be addressed in the CRR. Accordingly, a significant proportion of the supervisor's own assessment may be informed by the detailed work to be performed as part of the approval process.
- 4.18 For firms adopting the standardised approaches, we will develop a template which identifies those elements unlikely to be adequately catered for by the standard models, and so requiring supervisory review.
- 4.19 The dialogue will also need to cover other risks which firms themselves identify as key. Considerations of such issues will need to be undertaken on a case-by-case basis.
- 4.20 It will be for the firm in the first place to justify its process for identifying and measuring other risks arising from its specific circumstances and how much capital, if any, it allocates against them. We aim to develop key elements to be covered in each risk category to ensure these can be compared appropriately in our dialogue with firms. This will bring together individual firm outcomes for benchmarking and peer group comparison purposes.

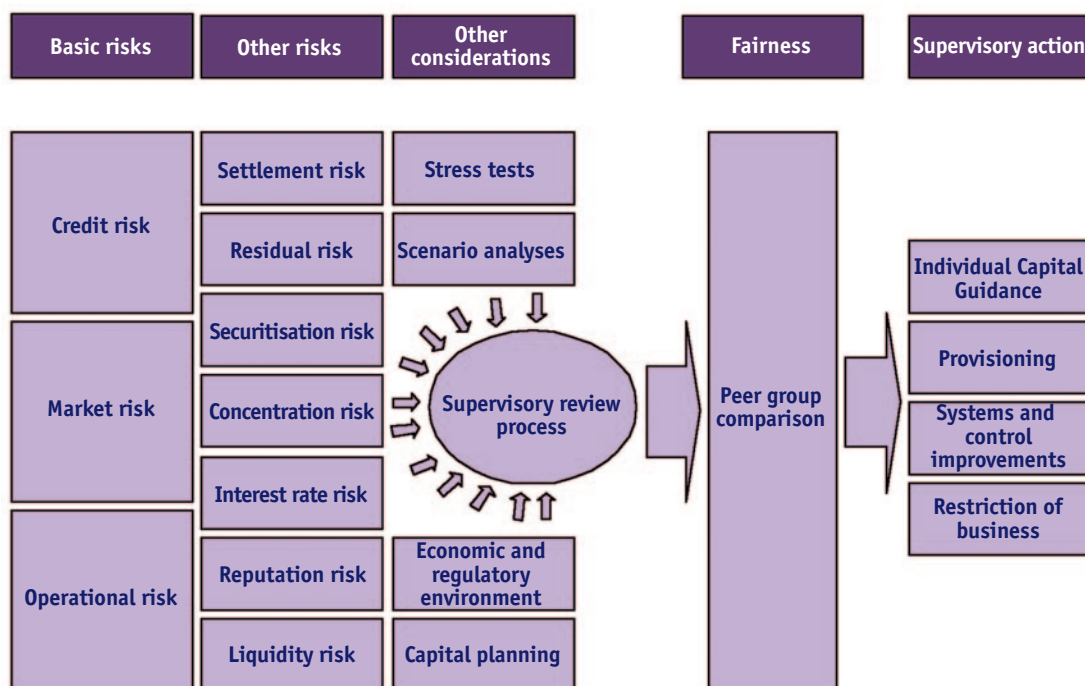
Intensity of the dialogue with firms

- 4.21 We will determine when the dialogue should start and how intensive it will be. The dialogue with large, sophisticated firms will reflect their complexity. For smaller firms, when we think a detailed dialogue is required, we may provide guidance on the factors which may influence the amount of capital appropriate for risks not covered by the CRR.

Individual Capital Guidance

- 4.22 The Directive requires supervisors to ensure, through the SREP, that firms hold additional capital or take other measures to mitigate the risks identified. We propose to achieve this result by issuing Individual Capital Guidance (ICG) to firms, backed up by other regulatory measures, as necessary.
- 4.23 There will be a continuing need to exercise judgement when giving ICG but, compared to the current individual capital ratio and threshold ratio frameworks for banks and building societies, this will be better informed from a quantitative perspective by firms' ICAAP.
- 4.24 The more firms are able to demonstrate to our satisfaction that their ICAAP is thorough, objective and prudent in capturing and quantifying all the risks they are exposed to, the more we are likely to align our ICG closely with the ICAAP - providing an incentive for good risk management. We expect to give more credence to capital assessment processes which are embedded in the firm's business operations and decision-making processes. However, our ICG will probably differ from the outcome of a firm's ICAAP, as our regulatory objectives typically differ from a firm's economic objectives.
- 4.25 ICG gives our view of what is an adequate level of capital for a particular firm. Guidance in the supervision manual (SUP) will explain that failure to maintain capital at the level advised in ICG is an event of which we would expect to be notified under Principle 11 (PRIN 2.1 – relations with regulators).
- 4.26 A firm needs to manage its capital so that its financial resources do not fall below the level advised in the ICG. If a firm's financial resources fall below the level specified in the ICG, we expect it to explain why. Similarly, if a firm expects such a situation will arise, we expect the firm to advise us as soon as practicable. In the event that its financial resources fall below the level specified in the ICG, we will ask the firm to set out a plan for restoring an adequate capital position, and, depending upon the circumstances and frequency with which these situations occur, we will also regard this as indicative of systems and control weaknesses. Nevertheless, we will expect a firm to manage its capital so that it maintains financial resources at or above the level specified in the ICG at all times.
- 4.27 There may be cases where a firm indicates that it does not accept the ICG or proposes to ignore it, and agreement cannot be reached through further analysis and discussion. We would then consider using other regulatory powers, including, for example, the own initiative variation of permission process under section 45 of FSMA to impose a requirement on the firm's permission.

4.28



Other policy issues

Groups

- 4.29 Our prudential concern is to ensure that capital is held by the right legal entities within the group reflecting, as far as possible, their risk profile.
- 4.30 We propose that for firms which are members of a group, their ICAAP should be based on the consolidated financial position of the UK group and the total capital estimated as appropriate for the group then allocated to each group member, according to its risk profile.
- 4.31 For firms that are not part of a UK group, the ICAAP should apply at the solo level.
- 4.32 A firm which is part of a UK group needs to assess the amount of capital that is adequate for the group, based on the consolidated position. We will then apply the SREP to the group as a whole and engage in a dialogue with the firm at the group level. The result of the dialogue will be individual guidance (group ICG) on the amount of capital the group should hold to meet group capital requirements which are set out in BIPRU 8. We will also give ICG to each firm within the group normally based on a reasonable apportionment of the group ICG, based on the risk profile of each firm within the group.

- 4.33 Investment firms which are part of a UK group for which consolidated capital requirements have been waived in accordance with BIPRU 8.2, should prepare an ICAAP on an individual basis.

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

Diversification benefits

- 4.34 Firms have consistently told us they want to be able to take account of diversification benefits, including diversification benefits for groups based on the consolidated financial position. Our starting point is that diversification benefits appropriate for large, well-diversified, internationally active firms, are already fully reflected in the calibration of the CRR. This is an important benchmark considered as part of the SREP. If firms have calibrated their assessment of individual risks differently to the assumptions made in the CRR - and therefore aggregated those risks using different correlation assumptions - this approach will need to be reconciled with the approach taken in calibrating the CRR. Therefore, the onus will be on the firm to persuade its supervisor that it supports empirically - and justifies analytically - any further diversification benefits claimed.
- 4.35 However, given the level of calibration of the CRR described above, we generally expect that most firms will require additional capital to reflect the risk arising from concentrated portfolios.
- 4.36 In addition to establishing that diversification benefits exist, firms must be able to show that:
- they have fully evaluated the risks they face by virtue of their membership of a wider group (for instance, reputational risk should another group firm fail or the risks they face due to exposure to or dependence upon other group members); and
 - capital is freely transferable within the group even in situations where the group is under financial stress, especially in relation to cross-border presences where jurisdictional issues come into play.

Calibration

- 4.37 Any assessment of capital adequacy must, implicitly or explicitly, take account of a firm's (or regulator's) risk appetite; technically, the confidence level desired for capital to protect a firm from insolvency. We have not stated what confidence level firms should use in their ICAAP – neither the confidence level desired after aggregating all risks nor the confidence level applied to deriving capital against particular risks. This differs from the position for insurers, who are asked to prepare their individual capital

assessments using a 99.5% confidence level over a one-year period or equivalent confidence levels over longer periods. Assessing diversification benefits, as discussed above, is also impossible without taking into account the ways in which the amounts of capital required to cover different risks are aggregated, the correlation assumptions made as part of the aggregation, and hence the confidence levels used to determine the amount of capital sufficient to cover the individual risks.

- 4.38 We would expect to base our SREP on the assumption that the same confidence level implied by the CRR (as calibrated for large, well-diversified and controlled firms) is appropriate for all firms. It would clearly be helpful if firms' ICAAP were prepared on this assumption. However, we understand that firms may choose to adopt a different confidence level for internal management purposes. If this is the case, firms will need to be able to quantify the effect of such a different assumption, if we are to apply our SREP on a fair and consistent basis.
- 4.39 However, the impact of specifying a confidence level for all firms subject to the Draft Directive to use in the ICAAP or SREP is unclear, as is its relation to the current and new minimum capital requirements. Although there may be a presumption that the minimum requirements correspond to a 99.5% confidence level and a one-year time period, the actual minimum requirements have evolved largely through empirical evidence and compromise rather than from such a theoretical approach. So before providing firms with more detailed guidance in this area we would need to address complex issues, including:
- what confidence level has, in practice, been used to calibrate each of the components (credit, market, and operational risks) of the minimum regulatory capital requirement;
 - whether aggregation of these components without allowing for diversification benefits between them is appropriate; and
 - what overall confidence level the minimum regulatory capital requirements actually produce for less well-diversified or well-controlled firms.
- 4.40 In the absence of an explicit confidence level, we would generally expect that a firm supports its assessment by comparing the capital required by the CRR plus additional capital to mitigate risks not adequately captured in the CRR with the capital which the firm's assessment produces and explaining the differences. Alternatively, we need to be satisfied that the firm's approach to the aggregation of risks does not produce a weaker calibration than is assumed in the overall calibration for only those risks covered by the CRR.

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.

Development and implementation

- 4.41 Developing guidance for firms on the ICAAP and our own SREP will take time and continue after the Draft Directive is implemented. The main elements of this work are as follows

March 2005: CEBS CP: Interaction between ICAAP and SREP	
<ul style="list-style-type: none"> • This will define in more detail the interaction between the two processes, including the nature of the dialogue between the firm and the supervisor. Firms and trade associations should provide feedback to CEBS. 	
April 2005: completion of Phase 1 of the FSA's ICAAP and SREP project	
<ul style="list-style-type: none"> • Our intention is to complete the development of the main elements of our approach and our strategy for implementing those two frameworks. We will discuss our approach with trade associations and industry in relevant Standing Groups. 	
July-December 2005: first application window for minimum capital requirements waiver approval for Foundation and Retail IRB.	
<ul style="list-style-type: none"> • The review work undertaken as part of the model approvals process will likely identify material risks which cannot be addressed in minimum capital requirements and therefore need to be reviewed as part of the SREP. We will need to define the impact this is likely to have on model applications and level of capital to be held. We intend to give firms clarity on this by the end of April 2005. 	
September 2005: second FSA CP on Strengthening Capital Standards	
<ul style="list-style-type: none"> • This will contain a more detailed description of the ICAAP and SREP frameworks, including an approach to the policy issues raised in this CP. For example, it will reconcile regulatory capital to internal or economic capital and approaches to diversification benefits. 	

Implementation

- 4.42 All firms should be ready to discuss their ICAAP at the request of their supervisor from 1 January 2007.
- 4.43 The review and evaluation of a firm's ICAAP:
- will be performed routinely as part of a firm's normal Arrow assessment cycle, unless circumstances require a review outside the normal timetable; and
 - will result in giving ICG.
- 4.44 We propose transitional arrangements so that ICG is in place from 1 January 2007 for firms adopting the standardised approach to credit risk and Foundation IRB, and from 1 January 2008 for firms adopting the Standardised Approach to operational risk and the advanced approaches for IRB and operational risk.
- 4.45 We propose phasing in the SREP individually for larger firms ahead of the effective implementation dates. We will otherwise seek to transition en bloc existing Individual Capital Ratios (ICRs) or threshold ratios to ICG where applicable. For those firms which currently do not have an ICR and are not subject to an individual Arrow, but will be subject to the CRD, we are presently considering how the SREP will be applied and how we will approach giving ICGs.
- 4.46 For those banks and building societies intending to apply for advanced approaches, we intend to retain the existing ICRs for the period between 1 January 2007 and 1 January 2008, unless there is a material change in circumstances or the evaluation of the ICAAP identifies material risks which had not been previously reflected. We will also review the ICAAPs of investment firms which opt to go straight to advanced approaches to assess whether any ICG should be given for the interim period.

5 The standardised approach to credit risk

Introduction

- 5.1 The standardised approach to credit risk (the standardised approach)²³ will apply to all firms that do not adopt an internal ratings based (IRB) approach to credit risk. It is likely also to apply to some exposures of firms that intend to adopt IRB as their main approach to credit risk. This could occur as a result of a phased roll-out of the IRB approach, or because of permanent exemptions from the application of the IRB approach in some areas.
- 5.2 Also relevant to firms using the standardised approach is the expanded range of credit risk mitigation techniques and counterparties. Credit risk mitigation is discussed in detail in Chapter 13 of this CP. Changes to the securitisation framework, covered in Chapter 14 may also affect standardised firms. Concentration risk is a further area of change that will impact firms on the standardised approach - we cover it in Chapter 8.
- 5.3 We consulted on some aspects of the standardised approach in CP189. A full list of the issues and our responses can be found in Annex 3. This chapter covers those issues where additional consultation is necessary as a result of feedback from CP189 or where we are now seeking additional input.
- 5.4 Overall the standardised approach aims to be more risk-sensitive than the current Basel 1 approach which bases risk weights on the type of exposure counterparty. Our general approach to those areas of the standardised approach where we have discretion is to take the more risk-sensitive approach. This means we are seeking to make risk weightings more granular to allow more efficient capital allocation and to reduce arbitrage opportunities. In this way we are seeking to give firms on the standardised approach incentives to move to the IRB approach, which is even more risk-sensitive. This is also an incentive to improve risk management. However, we are conscious of the need to balance this desire for risk sensitivity against the

23 BCD Articles 78 to 83 and Annex VI.

relative crudeness of the standardised approach in some areas. In addition, to ensure that UK firms are not competitively disadvantaged, we have generally opted to recognise the national discretions exercised by other competent authorities. Annex 4 of this CP details our proposals in relation to all the standardised national discretions.

5.5 At this stage we are proposing to copy out the Directive to produce our Handbook text for the standardised approach. As a result, draft rules and guidance on the standardised approach are not included in this consultation. However, we are consulting on some areas where we may want to add additional guidance, and on some significant national discretions. These are the following:

- exposures to institutions;
- risk weighting residential mortgages;
- the definition of regulatory retail exposures;
- commercial real estate;
- composition and risk weight of the regulatory high-risk categories;
- regional governments, local authorities and public sector entities;
- collective investment undertakings;
- covered bonds;
- collateral eligible for securing past due loans;
- integrated groups regime; and
- use of the credit assessments of Export Credit Agencies.

5.6 As indicated earlier this CP is based on the Draft Directive of July 2004. In the context of the standardised approach, the most important changes to the Draft Directive through the ECOFIN text are the following:

- Regional governments and local authorities – exposures that are equivalent to central government exposures will now automatically be treated as such. Competent authorities will be required to publish a list of entities being treated in this way.
- Public sector entities (PSEs) – it is proposed that exposures to PSEs may also be treated as exposures to central government in cases where the competent authority believes there is no difference in risk between such exposures.
- Covered bonds – there is a proposed extension to the exposure classes that may be included within covered bonds.

- Short-term exposures to institutions - it is proposed that the preferential treatment available for short-term institutional exposures apply to exposures with residual maturity of 3 months or less rather than original exposures of 3 months or less.
- National discretions – two national discretions are to be removed. Exposures to member states' central governments and central banks denominated in local currency will now automatically be risk weighted at 0%, and exposures falling within the regulatory retail portfolio will automatically be assigned a 75% risk weight.

Exposures to institutions

- 5.7 The Draft Directive²⁴ allows two methods for determining the risk weight of exposures to institutions: using the external rating of the country in which the institution is incorporated, or using the external rating of the institution itself.
- 5.8 In CP189 we proposed using the external rating of the institution itself. This compares to a current risk weight of 20% for all exposures to institutions. The majority of respondents supported this proposal as it provides greater risk sensitivity in line with firms' own approaches. Consequently, we propose to continue with this proposal. However, some respondents – including smaller firms - were concerned that the 50% risk weighting that would be attributable to institutions rated single A by Standard and Poor's (as set out in the mapping contained within the Basel Framework²⁵) and to unrated institutions was too conservative. As indicated in Chapter 6, we have not yet undertaken our own mapping exercise. But we will consider these comments and the results of the international convergence discussions in doing so.
- 5.9 The Draft Directive²⁶ provides a preferential risk weighting for short-term exposures to institutions with an original maturity of 3 months or less. It also gives us the option²⁷ of assigning a risk weight one category less favourable to that assigned to central government exposures when the short-term exposures to institutions are denominated and funded in local currency. We do not propose taking up this additional national discretion as it would result in a less risk-sensitive approach. In the absence of a specific short-term rating,²⁸ short-term sterling exposures to UK institutions falling within credit quality steps 1 to 3 (or without an external credit rating) would receive a

24 BCD Article 80(3) and BCD Annex VI, Part 1, paragraphs 24 to 29.

25 The Basel Framework, Annex 2.

26 The preferential risk weightings are stipulated in BCD Annex VI, Part 1, paragraph 30, and their application explained in BCD Annex VI, Part 1, paragraphs 32 to 35.

27 BCD Annex VI, Part 1, paragraphs 36 to 37.

28 As described in BCD Annex VI, Part 1, paragraphs 32 to 35, the actual risk weight applicable depends on whether a specific short-term rating is available and whether that results in a more preferential treatment than described in paragraph 30.

20% risk weighting under both approaches. However, if we do not adopt the discretion, exposures to UK institutions within credit quality steps 4 to 6 would receive a more conservative risk weighting (of 50 - 150%), as opposed to a 20% risk weighting if the discretion were adopted.

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?

Risk weighting of residential mortgages

- 5.10 The risk inherent in residential mortgage lending is mitigated by the presence of physical collateral. The Draft Directive²⁹ recognises the relatively lower risk profile of residential mortgage lending by assigning it a risk weight of 35%, compared to a current risk weight for residential mortgages of 50%. However, the Draft Directive imposes conditions on access to the lower risk weight. One of these is that we must satisfy ourselves that the mortgages are fully secured - in particular, that the value of the property exceeds the value of the exposures by a substantial margin.³⁰
- 5.11 The Draft Directive presents us with a choice of how to interpret ‘substantial margin’. In CP189, we proposed to implement this as follows:
- apply the 35% risk weight to loans with a Loan-to-Value (LTV) up to 75%; and
 - apply a higher effective risk weight to loans with an LTV higher than 75%. This will be calculated by applying the 35% risk weight to the proportion of a loan up to 75% LTV and applying a marginal risk weight of 75% (the risk weight for other retail exposures) thereafter.
- 5.12 Some responses to the related question in CP189 were supportive, provided that our proposed treatment was equivalent to that of other EU and G10 supervisors. Others contended that our proposed treatments were overly conservative. In particular, some respondents asserted that the majority of losses on such lending occurred above 90% LTV. It was also suggested that a 75% risk weight was too high, given the levels of payment protection prevalent in the UK mortgage market, and 50% was proposed as a more appropriate marginal risk weight.
- 5.13 We discussed this issue with the Council of Mortgage Lenders, which conducted a survey of members on the number and value of losses on defaulted loans by LTV band between 1990 and 1998. We also reviewed data from individual firms. On the basis of these analyses, we now propose applying an 80% LTV threshold which we would review on a three-yearly basis. Firms will need to keep the possibility of revision in mind while

29 BCD Annex VI, Part 1, paragraph 43.

30 BCD Annex VI, Part 1, paragraph 45.

developing their systems. The higher effective risk weight will be calculated on the same basis as in CP189, with the portion of the exposure up to 80% LTV attracting 35% risk weight, and the portion above 80% LTV attracting a marginal risk weight of 75%. This proposal has the benefit of risk sensitivity by increasing the effective risk weight as the LTV rises as opposed to a 'cliff effect' at a certain LTV point. We are not proposing to take account of mortgage indemnity guarantees as part of determining LTV because of the unfunded nature of that protection, which does not meet the requirements for collateral security under the standardised approach.

- 5.14 In CP189, we also proposed that firms could either determine their LTV at origination or use a current LTV which could be estimated using a house price index. Respondents supported this proposal. However, some questioned which house price indices should be used. We do not propose to mandate particular house price indices for this purpose. However, we consider it important that the house price index used is appropriate for the portfolio being considered. We propose issuing guidance on the criteria firms should consider when determining whether or not an index is appropriate. Our current thinking in this area is that:
- the index should be credible to the market and used by a sufficient number of lenders for asset valuation purposes;
 - the geographic coverage of the index should be sufficiently representative of a firm's residential mortgage portfolio to provide valid estimates of LTV;
 - as far as possible, the administration of the index should be independent of the firm;
 - the firm should use the index consistently; and
 - a firm's credit policy document should set out how the index is used.

- 5.15 As an alternative to calculating the LTV on residential mortgage lending, and applying an LTV threshold as described above, we also proposed in CP189 to allow a firm to risk weight at 45% all its residential mortgage exposures, without reference to LTV. This approach was much simpler than the LTV threshold alternative. However, as it was less risk-sensitive, it also involved a higher degree of conservatism. The majority of responses to CP189 did not support this proposal, considering the conservatism as excessive. So we do not propose to continue offering this option, although we do appreciate that the need to monitor LTV under the remaining approach may impose greater systems costs for some smaller firms.

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

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?

Definition of regulatory retail exposures

- 5.16 The Draft Directive states a number of conditions that must be met if an exposure is to be eligible for the regulatory retail risk weight of 75%. One of these conditions is that the total amount of the exposure owed to the credit institution must not, to the knowledge of the credit institution, exceed €1m and that firms must take reasonable steps to acquire this knowledge. Firms have asked us whether exposures to residential mortgages must be included in the calculation of total exposure for the purpose of determining compliance with this limit. We believe that the Draft Directive does require mortgages to be included. However, we propose to pre-consult with the industry on the practical implications of meeting this requirement and how they might be addressed in the first quarter of 2005.

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

- 5.17 The Draft Directive³¹ contains four national discretions relating to the treatment of exposures either secured by, or subject to leases on, commercial real estate. These discretions allow us to choose whether to risk weight these exposures at 50% rather than 100%, and allows us the option to recognise this treatment if other Member States adopt it.
- 5.18 We believe that the loss history of exposures backed by commercial real estate in the UK suggests that risk weighting such UK exposures at 50% would not be prudent. Therefore, we propose to apply a 100% risk weight to exposures backed by commercial real estate in the UK. While this approach is not the minimum option available to us under the Directive, we believe it is appropriate given the risks associated with commercial real estate lending in the UK. It will not require firms to hold additional capital against these exposures compared to the current requirements, as our approach under the current BCD also risk weights exposures backed by commercial real estate at 100%.
- 5.19 Where exposures are backed by commercial property located in a Member State that permits the use of the 50% risk weight, we will permit the firm to use the 50% weighting. This situation may arise, for example, where a firm has a branch in another Member State that is lending or leasing into that local market. Additionally, we propose adopting the mutual recognition provisions in the Draft Directive. This would allow UK firms

31 BCD Annex VI, Part 1, paragraphs 48-50 and 54.

to operate on an equivalent basis to their competitors in other Member States where the discretions have been taken up.

- 5.20 As we propose not to exercise the 50% risk weight for lending backed by commercial real estate, we do not propose implementing the further national discretion³² that allows the 50% risk weight to apply even in cases where the borrower's repayment capacity materially depends on the performance of the underlying property. However, we do propose to recognise other Member States' use of this further discretion. This would also apply where the property backing an exposure is located in that Member State.

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?

Regulatory high risk categories

- 5.21 A key feature of the standardised approach is its use of external credit assessments to differentiate between levels of credit quality of borrowers of the same type: the better the external credit assessment the lower the risk weight, and vice versa. However, the form an exposure takes is also important in determining the credit risk as the external rating of the borrower. This is because the risk of loss from default is dependent, among other things, on the status and rank of the lender's claim on the borrower in case of default.
- 5.22 To ensure that sufficient regulatory capital is held against significantly more risky types of exposure, the Draft Directive includes a national discretion to allow the supervisor to assign a risk weight of 150% to exposures associated with 'particularly high risks'. The Draft Directive also provides examples of two such exposure types: investments in venture capital firms and private equity investments. Furthermore, the Draft Directive allows supervisors to include other examples within these categories, should they consider it necessary.
- 5.23 This national discretion presents us with two decisions:
- whether to apply a 150% risk weight to particularly high risk lending; and,
 - if we decide to apply this 150% risk weight, how to define the set of exposures it should apply to.
- 5.24 Where an exposure type, or feature, results in a significantly higher level of credit risk than that associated with a 100% risk weight, we believe it is

32 BCD Annex VI, Part 1, paragraphs 48 to 50 and 54.

33 BCD Annex VI, Part 1, paragraph 63.

prudent and risk-sensitive for additional regulatory capital to be held against it. So we propose applying a higher risk weight to exposures associated with particularly high risks.

- 5.25 We have also considered the types of exposure that warrant inclusion in the regulatory high-risk categories. In doing so, we have considered the work undertaken to develop the approach to equity in the IRB approach and papers prepared by industry bodies. We believe that the risk inherent in private equity investments and equity investments in venture capital firms and vehicles should receive a more conservative treatment than other types of exposure under the standardised approach. This is because equity exposures rank most junior compared to other types of claim, and the losses associated with venture capital and private equity are higher than those associated with more senior credit exposures. Therefore, we propose to apply the 150% risk weight to these two types of investment. We propose to define private equity as equity that is not quoted on a stock exchange. At this stage, we do not believe it necessary to expand the list of regulatory high risk categories beyond private equity and venture capital exposures.

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

Exposures to Regional Governments and Local Authorities and to Public Sector Entities

- 5.26 The Draft Directive³⁴ allows us to treat exposures to regional governments and local authorities as exposure to central government, in cases where the regional bodies have specific revenue-raising powers and institutional arrangements reduce the risk of default. Currently, these entities would be risk weighted at 20%. Even if not required as a result of ECOFIN changes, we would consider creating a list of regional bodies that satisfy such conditions.

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?

- 5.27 The Draft Directive³⁵ also allows us to treat exposures to public sector entities as exposures to institutions. Currently these entities would be risk weighted at 20%. In line with current definitions, this will require us to identify bodies which carry out non-commercial functions on behalf of - and are responsible to - regional governments or local authorities.

34 BCD Annex VI, Part 1, paragraph 10.

35 BCD Annex VI, Part 1, paragraph 15.

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?

Collective Investment Undertakings

- 5.28 The Draft Directive³⁶ requires firms to assign a 150% risk weight to Collective Investment Undertakings (CIUs) that are considered to involve particularly high risks. We are considering when such a risk weighting will be appropriate. Our current thinking is that this should apply to CIUs that do not have an external credit assessment from a recognised ECAI or which have specific features (such as high levels of leverage or lack of transparency) that prevent it from meeting the eligibility criteria laid out in the Draft Directive.³⁷

Q22: Is our approach to high risk CIUs appropriate?

Covered Bonds

- 5.29 Article 63(2) of the current BCD provided for supervisors to assign a transitional risk weight of 10% to covered bonds. We did not implement this transitional provision, and it has expired. We are proposing to implement the risk weighting provisions in the new Draft Directive³⁸ pertaining to covered bonds. We are also currently evaluating (a) the need for primary legislation for us to be able to implement Article 22(4) of the UCITS directive and (b) the prudential treatment of covered bonds prior to the implementation of the Draft Directive. We propose to pre-consult with the industry on our prudential treatment of covered bond issuance during 2005.

Collateral eligible for securing past due loans

- 5.30 In two instances when defining the secured portion of past due loans, the Draft Directive provides discretion to extend the definition of eligible collateral beyond assets meeting the criteria specified for CRM purposes (see Chapter 13).³⁹ In neither case do we propose taking up the discretion. We believe that to ensure that the value of the collateral is adequate and realisable, the recognition of collateral should be limited to those forms that meet the eligibility criteria specified in Chapter 13. In the absence of such conditions, we are not convinced that collateral will be of sufficient quality and adequacy to warrant the favourable risk weighting offered by the discretion.

36 BCD Annex VI, Part 1, paragraph 73.

37 BCD Annex VI, Part 1, paragraph 74.

38 BCD Annex VI, Part 1, paragraphs 65 to 68.

39 BCD Article 153 provides discretion to recognise ineligible collateral for the purposes of defining the secured portion of past due loans on a transitional basis until end-2010. BCD Annex VI, Part 1, paragraph 60 provides discretion to apply a 100% risk weighting to past due items secured by ineligible collateral where strict operational criteria are in place to ensure the good quality of the collateral when value adjustments reach 15% of the exposure gross of value adjustments.

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

Integrated groups

- 5.31 This section should be read in conjunction with paragraphs 2.23 to 2.30, which provide an overview of the integrated groups regime, paragraphs 7.40 to 7.46, which explain permanent exemptions from the IRB, and Chapter 8, which explains the concentration risk treatment of UK integrated group exposures.

Conditions for forming a UK integrated group

- 5.32 The Draft Directive⁴⁰ includes specific conditions under which a 0% standardised risk weight may be granted for exposures to group counterparties. These conditions replace the minimum conditions for integrated group membership specified in CP97. We propose in our implementation to amend some of the minimum conditions of the Draft Directive for a 0% risk weight for intra-group exposures, and to provide additional guidance on others in order to clarify the scope of application of treatment within the integrated groups regime.
- 5.33 This CP does not include draft rules and guidance for the standardised approach. However, in order to provide early clarity, we propose that the following conditions must be met in order for a firm's exposures to a connected counterparty to fall within the UK integrated groups regime and qualify for a 0% risk weighting:⁴¹
- (a) the counterparty must be a parent undertaking, a subsidiary undertaking or a subsidiary of the parent undertaking of the firm;
 - (b) the counterparty must be an institution or a financial holding company, financial institution, asset management company or ancillary services undertaking subject to appropriate prudential requirements;⁴²
 - (c) the counterparty must be included in a group that is subject to consolidated supervision by us, another EEA supervisor, or a non-EEA supervisor that undertakes equivalent supervision (see BIPRU 8.1 for further details;
 - (d) the counterparty must be subject to the same risk evaluation, measurement and control procedures as the firm;

40 BCD Article 80(7).

41 Derived from BCD Article 80.

42 Connected exposures to participations and non-financial companies (for example insurers) would not be eligible for inclusion in the UK integrated group.

- (e) the counterparty must be incorporated in the UK and, where subject to the EU insolvency law, have its main interests in the UK; and
- (f) there must be no current or foreseen material or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the firm.

A firm must also have notified us that it met these conditions and intended to apply the regime.

- 5.34 We have amended condition (c) of the Draft Directive⁴³ to clarify that consolidated supervision means supervision based on consolidation under the EEA or 'equivalent' standards. This is in line with the commitment given in our feedback on CP97.⁴⁴
- 5.35 For the purpose of applying condition (d) we propose adding the following guidance to our 'copy-out' implementation of the requirements of the Draft Directive:
- it is the risk management functions of the group that should be integrated, rather than the group's operational management; and
 - the FSA should be capable of undertaking qualitative supervision of the management of the integrated risk management function.

This clarification is in response to the comments we received on the CP97 integrated groups regime, and explained in our feedback on CP97.

- 5.36 Condition (e)⁴⁵ is more restrictive than the current integrated groups capital regime for banks, as it introduces a geographical restriction for connected exposures to receive a 0% risk weighting. The Draft Directive requirement introduces this geographical restriction. We proposed in CP97 to implement a similar restriction. We have amended condition (e) to provide greater clarity on the types of connected counterparty that may - or may not - be capable of meeting the principles of, and so forming, a UK integrated group.
- 5.37 Exposures that do not meet these conditions would be risk weighted as normal under the standardised approach.

Other points

- 5.38 In CP97, we proposed that a member of an integrated group must disclose this in its financial statements. In the light of industry comments in response to CP97 we have decided not to require this level of disclosure.

43 See BIPRU 10.SA 1R(2)(c).

44 'Integrated Prudential Sourcebook – Feedback on CP115 (Integrated Prudential Sourcebook – Timetable for Implementation) and CP97 (Integrated Prudential Sourcebook)', July 2002.

45 See BIPRU 10.SA 1R(2)(c).

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?

Export Credit Agencies

5.39 The Draft Directive⁴⁶ states that the credit assessment of an Export Credit Agency (ECA) may be used to determine the risk weight of exposures to central governments and central banks, provided that the ECA has been recognised as eligible for such purposes by the competent authority. The Draft Directive provides criteria for ECA recognition which revolve around adherence to OECD-agreed assessment methodologies and the publication of credit assessments. If it would help firms, we would consider compiling a list of ECAs that meet these recognition criteria.

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

46 BCD Annex VI, Part 1, paragraphs 7 and 8.

6 Outline of our approach to ECAI recognition and mapping

Introduction

- 6.1 Under the standardised approach, external credit assessments may be used to determine the risk weight of a firm's exposure only if the External Credit Assessment Institution (ECAI) providing it has been recognised as eligible for such purposes by the firm's competent authority. So the status of ECAIs will be relevant to all firms using the standardised approach and for some exposures for firms using the IRB - for example, where they are subject to a permanent exemption and for the purposes of securitisation. However, this chapter will be particularly significant for ECAIs themselves, as it sets out our proposals for the ECAI recognition process.
- 6.2 The requirements for ECAI recognition and mapping can be found in Articles 81 and 82 and Annex VI, Part 2 of the Draft Directive. The way in which firms may use the rating of an ECAI that has been recognised as eligible is set out in Article 83 and Annex VI, Part 3 of the Draft Directive.
- 6.3 The Draft Directive specifies the recognition requirements an ECAI must meet to qualify as eligible for its ratings to be used as the basis for risk weightings. Within the requirements set by the Draft Directive, the ECAI recognition process is left for us to define. Given that the recognition and mapping processes are new, it is necessary to provide guidance if the requirements of the Draft Directive are to be implemented effectively.
- 6.4 We propose to take a robust, but proportionate approach to ECAI recognition, that fulfils our prudential obligations under the Draft Directive, whilst seeking to minimise the compliance burden on eligible ECAIs.
- 6.5 ECAI recognition is also the subject of supervisory convergence work in CEBS. This work will be essential in ensuring the consistent application of ECAI recognition and mapping across Europe. We therefore may need to revisit the proposals in this chapter, in order to account for CEBS' guidance in this area. We are also aware that CESR has recently issued a CP on the

potential need for registration of rating agencies in Europe. We are feeding into the CEBS' collaboration with CESR on this issue and will continue to monitor CESR's progress.

6.6 The specific issues on which we are consulting in this chapter are:

- direct and indirect recognition: an overview;
- direct recognition;
- recognition requirements;
- recognition process;
- timetable for recognition;
- on-going recognition; and
- initial thoughts on the mapping process.

Direct and indirect recognition: an overview

6.7 The Draft Directive⁴⁷ allows us to recognise ECAIs as eligible in two ways: by devising our own evaluation processes and recognising ECAIs directly ('direct recognition'); or by recognising the ECAI recognition of the competent authorities of another Member State without undertaking direct assessment ourselves ('indirect recognition'). Given the diverse and multinational nature of many rating agencies' businesses, we believe it would be appropriate to use a combination of direct and indirect recognition. Adopting only a direct approach to recognition would result in us duplicating work carried out by other competent authorities. It would also potentially add to the compliance burden faced by ECAIs that have sought recognition in the UK and other European jurisdictions.

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

Direct Recognition

6.8 The Draft Directive does not specify the level at which ECAI recognition should apply: that is, whether it should apply at the group level, covering all entities within the group; or at the level of every subsidiary of an ECAI. We propose to recognise ECAIs on a group-wide basis. We believe this approach to be prudentially appropriate, and potentially less burdensome for multinational agencies which apply uniform policies, procedures and rating methodologies on a global basis. It will also avoid the need for ECAIs to allocate global rating decisions to specific subsidiaries purely for regulatory

47 BCD Article 82.

purposes. It will maximise the quantity of loss data that may be drawn on in the recognition and mapping processes.

- 6.9 We propose requiring ECAIs to apply for additional recognition for group entities (such as joint ventures) that are not subject to identical processes, procedures and methodologies as those applied in the rest of the group. This is not an explicit requirement of the Draft Directive. However, we believe it is necessary to ensure that the ratings used for risk weighting purposes are derived in a consistent manner.

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?

Recognition requirements

- 6.10 The Draft Directive⁴⁸ requires us to assess on both an initial and an on-going basis, the objectivity, independence, on-going review, transparency and disclosure of an ECAI's methodology. It also requires us to assess on the same bases the credibility, market acceptance, transparency and disclosure of its individual credit ratings.
- 6.11 The guiding principles of our proposed approach to assessing compliance with the recognition requirements are as follows:
- In determining the adequacy of an ECAI's methodology, we propose to focus on assessing whether the rating processes and procedures adopted by an ECAI are sufficient to ensure that its methodologies are well-founded, rigorous and systematic. We do not propose to directly assess whether an ECAI's methodologies, and the ratings they produce, are objectively correct. Any direct judgement of what constitutes an acceptable rating methodology could create moral hazard problems and potentially hamper competition.
 - In undertaking ECAI recognition, we do not propose to impose additional hard requirements beyond those of the Draft Directive. For example, in respect of independence, we would not wish to set a hard limit preventing ECAIs from issuing ratings for major clients or controlling companies. Instead, we would expect an eligible ECAI to be able to demonstrate the adequacy of its internal procedures for ensuring independence in such situations.
 - Data we request as part of an initial or on-going assessment of eligibility should be sufficient only to exercise our responsibilities under the Draft Directive.

48 BCD Annex VI, Part 2.

- 6.12 Annex 6 of this CP sets out our current thinking on the information that we propose to request from applicant ECAIs, to assess their eligibility for recognition.

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?

Recognition Process

Initiating an application for ECAI recognition

- 6.13 The Draft Directive does not specify who should initiate an application for ECAI recognition: the competent authorities; regulated firms intending to use an ECAI's ratings under the standardised approach; or ECAIs themselves. We propose that ECAIs should approach us directly for recognition. We believe that this would be consistent with the powers afforded to us under the Draft Directive, would ensure that prospective eligible ECAIs are not inadvertently excluded from recognition, and avoid multiple applications for the same ECAI.

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

Segmented recognition

- 6.14 The Draft Directive is also not specific on whether an ECAI should be recognised for its entire rating activity or for different product segments. We propose that ECAIs will need to seek separate recognition for different product segments. While this could potentially increase the costs of recognition, we do not want to hinder the recognition of niche players, or allow ECAIs recognised on the basis of expertise in one area to later issue 'recognised' ratings in other areas where they lack expertise. However, to keep recognition costs to a minimum and avoid duplicative submission of group-wide information, we propose that ECAIs need only make a single submission covering their application for recognition in various different product segments.
- 6.15 A related choice is the basis on which to sub-categorise recognition. Determining the appropriate product segments involves weighing up the need for the segment to be large enough to provide statistically significant data, against the need for a core rating methodology to be applicable across the entire segment. Given such factors, we believe it appropriate to have several different recognition categories:

- public finances (sovereigns, municipalities etc),
- corporates,
- banks and investment firms,
- insurance companies,
- structured finance (including securitisation).

6.16 However, we note that the heterogeneous nature of structured finance products suggests that recognition may require greater flexibility and the assessment of a number of methodologies. We may also choose to create different recognition categories over time as more data becomes available on existing products or new products are created.

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?

Timetable for recognition

6.17 ECAs will not be formally recognised until the Draft Directive has been finalised and implemented. However, we appreciate that it will be important to provide early clarity where possible for firms that will be subject to the standardised approach and securitisation requirements of the Draft Directive. Consequently, we propose undertaking shadow ECAI recognition and mapping processes before the Directive is implemented. Such shadow assessments would form the basis of the formal recognition assessments, for which ECAs can apply at the end of 2006.

6.18 To assist firms' preparations, we propose producing a shadow list of recognised ECAs by June 2006. On the basis that there may be scope for indirect recognition of other EU supervisors' ECAI recognition and that we will not need to directly assess the entire universe of ECAs, we believe that we will require approximately nine months to undertake this shadow recognition and mapping process. Consequently, we propose that ECAs be allowed to apply for shadow recognition from June 2005 onwards. However, depending on the volume of applications, we cannot guarantee that ECAs applying after September 2005 will be shadow recognised by June 2006. For these applicants, and future applicants, a separate timetable will be agreed 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?

On-going recognition

- 6.19 After initial recognition, the Draft Directive requires us to undertake on-going assessments of ECAIs to ensure their methodologies and ratings remain acceptable. As part of this, the Draft Directive⁴⁹ requires ECAIs directly recognised by us to inform us of material changes in rating methodology. We propose that ECAIs interpret for themselves what constitutes a material change in their rating methodology, subject to our review. While we will discuss this issue further with ECAIs once initial recognition has been completed, we believe that material changes will – at a minimum – include methodological changes that alter a significant number of ratings or potentially prompt the need for a change in mapping. In accordance with the Draft Directive,⁵⁰ we will also require ECAIs to demonstrate that their ratings are reviewed at least annually, and revised in response to changes in financial conditions. As part of this, we propose that ECAIs undertake ‘back-testing’ of their ratings on an annual basis and inform us of instances where there has been a material change in rating accuracy or consistency. We would seek to have a dialogue with ECAIs to understand the rationale for such changes, and their potential impact on the on-going eligibility of the ECAI and its mapping. We are still considering what procedures may fulfill the ‘back-testing’ requirement. One option that we are pursuing is producing transition matrices.
- 6.20 While the Draft Directive has no specific provision to this effect, we also propose that ECAIs should notify us immediately of material changes in any other recognition criteria - for example, changes in ownership, a major deterioration in financial position, or a change in arrangements concerning rating committees or internal audit. While this imposes a potential extra burden on ECAIs, it is important to the integrity of firms’ capital requirements that they be based upon sound ratings. This implies a need to ensure that ECAIs continue to meet all the recognition criteria on an ongoing basis.

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

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

49 BCD Annex VI, Part 2, paragraph 6.

50 BCD Annex VI, Part 2, paragraph 4.

Mapping

- 6.21 Mapping is the process by which the ratings of eligible ECAIs are translated into risk weightings. It is not possible to provide any definite proposals for mapping at this stage, as this will depend on the resolution of recognition issues and the scope for international convergence in this area. However, our current thoughts are to:
- create benchmark default rates as required by the Draft Directive;⁵¹
 - adopt the mapping approach outlined in the Basel Framework;⁵²
 - where appropriate, indirectly to recognise the mapping process undertaken in other Member States;
 - consider the need to include all an ECAI's default rates in the mapping process, or to map by segment; and
 - consider the need for mapping data to be submitted in a standardised format. We will discuss this with ECAIs intending to apply for recognition over the coming months.

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

51 BCD Annex VI, Part 2, paragraph 14.

52 The Basel Framework, Annex 2.

7 The internal ratings based approach to credit risk

Introduction

- 7.1 The internal ratings based (IRB) approach⁵³ will apply to all firms which successfully obtain a waiver from the standardised approach for the majority - or all - of their exposures.
- 7.2 The IRB approach is more risk-sensitive than the standardised approach as it is based on firms' own estimates of risk parameters. With this in mind, our approach to implementing IRB has been to take the most risk-sensitive options where we have discretion to do so. We believe that this is important, as this allows us to recognise firms' own approaches to risk management, allows firms to allocate capital more efficiently and reduces arbitrage opportunities. The IRB approach may not always give an incentive to move from the standardised approach as the capital requirements for some portfolios under IRB may be higher. However, we believe that, overall, there is a positive incentive for firms to move to the more sophisticated approach if this is appropriate for their business. Therefore, we continue to believe that firms should not be compelled to or prohibited from using the IRB approach.
- 7.3 The treatment of credit risk mitigants is also relevant to firms using IRB. This chapter outlines only those credit risk mitigation (CRM) issues that are relevant to IRB firms. Other CRM issues are contained in Chapter 13. Firms also need to be aware of the requirements relating to concentration risk, which are covered in Chapter 8. Issues relating to the application pack and process can be found in Annex 7. Our proposed rules and guidance implementing the IRB provisions are in BIPRU 4 (see Appendix 1). Previously, there was no IRB approach, so all these requirements represent new rules for firms.
- 7.4 As indicated earlier, this CP is based on the 14 July text of the Draft Directive – it does not take account of the subsequent changes resulting from discussions in the Commission Working Group. The main changes that have been made to the Draft Directive in the ECOFIN text are the following:

53 BCD Articles 84 to 89 and Annex VII.

- Islamic mortgages – clarification has been given that these fall within the residential mortgage asset class.
- Covered bonds – the asset classes capable of being included in a covered bond have been extended.
- Experience requirement – the Draft Directive, from 31 December 2010, required firms to have at least three years' experience prior to its approval to use the IRB approach. Changes introduced will require all firms to have three years experience prior to adopting an IRB approach. However, two national discretions have been re-introduced permitting the experience requirement for firms intending to adopt the foundation approach to have experience of at least one year if adopting IRB prior 31 December 2009 with firms intending the advanced approach to have experience of at least two years if adopting IRB before 31 December 2008.
- LGD Economic downturn for defaulted assets – the treatment in the Basel Framework has now been reflected in the Draft Directive (see paragraph 7.125).
- Data requirements – the Draft Directive permitted the data requirements to be relaxed until 31 December 2010, subject to national discretion. Changes introduced now permit a national discretion relaxation of the data requirements relating to retail exposure class and foundation corporate exposure class for all new applicants beyond 2010.
- Purchase receivables (including invoice discounting and factoring) - changes introduced reduce the standard maturity (M) for purchased receivables from one year to 90 days. There will also be a distinction in treatment between those receivables with recourse and those without.
- CRM minimum requirements for residential real estate - the requirement to revalue residential real estate held as security has changed from once a year to once every three years.
- Foundation IRB - qualifying assets receiving a preferential supervisory loss given default (LGD) have been extended to include residential real estate (RRE) and commercial real estate (CRE) of 30% from 35% subject to indicated levels of over-collateralisation for the transitional period until 31 December 2012.

7.5 We consulted on some aspects of the IRB approach in CP189. A full list of the issues in CP189 and our responses are contained in Annex 3. In this Chapter, we consider in more detail those issues where our position has changed as a result of that consultation and the issues we are carrying forward into our Handbook. Issues resulting from our further review of the IRB requirements since CP189 and our proposals in relation to certain more significant national discretions are also included. (A complete list of the

national discretions is contained in Annex 4.) This Chapter also includes our current thinking in certain areas which are not included in the draft BIPRU text. We are therefore consulting on whether such guidance should be included. We discuss issues covered in this Chapter under the following headings, which follow the sections in the draft BIPRU text contained within Appendix 1:

- high-level provisions;
- provisions common to different exposure classes;
- exposures to corporates, institutions and sovereigns;
- specialised lending;
- retail exposures;
- equity; and
- credit risk mitigation within IRB.

7.6 In this Chapter, we have not discussed BIPRU sections 4.8 (the IRB approach: Purchased receivables) and 4.9 (The IRB approach: Securitisation, non-credit obligations assets and collective investment undertakings (CIUs)). This is because we have not provided any additional clarification in these sections other than cross referencing to other Handbook provisions. Material in addition to the text in the Draft Directive is highlighted in bold in the draft BIPRU text. BIPRU 4.7 (the IRB approach: equity) also contains no additional guidance, however one national discretion is discussed in this CP (see 7.198).

7.7 In the draft BIPRU text on IRB, we will be using a mixture of ‘copy-out’ and additional guidance for issues where we think this will aid firms in their preparations. In line with our intent not to be superequivalent, we have kept the additional material to a minimum and we have tried to include guidance without prescription, for example asking firms to consider particular issues, without specifying a specific solution. This seeks to address the preference expressed by smaller firms interviewed in the LECG survey for targeted additional guidance. Our draft BIPRU text does not follow the order of the Draft Directive, but groups together the overarching requirements for IRB, followed by provisions relating to all exposure classes and finally provisions applying to different exposure classes. It is important to note that this is a first draft of the BIPRU text for consultation, which will enable firms to understand what a ‘copy-out’ approach might look like. We anticipate revising this text in the light of the consultation and as further issues are discussed as part of the pre-consultation process.

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

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

Status of CP189

- 7.8 CP189 no longer represents our current thinking on the IRB approach, so firms should now look to this CP and draft BIPRU text for guidance on implementation. However, where firms have relied on CP189 for their implementation preparations, we will take into account any actions that firms undertook in good faith when agreeing the timetable to comply with our final rules.

High-level provisions

- 7.9 The high-level provisions in BIPRU 4.2 include all the general requirements that a firm seeking IRB approval must meet - experience text, use test, roll-out provisions and permanent exemptions.

Materiality

- 7.10 The Draft Directive makes occasional reference to materiality (for example, ‘material biases’ or ‘material changes’). Although in some cases we will set absolute levels of materiality, we do not intend to do so in all cases. This is because we consider it the responsibility of a firm’s senior management to determine what ‘material’ means in most cases. For example, it is the responsibility of a firm’s senior management to determine whether the omission or misstatement of an item could affect the assessment of a user relying on that information for the purposes of making economic decisions - particularly on the adequacy of the institution’s capital. We have added additional guidance in the BIPRU on materiality as indicated in this chapter, but have not provided overarching guidance of the nature contained in this section.

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?

Data accuracy

- 7.11 Data accuracy is not an area where the Draft Directive has set detailed standards, although provisions in the text highlight the need to have appropriately robust data.⁵⁴ The integrity of data is fundamental to the IRB process and to better risk management. We also recognise that firms see this as one of the key challenges of moving toward the IRB approach.

⁵⁴ For example, BCD Article 84(2)(a) and (2)(b) and Annex VII, Part 4, paragraph 31(b).

- 7.12 In CP189 we consulted on an approach that would focus on evaluating the systems and controls firms have in place to produce IRB information. In particular, we consulted on a data accuracy scorecard that outlined the need for standards to cover ‘core’ areas relating to the quality and integrity of the numbers and ‘supplementary’ areas focussed on the integrity of the supporting processes. Core components relate to issues such as clear sign-off procedures, adequate internal controls, reconciliation of risk-related information to accounting information, completeness of regulatory information, accuracy of data inputs, aggregation of information, and timeliness of updates to inputs into risk parameters. Supplementary components relate to consistent view, estimation maintenance, appropriateness of data feed information, automation of data feed information and contingency arrangements.
- 7.13 Firms responding to CP189 agreed that data accuracy was important, but were less comfortable with the scorecard approach than with the principle of improving data accuracy. Some suggested it would be useful as a guideline for self-assessment. As a result - and because we consider the issues in the scorecard to be important in ensuring the robustness of the capital requirement calculations - we have incorporated additional guidance in the draft BIPRU text.⁵⁵ This guidance sets out our expectation that firms will take account of the needs of different users of the information and will set their own standards for assessing data accuracy and potential methods of assessing accuracy including reconciliation. While this guidance goes beyond the requirements of the Draft Directive, we consider that robust data is fundamental in delivering materially correct capital requirements. So we think it is important for firms to understand the strengths and weaknesses of their data and be able to explain that to us. We will also require firms to include a description of how they ensure themselves that IRB data standards are met as part of their application.
- 7.14 Firms have also asked us to outline our philosophy to reconciliation and the level of materiality we would require in the reconciliation between credit risk systems and accounting and financial systems in more detail.
- 7.15 The Draft Directive states that a ‘credit institution shall have in place a process for vetting data inputs into the model which includes an assessment of the accuracy, completeness and appropriateness of the data’.⁵⁶ This defines the purpose for which reconciliation is performed. Reconciliation is an explanation of how and why two data sets differ. The reconciliation needs to be reasonably fit for this purpose. In determining what is fit for purpose, it is important that this reconciliation will only form part of the evidence that a firm would need to have as to the

55 BIPRU 4.2.5

56 BCD Annex VII, Part 4, paragraph 31(b).

accuracy, completeness and appropriateness of the data. The evidential weight that would need to be put on the reconciliation would therefore, in part, depend on the strength of the other evidence.

7.16 The following points are relevant for data accuracy.

- The amount of the difference between the two data sets is less important than the quality of the explanation as to why - and how - it has arisen.
- Both a firm's IRB rating system and its accounting systems take data inputs and transform them into data outputs. Reconciliation between these systems may focus on inputs, outputs or both. We accept that, in practice, a focus on input reconciliation is likely to be more relevant.
- For inputs, the reconciliation needs to be sufficiently detailed so that - together with other available evidence - it gives reasonable assurance that data input into the IRB systems is 'accurate, complete and appropriate' as required by the Draft Directive. That is, the emphasis is on explaining the differences between the accounting and regulatory results. Here, the concepts of accuracy, completeness and appropriateness themselves have a context. Input data is used through the IRB rating model to generate probability of default (PD), LGD, exposure of default (EAD) and Maturity (M) estimates which in turn are used to calculate the IRB capital requirement. Input data fail the required standard if they give rise to a serious risk of material misstatement in the capital requirement either immediately or subsequently. The latter is relevant because, for example, input data might be retained as data histories that are also used to inform estimates in subsequent periods.
- For outputs, the IRB and accounting rules may differ even where they might superficially appear to describe similar concepts, for example, IRB expected loss and accounting provisions for incurred loss.

7.17 We have included additional guidance in the draft BIPRU text⁵⁷ beyond that contained within the Draft Directive on the approach outlined above.

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

Outsourcing within a group

7.18 Firms have sought guidance through the FAQ process on whether services or data can be provided by other members of a group and still meet the Pillar 1 standards and whether we will implement the national discretion contained within Article 84(2) of the Draft Directive.

⁵⁷ BIPRU 4.2.5.

- 7.19 We would accept data and services provided by other members of the group as meeting Pillar 1, provided:
- we can do so under the Draft Directive (which would include meeting the standards imposed upon us for supervisory review);
 - the function has been formally outsourced to a proper standard (that is, meeting our policy on outsourcing) so that the integrity of a firms' systems and controls is maintained; and
 - it is appropriate, given the nature of the subsidiary's business.
- 7.20 We have included additional guidance to this effect within the draft BIPRU text⁵⁸ as we believe this provides helpful information to firms in developing their implementation plans. It also gives us flexibility in assessing firms' IRB compliance while still meeting our obligations under the Draft Directive for supervisory review.
- 7.21 However, where data and services are provided by a member of the group located in another jurisdiction, we will need to consider the views of other supervisors.
- Q43: Do you support our approach to the provision of data and services by other members of the group?
- 7.22 The issue of the appropriateness of models and data is considered in more detail in paragraphs 7.70 to 7.75.

Use test

- 7.23 Another key requirement of the Draft Directive⁵⁹ is that use of the IRB approach is embedded within a firm's own risk measurement and management. We proposed in CP189⁶⁰ that a firm should prepare a self-assessment of its compliance with the use test (via a scorecard approach), based on three broad categories – core credit issues, broader activities and infrastructure. We proposed that the core areas should be mandatory for all firms, but that firms need not meet all the broader activity issues. Respondents to CP189 generally supported the issues outlined as indicative of meeting the use test and broadly supported the distinction between core and broader activities proposed. Concern was expressed about the inclusion of provisioning, given the differing requirements between IRB and accounting standards. Most respondents called for an open-minded approach to the use test, as excessive reliance on new or relatively untried models would present risks to a business. Some

58 BIPRU 4.2.4.

59 BCD Article 84(2)(b).

60 3.43 to 3.51 and 3.63 of CP189.

respondents were also sceptical about using a ‘scorecard’ approach. Others wanted more detailed guidance.

- 7.24 As a result of this consultation we have decided not to implement the use test ‘scorecard’ as we think it places an unnecessary burden on firms given the range of models being implemented and that we can achieve the same aim by other means. As part of the FAQ process, firms have asked for further guidance on the philosophy behind our approach to the use test. And they have queried whether we will focus more on the risk management process or on the risk values.
7. 25 We consider that a firm’s IRB system must have an ‘essential role’ in both risk management and decision-making. However, use of estimates for probability of default (PD), loss given default (LGD), and exposure at default (EAD)⁶¹ solely for high-level qualitative risk management reporting is unlikely to be sufficient to establish an ‘essential role’ in decision-making. The estimates must play an ‘essential role’ in the risk management and decision-making process, and in the firm’s credit approval, internal capital allocation and corporate governance functions. Therefore, we intend to incorporate the issues that were outlined in the use test scorecard into the application pack and as guidance in the draft BIPRU text⁶² as we believe this guidance gives firms additional clarity on our expectations and provides a suitably risk-sensitive - while prudentially sound - approach.
- 7.26 However, an ‘essential role’ in risk management and decision-making does not necessarily mean an exclusive or primary role. For example, internal standards and policies may refer to estimates of PD and LGD for the term of the asset rather than the IRB one-year PD and LGD estimates. However, the Draft Directive imposes three conditions which must be met to determine compliance with the use test requirement:
- Consistency: ‘The criteria (used for assigning exposures to grades or pools within a rating system and so in determining the IRB estimates of PD, LGD and EAD) shall be consistent with the credit institution’s internal lending standards and its policies for handling troubled obligors and facilities’.⁶³ This implies that the information the IRB estimates are based on also informs the credit institution’s internal standards and policies.
 - Use of all relevant information: ‘A credit institution shall take all relevant information into account in assigning obligors and facilities to

61 Also referred to as conversion factor.

62 BIPRU 4.2.6 and 4.2.7.

63 BCD Annex VII, Part 4, paragraph 18(c).

grades or pools.⁶⁴ This implies that any relevant information used in a credit institution's internal standards and policies should also have been taken into account in the IRB estimates.

- Disclosure: 'If credit institutions use different estimates for the calculation of risk weights (that is, the IRB estimates PD, LGD and EAD) and internal purposes it shall be documented and their reasonableness shall be demonstrated to the competent authority'.⁶⁵

7.27 On the CP189 responses regarding provisions, we would like to emphasise that we do not expect provisions to be exactly the same as expected loss, but that firms should be able to explain the differences between the two. We are not proposing to take a 'one size fits all' approach and will take account of a firm's controls and processes around the integration of new models. We have not included explicit guidance on these last two issues within the draft BIPRU text.

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

Experience requirement

7.28 One of the requirements for use of the IRB approach is that a firm must have been using a rating system broadly in line with the minimum requirements for at least three years before using the IRB approach for regulatory capital purposes. This is referred to as the experience requirement.

7.29 In CP189, we set out what we considered the main elements of the experience requirement – 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. Respondents did not disagree with the elements outlined, so we have included guidance within section 4.2 of the draft BIPRU text. Additional clarification was sought on our expectations regarding the level of experience that would be required. We have, therefore, included guidance in the draft BIPRU text that we would expect firms to improve their systems in light of experience over the three year period, so that they more fully meet the requirement in the final year.

7.30 The Commission's CP3⁶⁶ contained national discretions⁶⁷ allowing the experience requirement to be relaxed for the first three years after implementation of the new capital arrangements. As a result, in CP189 we proposed relaxing the requirement, except in the case of Advanced IRB for

64 BCD Annex VII, Part 4, paragraph 19.

65 BCD Annex VII, Part 4, paragraph 55.

66 'Review of Capital Requirements for Banks and Investment Firms', 15 March 2004.

67 Article 146(2) of the Commission's CP3.

corporates, institutions and sovereign portfolios. We proposed this because, given the lower level of experience of estimating LGD in the industry, we considered that firms' estimates would be a less robust base for regulatory capital purposes until they had experience of using these in practice. Stressed LGDs are considered further in paragraphs 7.119 to 7.121.

- 7.31 Subsequently the Draft Directive⁶⁸ changed the experience requirement from a discretion to a transitional provision. The experience requirement now applies in full from 31 December 2010. As a result we have revised our proposal. As firms are still gaining experience of LGD, we propose to be superequivalent to the Directive and not implement the transitional provision in full. We will waive the experience requirement for Retail and foundation IRB approaches but not for firms on Advanced IRB for their corporate, institution and sovereign portfolios.⁶⁹ While our proposal goes beyond that of the Draft Directive - and may bring forward costs that would ultimately be incurred - it will ensure that a firm's IRB system is fully embedded within the risk-management process and that the capital requirements generated are robust. However, firms may put a case to us that in their circumstances we should waive the requirement. This will allow us to be flexible where there is a case to do so. A table containing this transitional and other IRB transitionals is contained in Annex 7.

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?

Roll-out

- 7.32 The Draft Directive⁷⁰ requires IRB approaches to be implemented by a firm within a reasonable period of time, to be agreed with the competent authorities. In CP189, we proposed that we would expect this to be carried out over a period of three years and that firms would be required to send us a roll-out plan for the entire group. We also stated that we would implement the Draft Directive provision requiring us to set conditions about phased implementation that are designed to prevent it being used selectively to minimise capital ('cherry picking') through Pillar 2. Our proposals for roll-out and the partial use of IRB methods contained in CP189 were well received. Respondents said this represented a pragmatic approach to implementation that would give them reasonable time to implement these fairly complex requirements. So we intend to continue with them.

68 BCD Article 154(5) and (6).

69 BIPRU Transitional provision 2.

70 BCD Article 85(1) and (2).

- 7.33 In general, firms should aim to achieve full roll-out (subject to permitted exemptions) within three years of starting to use of either the Foundation or Advanced IRB approach.⁷¹ For this purpose, the Retail IRB approach may be classified according to the approach adopted by the firm for its corporate, institution and sovereign exposures. We acknowledge that firms' entry into new products and markets may require revisions to previously agreed roll-out plans. But we expect that, in many cases, these can be accommodated within existing waiver conditions. Major mergers or acquisitions, however, will provide greater challenges and we would expect to discuss with firms how they intend to update their roll-out plans to take account of these. Therefore, we have proposed specific guidance within the draft BIPRU text⁷² to address how an acquisition would impact a firms' roll-out plan. We also propose to continue with our Pillar 2 approach to 'cherry picking' and will discuss this in more detail in the next CP.

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?

Permanent exemptions

- 7.34 The Draft Directive⁷³ sets out the exemptions from the IRB approach available to firms to calculate risk weighted exposure amounts for certain asset classes under the standardised approach. In implementing these exemptions we are proposing that firms have a documented policy setting out the exposures they are intending to use the standardised approach for. While this guidance goes beyond the requirements of the Draft Directive, we consider that having a policy on this accords with firms' own internal practices and will help us understand their approach to these exemptions.

Permanent exemption of exposures to sovereigns and institutions

- 7.35 In CP189, we consulted on allowing firms to exempt exposures to sovereigns and institutions from IRB. Respondents supported this proposal. Since CP189 there has been a change to the Draft Directive text⁷⁴ which has now made the exemption available only to firms with exposures to a limited number of material counterparties for whom it would be unduly burdensome to implement a rating system for such counterparties.
- 7.36 Rather than set specific numbers of counterparties that we would consider immaterial, we propose leaving firms to decide for themselves, subject to supervisory review. Hence, we are not proposing to include guidance on this

71 BIPRU 4.2.18.

72 BIPRU 4.2.31.

73 BCD Article 89.

74 BCD Article 89(1)(a) and (1)(b).

issue in the BIPRU text. Nevertheless, we are aware that firms are seeking early guidance on whether the supervisory review would result in the exemption being allowed in their case. The following represents our current thinking. We do not want to disincentivise firms from spreading their exposures amongst a number of low risk counterparties. So we think the ‘limited number of material counterparties’ test is unlikely to be met if for the UK group total outstandings to ‘higher risk’ sovereigns and institutions exceed either £1bn or 5% of total assets. This is not a hard limit insofar as it is intended to accommodate temporary fluctuations above these levels. For these purposes, ‘higher risk’ sovereigns and institutions are considered to be those that are unrated or carry ratings of BBB+ (or equivalent) or lower. In determining whether to allow this exemption we will take a secondary consideration into account. This is whether a firm incurs exposures to ‘higher risk’ counterparties which are below the levels set out below, but are outside the scope of its core activities. There is a condition that it needs to be unduly burdensome to implement a rating system for sovereign and institutional counterparties. On this, we think an adequate, but not perfect, proxy for the likely level of expertise is whether the group has a trading book. Accordingly, if the group does not have a trading book, we are likely to accept their argument that it would be unduly burdensome to implement a rating system.

- 7.37 It follows that if a firm is part of a group that either habitually incurs exposures to higher risk counterparties in excess of the amounts suggested above or does have a trading book, it should expect us to ask searching questions before allowing the exemption in its case. In implementing this proposal, firms will need to outline their proposed approach to institutions and sovereigns in the roll-out plans they submit to us. This approach will need to address both aspects of the exemption, including rationale on why implementing IRB would be unduly burdensome. We also propose keeping this under review and will update our position if CEBS provides guidance on this issue. We are not aware that CEBS has any plans to do so at this stage.

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

Materiality exemption

- 7.38 The Draft Directive⁷⁵ also permits firms to exempt exposures in non-significant business units and exposures that are immaterial in terms of size and perceived risk profile and include them within the standardised approach. While the Draft Directive defines materiality for the equity

75 BCD Article 89(1)(c).

78 CP05/3: Capital standards (January 2005)

exposure class, it does not do so for other exposures. In CP189⁷⁶ we proposed defining ‘immaterial in terms of size’ as 15% of the Pillar 1 credit risk requirement. Where a firm moves to the Advanced IRB, the 15% would include all exposures that remain on the standardised approach or Foundation IRB. Although some queried how the calculation would be done, respondents generally considered this proposal to be helpful, as it struck a reasonable balance between risk sensitivity and pragmatism of implementation.

- 7.39 As a result, we have included the definition of immaterial as guidance in the draft BIPRU text.⁷⁷ We propose that the calculation of the 15% should be undertaken after taking out other exempt assets. Additionally for the purposes of calculating the 15%, the retail exposure class will not be deemed as advanced unless the firm has adopted the advanced approach for its corporate, institution and sovereign exposures. This means that it would be acceptable for a firm to adopt the foundation approach for its corporate, institution and sovereign exposures and retail without using this exemption. To implement this proposal, firms will need to outline their proposed application of this provision in their roll-out plans. Once on IRB, a firm that subsequently acquires or divests itself of a business that takes it over 15% of the Pillar 1 credit risk requirements will need to submit a revised roll-out plan to its supervisor. This roll-out plan may take it beyond the three year general guidance on roll-out.

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

Exposures to group companies and the integrated groups regime

- 7.40 The Draft Directive⁷⁸ provides for the permanent exemption of certain intra-group exposures. This facilitates the introduction of the integrated groups regime. A firm may choose permanently to exempt from the IRB its exposures to a counterparty which is:
- its parent undertaking, its subsidiary; or a subsidiary of its parent undertaking; and
 - provided that the counterparty is an institution or a financial holding company, financial institution, asset management company or ancillary services undertaking subject to appropriate prudential requirements.

76 3.18 of Annex 3 to CP189.

77 BIPRU 4.2.27.

78 BCD Article 89(1)(e).

- 7.41 Generally, any parent or subsidiary that is included within a regulatory group that is subject to consolidated supervision by the FSA or an equivalent supervisor, would be eligible for this permanent exemption from an IRB approach. Exposures to participations - or any non-financial firm (such as insurers or commercial companies) in the group - could not be exempted, and would remain on the IRB approach. Exposures to these types of firm would still be potentially eligible for treatment under the standardised approach under another of the permanent exemptions from the IRB approaches.
- 7.42 Intra-group exposures that were permanently exempted for integrated groups purposes would be subject to the capital requirements of the standardised approach. If both the firm and the group entity permanently exempted in this way met the conditions for membership of the UK integrated group, exposures between them would receive a 0% risk weighting (see paragraphs 5.31 to 5.38). In addition, such exposures would be exempt from large exposures limits (see paragraph 8.12).
- 7.43 Exposures to connected counterparties that were permanently exempted from an IRB approach that did not meet the UK integrated group conditions would be subject to standardised approach risk weightings. These risk weightings, will depend on the type of counterparty and their credit quality. Exposures that remained on an IRB approach would be risk weighted in accordance with the IRB requirements in the draft BIPRU text. We detail the concentration risk limits that would apply in each case in Chapter 8 and BIPRU 10.5.
- 7.44 The firm would decide which intra-group exposures would be permanently exempted for integrated groups purposes, and which would remain on an IRB approach. A firm should include in its IRB waiver application details of intra-group exposures permanently exempted in this way, in the same way as for other exposures subject to permanent exemption from an IRB approach. We will expect a firm seeking to use the integrated groups permanent exemption from IRB to be able to demonstrate it has a policy providing for the identification of connected counterparties, and the circumstances in which they would be permanently exempted from the IRB framework. The policy should also identify the connected counterparty exposures that are not permitted to be permanently exempted from the IRB approach. The policy should be consistently applied to all connected counterparty exposures.
- 7.45 The requirement referred to in paragraph 7.44 above is superequivalent to the Draft Directive. However, we believe it to be prudentially sound, and necessary to ensure that firms do not choose which exposures should remain on the IRB approach purely in order to minimise the regulatory capital charge – that is, ‘cherry picking’.

- 7.46 The flow chart in Annex 8 illustrates the way in which the IRB permanent exemption would operate in practice.

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

Application of partial use across a financial group

- 7.47 In CP189,⁷⁹ we set out our proposed approach to partial use of IRB across a financial group. In summary, we stated that for UK groups we would apply our provisions at a group level: for UK subsidiaries of foreign groups with a supervisor deemed to be ‘directive equivalent’, we said we would rely upon the partial use provisions of the home supervisor. And for UK subsidiaries of foreign groups with a supervisor deemed not to be ‘directive equivalent’, we would apply our partial use provisions at a sub-group level.
- 7.48 Respondents generally found this clarification helpful, as it balanced a pragmatic approach to implementation with consistency of application of the requirements. So we have included it in the draft Handbook text.⁸⁰

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

Cross-Border Implementation

- 7.49 There are many areas where implementing the IRB approaches is subject to either formal national discretions or interpretations that may vary from country to country. We recognise that groups operating in several jurisdictions may be faced with potentially conflicting IRB requirements. Whilst it is important to maintain equal treatment between firms operating in the UK, we will not rule out the recognition of other supervisors’ approaches for the overseas operations of international groups where we are able to do so within the Draft Directive. Moreover, within the EU, CEBS is working on convergence of standards to deliver an appropriate degree of consistency. We consider that this represents a pragmatic approach to implementation across jurisdictions while still aiming for consistency of application of the requirements. At this point, we are not proposing specific guidance on this issue in the Handbook.

Provisions common to different exposure classes

- 7.50 This section of the draft BIPRU text sets out the different exposure classes covered by the IRB approach, corporate governance, credit risk control, rating systems and their validation, stress testing, definition of default, data and model issues.

79 3.15 of Annex 3 to CP189.

80 BIPRU 4.2.29.

Validation of IRB estimates

- 7.51 The Draft Directive⁸¹ requires firms to have robust systems in place to validate the accuracy and consistency of rating systems, processes, and the estimation of all relevant risk parameters.
- 7.52 Appropriate approaches to the validation of IRB estimates remain the subject of much discussion. As we had noted in CP189, a single approach is not appropriate. Rather, a mixture of direct quantitative and indirect benchmarking techniques may be required. As an initial step, we proposed in CP189⁸² a framework for validation standards which included a number of principles. We also proposed a draft scorecard in which firms would compare estimates and experience from various sources and outline adjustments made. Comments received were mixed, ranging from the validation standards and scorecard appearing reasonable to criticisms that they were too simplistic and that firms required further guidance. Some respondents made the specific point that while the scorecard may be useful for wholesale portfolios, it was not appropriate for retail, where firms rely entirely on internal default data.
- 7.53 At present, we are not planning to proceed with a formal scorecard as set out in CP189. However, we continue to regard the items covered by that scorecard as important to the validation of firms' estimates. The draft BIPRU text⁸³ includes guidance on what we would expect firms to consider in developing their validation practice. This would include independent input into the process, appropriate involvement of senior management, the extent of the validation across the portfolio, discriminative power and accuracy of calibration, the appropriateness of the approaches used to different portfolios, and the appropriateness of the process over time. We will also require firms to summarise their validation approach in the Application Pack. While this guidance goes beyond the requirements of the Draft Directive, we consider that the issues raised already accord with good practice within the industry.
- 7.54 The results of our visits to firms to date indicate that firms are not presently able to articulate how their actual default rates vary from their estimates due to the use of conservatism, cyclical factors and small sample size. Furthermore, firms do not yet appear to have established tolerance levels around their estimates as required by the Draft Directive.
- 7.55 Both AIG and CEBS have set up validation groups.⁸⁴ So far, discussions have indicated a consensus over the need for back-testing of outcomes against estimates to be supplemented by developmental evidence on whether a model might be expected to work well, and benchmarking of firms' estimates.

81 BCD Annex VII, Part 4, paragraph 109.

82 CP189, Annex 3, 3.109 to 3.120.

83 BIPRU 4.3.26.

84 The timetable for finalising this work is not yet certain.

Domestically, we have acted on our thinking through specific policy proposals involving the Credit Risk Standing Group and reflected in BIPRU 4.3, by holding discussions with a joint working group with the industry on low default portfolios (see paragraph 7.62), and through developing the draft IRB Application Pack (see Annex 10). We are also conducting a series of ‘drill down’ visits to build up a picture of current validation practices across the industry and across asset classes.

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?

Adequate discrimination

- 7.56 The Draft Directive⁸⁵ requires regulators to allow firms to use the IRB approach only if certain standards are met - for example, that the rating systems provide a meaningful differentiation of risk and accurate and consistent quantitative estimates of risk. It leaves it to national regulators to interpret what this means. We have taken account of the fact that industry usually considers a high degree of differentiation of risk to be a precondition for accurate estimates. In the absence of data, assessing adequate discrimination is of particular importance (see paragraphs 7.62 to 7.65).
- 7.57 In CP189, we proposed that rating systems should show a high degree of discriminative power in line with the industry norm for the relevant portfolio. However, as yet there is neither an industry standard, nor an initiative to develop one. In any event, the further work we have carried out since publishing CP189, and the responses to it, has highlighted that it is difficult and probably inappropriate to rely on a single measure, such as the widely used Gini coefficient. So we will collect more information about the use of metrics and review our approach as our experience develops. This will require us to collect information from firms, and will impact on our model validation strategy on a case-by-case basis. However, we no longer propose that compliance with an industry standard of discrimination forms a pass/fail test.
- 7.58 In general, our focus is shifting towards trying to build upon industry practices, while also seeking to increase awareness of the possible range of outcomes, as opposed to placing undue reliance on the accuracy of measures observed in individual periods. In the corporate and institutional markets, we are aware that firms often compare the discriminative power of their rating systems against the performance of external benchmarks on their portfolios. We wish to build on this to provide a measure of what constitutes acceptable discriminative power

85 BCD Article 84(2).

and so will expect firms to have selected their own benchmark against which they will assess themselves. This guidance⁸⁶ goes beyond the requirements of the Draft Directive. However, we consider it important that firms be able to assess the discriminative power of their rating systems to understand its strengths and weaknesses and to assess its robustness for calculating capital requirements.

- 7.59 As a consequence of adding guidance on benchmarking, we are proposing that firms should be able to explain their performance against their chosen measure (or measures) of discriminative power. In assessing performance, we will consider the sophistication of the chosen measure, that is, the less sophisticated the measure, the better we would expect a firm to be able to perform against it. In comparing performance against its measure, we would expect a firm to rely primarily on actual historic default experience where it is available. We expect firms to be able to explain the extent of potential inaccuracy in these measures, caused in particular by small sample size, and the potential for divergence in the future, whether caused by changing economic conditions or other factors.
- 7.60 It is important to emphasise that we will not necessarily construe individual instances of underperformance negatively. We want to be able to understand the range of possible outcomes more fully and have apparent divergences explained to us.
- 7.61 For example, in some corporate portfolios there is insufficient default experience to provide any confidence in statistical measures of discriminative power. In this case, one acceptable alternative is to compare the internal risk rating system with an external measurement approach to ensure that they rank common borrowers in broadly similar ways, and that differences between the two are understood and can be justified. However, we will discuss other alternatives with firms as we acknowledge that firms consider rank ordering a key element in determining the treatment of low default portfolios.

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?

Provisions common to probability of default, loss given default and exposure at default

Low Default Portfolios

- 7.62 Low Default Portfolios (LDPs) can be broadly defined as portfolios where a firm has experienced no - or a very low level of - defaults, and therefore feels

86 BIPRU 4.3.

unable to validate PD, LGD or EAD estimates on the basis of a proven statistical significance. Although there are overlaps and grey areas in practice, LDPs arise in three circumstances:

- Where the industry as a whole has sufficient default experience, but an individual firm does not. This is typically associated with smaller firms.
- Where the industry and/or firm do not have sufficient default experience now, but will have it in the future. This is typically associated with firms entering new markets – either newly-created markets or existing markets to which they are new entrants. It could also include some retail exposures where only short runs of data are available. Here, experience, and thus confidence in estimates, will improve over time.
- Where neither firms nor the industry as a whole have sufficient default experience now, and - realistically - this situation will not be cured with the passage of time. These include a significant proportion of wholesale exposures, such as exposures to sovereigns, institutions, large corporates and social housing.

7.63 There are no specific references to LDPs within the Draft Directive and thus no specific treatment is outlined for them. However, we recognise that this is a significant issue for firms seeking IRB because LDPs can be a significant portion of a firm's balance sheet. Therefore we intend to take as flexible an approach to implementing the Directive requirements as we are able to. We believe that firms' portfolios should be capable of inclusion in the IRB to the greatest extent possible, and are working with the industry on ways to achieve this. Acceptable estimates on LDPs are likely to require combinations of various indicators of relative and absolute measures of risk. Measures being considered include internal and external pricing, and external 'arm's length' measures of risk (such as agency ratings and external models). In general, the use test will be particularly important in supporting inclusion of LDPs in IRB - demonstrating the extent of firms' confidence in the estimates put forward. Inevitably, we will be looking for firms to exercise greater conservatism where data is scarce.

7.64 The initial focus of this work is on PD estimation (first quarter of 2005), which is the necessary input for Foundation IRB. Methodologies, for this and external benchmarks, are relatively well developed. Estimates on many portfolios may be supported by agency ratings, external default models, credit default swaps and bond spreads. There are a number of niche portfolios which do not benefit from these measures and therefore present greater challenges. Nevertheless, we expect that, working with industry, we may be able to find mechanisms to accommodate all of firms' LDPs and we will take greater comfort where firms are using this data for their own internal risk-management. This will be more likely where our work on firms'

other portfolios gives us a high degree of confidence in their general credit risk measurement and management capabilities.

- 7.65 Estimation of LGD and EAD for LDPs, for the Advanced IRB approach, produces greater challenges. This is because the LGD and EAD methodologies are generally less well-developed, there is a relative lack of external models and benchmarks, and the data set (that is, defaulted exposures only) from which firms have to produce estimates are even smaller. We intend to work with the industry in the first half of 2005, on how these issues might best be addressed after the work on PD has been taken forward. However, we recognise that some comfort may be gained in the LGD area from collateral data available in other portfolios. LDPs are also being considered by CEBS and we will factor conclusions reached in this forum into our national implementation. The timetable for the production of this guidance is as yet uncertain.

Rating philosophy

- 7.66 Rating philosophy is the term used to describe the assignment horizon of a borrower rating system. Assignment horizons of rating systems vary along a spectrum. There are those aiming to leave the grades unchanged on average during an economic cycle, with fluctuations in default rates in line with changes in the cycle, and those which expect to see cyclical variations in grades, but with the default rate experienced in each grade relatively constant. In practice, many rating systems are a hybrid between these extremes.
- 7.67 In earlier versions of the Draft Directive, the rating philosophy aimed to leave grades unchanged on average during the course of an economic cycle. We can confirm that, in the light of recent international discussions on the Framework, we do not intend to be prescriptive on the rating philosophy used. The reference in CP189 to a transitional period⁸⁷ may now be disregarded. However, the choice of rating philosophy has implications for the way in which capital requirements vary with the cycle. It is also necessary to know how default rates are expected to vary to assess the extent of deviation of outcomes from the estimates.
- 7.68 The discussion in CP189 around ‘through-the-cycle’ and ‘point-in-time’ estimates produced mixed reactions - with some respondents supportive while others felt the information was neither particularly helpful nor informative. A number of these reflected opposition to the interpretation of ‘assessment horizon’ proposed in the Basel Framework. However, as few rating systems could be considered to be wholly through-the-cycle or wholly point-in-time, the respondents welcomed our flexibility around the approaches.

87 3.247 of Annex 3 to CP189.

- 7.69 We are proposing to continue with this flexible approach. We expect firms to be able to discuss how the assignment of both ratings and PD estimates are affected by movements in the economic cycle (or other cyclical effects material to levels of default in the exposures covered by the rating system), as well as by applying conservatism.⁸⁸ We will also expect firms to be able to discuss the assignment of grades and quantitative estimates for LGD and EAD.

Use of external data and external models

- 7.70 External measures of risk – modelled approaches and more judgemental agency grades – are used in different ways by firms. We have observed the following external measures of risk, however, this should not be interpreted as an explicit approval of such measures:
- Direct use of external measure and associated PD estimate; or an internally-generated model with the objective to predict an external rating grade with a view to using that PD estimate associated with the latter.
 - The use of the PD estimate of an external measure justified on the basis of the degree of consistency/overlap between the internal and external grades.
 - A comparison between internal and external measures as an indication of the former's ability to rank order credits.
 - Using the external measure as a benchmark for acceptability of the discriminatory power of the internal rating system.
 - Association of internal PD estimates with default experience of external rating grades, when building a master scale covering all rating systems.
 - More general benchmarking to assist in either high-level or exposure level risk measurement.
- 7.71 The Draft Directive provides that the same requirements for rating systems, including documentation, apply to external models and internal models.⁸⁹ Respondents to CP189 agreed that it was a firm's responsibility to understand its models and assess their fitness for purpose. We believe that firms must understand the external risk measures used in their business to assure themselves that they are being used appropriately. We also believe that we should not explicitly approve the use of external measures.
- 7.72 We would expect firms to be able to demonstrate how they have satisfied themselves that these external measures or models are appropriate for their use. In particular, whether the measure or model is appropriate for

88 BIPRU 4.3.71.

89 BCD Annex VII, Part 4, paragraph 36.

its proposed use, with particular reference to the nature of the firm's portfolio to which it is applied. We have included guidance on the use of external models in draft BIPRU text.⁹⁰ While this goes beyond the text in the Draft Directive we consider that this adds clarity on our expectations, enabling firms to prepare for implementation. And we believe it is risk-sensitive as it highlights the issues associated with the use of external models. We are also proposing to keep this issue under review as firms' implementation projects progress.

- 7.73 The Draft Directive⁹¹ also requires that firms should complement statistical models and model based assignments with human judgement or oversight. While this is obviously important to ensure that models continue to produce sensible information we do not think this sort of oversight would be required for each and every rating assignment. We have added guidance within the draft Handbook text⁹² to make this clearer.
- 7.74 External scorecards are commonly used when a firm enters a new market of which it has no historical experience. In such circumstances, firms will often use a generic scorecard developed for that market by a specialist provider. Firms wishing to use a generic model under IRB would need to demonstrate that it was based on a population similar to its intended target market and reflected a credit process similar to its own.
- 7.75 Firms also regularly use scores provided by credit reference agencies as inputs to their in-house models. Direct testing of the relevance, stability and accuracy of these data seems to be limited. We do not wish to discourage the use of such data. However, where this data is used, firms should have knowledge of the composition of the scores and be able to demonstrate the statistical power of the data and its relevance for their own portfolios. This is because the Draft Directive is clear that the same standards should apply both to external and internal data.

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

Stress testing

- 7.76 Stress tests are an important tool for internal risk management purposes. There are a number of references in the Draft Directive to the need for firms to carry out stress testing. The most specific relates to the 'procyclicality' stress test, on which we comment below. There are also several other distinct uses of stress testing mentioned in the Draft Directive, for example: in the provision of robust long-term estimates

90 BIPRU 4.3.46.

91 BCD Annex VII, Part 4, paragraph 31(e).

92 BIPRU 4.3.45.

(general stress testing); in the consideration of capital requirements under Pillar 2, implemented through the ICAAP and SREP process (stress testing and Pillar 2); and in relation to the treatment of large exposures (see Chapter 8).

General stress testing

- 7.77 The Draft Directive⁹³ requires credit institutions to provide own funds which are at all times more than - or equal to - the minimum requirements. The estimates produced by risk-sensitive IRB models are likely to vary over time. So firms will need to consider what future developments might cause them to fall below the minimum requirements even though their current calculations are above them.
- 7.78 In the absence of any constraints, firms' IRB models are likely to produce risk estimates that show substantial cyclical variation. To reduce this variation, the Draft Directive requires that estimates be based on long runs of data to capture the behaviour of models over full cycles and that both LGD and conversion factor estimates must be appropriate for an economic downturn. Firms that do not have sufficient data history to cover periods of economic downturn will need to apply conservatism to their estimates. Given the benign economic climate in the UK over recent years, it is quite likely that many firms will not have sufficient data. Even firms that have been using Basel-type approaches since the early 1990s are likely to have changed their business model since then. So their data cannot be assumed to be directly applicable to their current practices. Firms may therefore need to make adjustments for periods of economic downturn by reference to stress tests that show how the models would behave in adverse conditions.
- 7.79 It is not a requirement of the Draft Directive that stress tests must be used as outlined above, so therefore any guidance on this would go beyond the requirements of the Draft Directive. However, we envisage that firms may find stress testing a useful tool in meeting their requirements relating to economic downturns (and this would be consistent with the CEBS CP on Pillar 2 which makes reference to stress testing of the ICAAP (see paragraph 7.88)). In this context, we will discuss with firms their use of stress testing (at a model or portfolio level) and how they take account of economic drivers already considered in their models.⁹⁴

Q55: Do you support our approach to general stress testing?

93 BCD Article 75.

94 BIPRU 4.3.33.

Ratings migration and procyclicality

- 7.80 Unlike the current regime where there is no such requirement, the Draft Directive⁹⁵ requires firms to perform a ‘procyclicality’ stress test to assess the effect of certain specific conditions on ratings migration and on their total capital requirements for credit risk. The purpose of this test is to identify the extent to which firms’ rating systems vary with the state of the economic cycle. However, the Draft Directive does not specify the precise form, nature or frequency that these stress tests should take.
- 7.81 In CP189, we consulted on the use of stress testing and, in particular, its role in dealing with procyclicality. We proposed an approach that would take into account firms’ expectations of the next three years and incorporate the result into the Pillar 1 capital charge. The responses to CP189 indicated that whilst firms agreed with the desirability of stress testing in general, they did not see benefit in the proposed procyclicality stress test and in particular its inclusion in Pillar 1. It was also not clear how this stress test should be applied and firms requested further guidance.
- 7.82 We have reconsidered our proposal and do not intend to pursue a Pillar 1 approach. This is because we think a more flexible approach to implementation can be achieved through the ICAAP process. We will only specify the general form of the stress test and we will require firms to undertake their own research and assessment of how cyclical factors affect their rating systems. While we will specify a macro-economic scenario, it will be up to firms to determine how this translates into specific risk drivers and how these drivers in turn affect their capital calculation. Firms may find it helpful to develop these linkages on an asset class by asset class basis (for example, factors relevant to mortgages may be different to the corporate asset class). This recognises that some types of business will be less sensitive to macroeconomic cycles than others.
- 7.83 The Draft Directive⁹⁶ requires firms to consider the effects of at least a ‘mild recession’. Following the Basel text, we suggest that this could be equated to two consecutive quarters of zero growth. We have added guidance to that effect as a placeholder in the draft BIPRU text,⁹⁷ but would welcome alternative proposals for how ‘mild recession’ could be interpreted. This guidance goes beyond the requirements of the Directive. However, we think it is important to develop a consistent approach to implementing this requirement and that this will assist firms in their implementation. Firms should assess the impact this would have on their ratings to determine the impact their required capital. We anticipate that

95 BCD Annex VII, Part 4, paragraphs 41 and 42.

96 BCD Annex VII, Part 4, paragraph 42.

97 BIPRU 4.3.35(8).

this will be easiest to determine on the basis of static analysis, assuming that the impact of the macroeconomic shock is instantaneous.

- 7.84 The stress test should be applied at the level of the institution. Where an institution has numerous businesses, questions of diversification arise, particularly across different geographies which may be subject to economic cycles that are not synchronised. We will not necessarily assume that the aggregated impact is equal to the simple sum of each business' figures. In the spirit of the test, we will expect firms to apply reasonable conservatism in specifying correlations and to be able to justify their choices.
- 7.85 We propose that stress tests be undertaken at least annually though we are considering whether firms should undertake stress tests as often as they report their Pillar 1 capital. In this way, we are aiming to ensure that stress testing becomes a useful tool to both firms and us in anticipating changes to the level of regulatory capital requirements and therefore encourage risk management. We note that firms do not necessarily undertake stress tests at an institution level for internal purposes. And we will consider further the form and level at which intra-year stress tests are prepared in the first quarter of 2005.
- 7.86 Where the stress test indicates a need for additional capital, we will impose a condition that the firm holds that additional capital. The stress test would not necessarily show a requirement for extra capital to the extent that:
- firms have already embedded conservatism in their estimates;
 - firms are dealing with products or counterparties that can be shown not to be sensitive to cyclical variations;
 - or if the economy is already in 'mild recession'.
- 7.87 Guidance on ratings migration stress testing is contained in the draft Handbook text.⁹⁸
- 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 the practical implications and costs associated with our approach to ratings migration stress testing?

Stress Testing for Pillar 2

- 7.88 CEBS consultation paper CP03, issued in May 2004, deals with the implementation of Pillar 2 processes. In particular, it discusses the requirements for a firm's ICAAP. CEBS is continuing to develop its approach

98 BIPRU 4.3.34.

but currently suggests that stress and scenario testing is appropriate at least for larger firms. We agree that these are useful and necessary practices for all firms if conducted in a manner proportionate to the size and complexity of their business. The ICAAP is the responsibility of the firm and must reflect the particular risks that the institution faces. However, it will be subject to review and challenge under the SREP. While prescriptive guidance on how an ICAAP should be developed is not appropriate, we think it should cover the following aspects of credit risk (the diagram in Chapter 4 refers more generally):

- Any cyclical variations in capital that have not already been taken into account under Pillar 1, including results of the procyclicality stress test.
- Concentration risk, especially in respect of geographic and industry concentrations, but also exposures to common external factors such as commodity prices.
- Residual risk arising from credit risk mitigation and potential concentrations on individual CRM providers.
- Risks relating to securitisations that are not covered in Pillar 1.

7.89 This list is not exhaustive and should be extended if the firm's circumstances warrant it. We will reconsider this issue once CEBS' work on Pillar 2 is complete.⁹⁹

7.90 While not under Pillar 2, stress testing is also required for collateral in a large exposures context (see paragraphs 8.39 and 8.40)

Exposures

Exposures to a group

7.91 The Draft Directive¹⁰⁰ requires firms to have acceptable policies for assigning ratings to groups of connected clients. In CP189,¹⁰¹ we addressed the extent to which default by members of a borrowing group should result in all group members being treated as being in default. We proposed the following approach:

- In situations where the rating process ordinarily applied to borrowers is substantially based on their membership of a group and they are assigned a common group rating, the combined exposures are aggregated and they are treated as a single obligor for default purposes.
- If some (or all) members of a group are rated on a stand-alone basis, or have their rating 'notched' to reflect different risk factors, they will not be considered to be the same obligor for default purposes. In other

99 The timetable for the finalisation of this work is as yet uncertain.

100 BCD Annex VII, Part 4, paragraph 23.

101 3.186 of Annex 3 to CP189.

words, if a group had two separately rated members and one was in default, it would not necessarily imply that the other would also be deemed in default.

- 7.92 We are doing further work, due to be completed in the first quarter of 2005, on the situations where it will be deemed acceptable to give common or notched ratings to members of a borrowing group so that standalone ratings are not required. Our current thinking is that, as part of this process, we will carry forward the treatment proposed in CP189 for when a default by members of a group should result in all members of that group being treated as in default. Guidance reflecting this has been included in the draft Handbook text.¹⁰²

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?

Definition of default

Definition of unlikelihood to pay

- 7.93 While much attention has been focussed on the days-past-due element of the definition of default, the Draft Directive¹⁰³ includes other indicators of when firms are unlikely to pay for consideration. In CP189¹⁰⁴ we commented on some of these, including distressed restructurings and the use of a firm's internal indicators.
- 7.94 We had suggested that renegotiation should only be regarded as distressed restructuring if independent third party lenders would not be prepared to provide financing under the same terms and conditions. This was not intended to preclude normal commercial variations of terms, but only to cover cases of distress. Following suggestions from the industry, we intend to amend this guidance to apply only where their terms and conditions differ substantially from normal commercial terms.
- 7.95 Firms have welcomed our intention to accept their own internal indicators of unlikelihood to pay and, unless constrained by the Directive, we intend to continue to allow firms to apply internal criteria. Firms should remember, though, that internal criteria are intended to be additional to - and not instead of - the Directive criteria. We have included additional guidance on the definition of default in the draft Handbook text.¹⁰⁵

102 BIPRU 4.3.50.

103 BCD Annex VII, Part 4, paragraph 45.

104 3.208 to 3.214 of Annex 3 to CP189.

105 BIPRU 4.3.56 to 4.3.61.

Amounts overdue and the definition of default

- 7.96 The 'days overdue' leg of the definition of default operates when an obligor is overdue by 90 days (or in some cases more) on a material credit obligation to the firm.
- 7.97 The main concern that had been expressed to us before CP189 related to the possibility of amounts owed by small members of large multinational groups triggering the regulatory definition of default for the entire group. However, we did not expect this to be an issue in practice as cross-group regulatory default would be limited to those cases where a firm had given common ratings to some or all members of the same group. And we considered the 90 day grace period to be sufficient to resolve operational problems. More generally, we considered excluding amounts that are small in absolute terms. However, we found it difficult to suggest a non-complex approach that would not result in the omission of defaults on many retail exposures.
- 7.98 So we proposed in CP189 that any amounts overdue would be considered material credit obligations. Respondents generally felt that there should be a materiality threshold, given that the systems of many firms automatically ignore immaterial balances. We were asked to consider excesses due to operational oversight and later reversed, small excesses on revolving facilities, excesses that were small percentages of total facilities, and other excesses that were small in absolute terms.
- 7.99 Our amended proposal attempts to steer a balance between avoiding distortion of the estimates used and providing incentives for good practice that do not undermine the IRB approach. This would mean that if firms have sufficient information, they may exclude from estimates and recording of defaults, retrospectively if necessary, any cases where the amounts become overdue by the relevant number of days-past-due because of administrative oversight on the part of the obligor and/or the firm. Firms wishing to take advantage of this provision would be required to have sufficiently detailed policies on the circumstances in which this provision would apply. As with other aspects of the IRB framework, this would be subject to our review.
- 7.100 In addition, firms are permitted to exclude from estimates and recording of defaults, any cases where the total amounts due are insignificant in line with a policy subject to our review.
- 7.101 We are not proposing to set an absolute materiality threshold at this time, but to permit firms to exclude from estimates and recording of defaults, any incidences where the total amounts due are insignificant in line with a policy agreed with us.
- 7.102 More generally, we expect firms to assess whether relatively low value defaults have different characteristics from others in the same portfolio, and to model these differently if necessary.

7.103 Guidance can be found on these issues in the draft Handbook text.¹⁰⁶

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

Time measure and money measure in the definition of default

7.104 In CP189 we consulted on two common interpretations of days-past-due in the industry – ‘the time measure’ and the ‘money measure’. The time measure is the number of days with some arrears; under the money measure the amount outstanding is equivalent to a number of monthly payments. While the Draft Directive refers to the former, it is silent on the latter.

7.105 In CP189,¹⁰⁷ we had stated our view was that a ‘money measure’ of days-past-due would be acceptable as an alternative to a time measure. Responses to this were generally favourable. The Draft Directive places some constraints on how this interpretation can be applied. The wording that we have included in the draft Handbook¹⁰⁸ text permits a money measure to be used only if the firm’s procedures in applying receipts against overdue payments are such that no payment can be past due for more than the maximum permissible number of days.

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

Realisation of collateral

7.106 Realisation of collateral may be considered an indicator of default in the Draft Directive.¹⁰⁹ In non-retail markets, we would generally consider the sale of collateral as indicating a default, even if none of the identified indicators of default were deemed to be explicitly triggered. This is because the sale of collateral in itself would be considered as conclusive evidence that payment would not be received in full without recourse to realising security.

7.107 For avoidance of doubt, the sale of collateral is not to be considered conclusive evidence of a default in cases such as commodity finance or property development where the sale of the collateral is the normal source of repayment of the facility. Moreover, references to collateral in this context should be taken to exclude ‘unfunded collateral’ such as guarantees and credit derivatives.

106 BIPRU 4.3.51 and 4.3.52.

107 3.200 of Annex 3 to CP189.

108 BIPRU 4.3.54.

109 BCD Annex VII, Part 4, Paragraph 4(a).

- 7.108 In retail markets where an obligation approach is being used we would generally expect PD to be reduced by the presence of collateral, but we do not intend to give more detailed guidance.¹¹⁰ In retail markets where an obligor approach is being used, we would expect the PD not to reflect the presence of any collateral.
- 7.109 In markets such as margin lending it is established practice for collateral to be sold if its value falls below a certain percentage of the loan and the borrower does not restore the margin. In these circumstances, we would not normally consider such sales to be a default for regulatory purposes unless the value of the collateral has fallen below the amount outstanding. We would, however, expect the rating grade of the obligor to be reassessed following such a sale. Guidance on this is contained in the draft Handbook text.¹¹¹

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

Considerations for assets which are close to default

- 7.110 We have not previously highlighted the treatment of exposures that the firm considers may be in danger of imminent default. Many firms use rating systems which focus on identifying and classifying borrowers where there is a relatively high possibility of incurring a loss, with a view to taking appropriate action. Often, the assessment and management of these 'watchlist' exposures passes to different units within the firm.
- 7.111 There may be challenges in converting this approach to the requirements of the Draft Directive that a rating approach should be applied to all non-defaulted borrowers, with a given level of default risk associated with all borrowers within each grade. So we remind firms to ensure they comply with these principles, although we have not provided any additional guidance on this issue within the draft Handbook text.
- 7.112 Issues also arise when assets which have previously been in default are returned to performing status. Firms will need to have clearly articulated policies¹¹² setting out how such assets are re-rated, and which are likely to vary with the indicator that triggered the default.

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

110 BIPRU 4.3.59.

111 BIPRU 4.3.58.

112 BIPRU 4.3.64.

Additional indicators

- 7.113 The draft BIPRU text¹¹³ also includes guidance on the treatment of provisioning in respect of retail portfolios. Where a firm employs a formulaic approach to portfolio provisioning based on a number of days-past-due, this will not necessarily be taken as an indicator of default for the exposures concerned.
- 7.114 We have also carried forward the treatments proposed in CP189 for acceleration of an obligation, revocation of authorisation where an obligor is an institution, and default by a sovereign under an ECAI definition.¹¹⁴

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

Provisions common to LGD and EAD

Firm specific nature of estimates

- 7.115 The Draft Directive¹¹⁵ requires that estimates should be based on a population which:

- is comparable with the firm's exposures and standards;
- relates to relevant economic and market conditions; and
- takes into account a firm's changes in lending practices.

In our discussions with firms, we have found that databases and techniques for the estimation of LGD and EAD are less well developed than for PD. Especially in relation to portfolios where there are few defaults, it is necessary to supplement internal experience with other data to produce reliable estimates. This might include external data or data relating to 'work out' experience in other portfolios relevant to the particular circumstance that the firm is facing. However, LGD - and, possibly to a greater extent, EAD - are materially affected by firms' actions. So, we would expect firms to be able to explain the extent to which they have made adjustments to estimates based on industry averages to account for their own experience.¹¹⁶

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

Adjustments to EAD or LGD

- 7.116 In some instances, it is debateable whether EAD or LGD is the parameter that needs to be adjusted - for example, if further drawings take place after

113 BIPRU 4.3.56.

114 BIPRU 4.3.58.

115 For example, BCD Annex VII, Part 4, paragraph 52.

116 BIPRU 4.3.67.

default. Where firms need to make adjustments to supplement data or to add conservatism, we do not mandate whether adjustments are made to EAD or LGD. But they should be very closely related as the amount that will be lost: (£LGD) is EAD times LGD%. Arithmetically, it should be irrelevant whether an adjustment is made by increasing (reducing) EAD or increasing (reducing) the LGD %, as either can achieve the same answer of increasing (reducing) £LGD (see paragraph 7.155).

- 7.117 If firms use different methodologies to estimate EAD and LGD, there will not be strict arithmetic equivalence. The IRB process does have different methodologies for EAD and LGD, but we currently have no information to suggest the differences would be material. Given this and the interchangeability between EAD and LGD specifically allowed for retail exposures, we think it appropriate to allow maximum flexibility in this area.
- 7.118 However, we would suggest that where there is ambiguity about the proper treatment of an item, firms should adjust EAD if the item is one that typically occurs before default, and LGD if it typically occurs after default. We have not provided additional guidance on this issue in the draft Handbook text.

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?

Loss given default

Economic downturn LGDs

- 7.119 EU CP3 indicated that where firms used their own estimates of LGD this should be on the basis of a long-run default weighted average, or an economic downturn estimate where LGD varied with the cycle. In CP189¹¹⁷ we said we expected firms to use an economic downturn approach unless they could demonstrate that recovery does not vary with the cycle. We also provided an example, based on the direct use of historic data, which aimed to demonstrate how this approach might work. At the same time, we noted that there might be ‘outlier’ years in which the LGD was particularly high and should not be used as the basis of the estimate for regulatory purposes.
- 7.120 In 2004, the Basel Committee has focussed on LGD measurement and, in particular, how this should be affected by movements over the cycle. The initial outcome of these deliberations confirmed that the LGD in the IRB framework is meant to be downturn concept.
- 7.121 A joint working group of Basel’s Capital Task Force (CTF) and AIG has been formed to take this work forward. We do not intend to make any further

117 3.259 to 3.269 of Annex 3 to CP189.

policy decisions on the relevant policy areas until there has been more progress in that group. CEBS has also set up a parallel work stream to consider this issue. This work is likely to be completed by mid 2005. At this point, we will review our implementation.

Non-zero LGD

- 7.122 Other than the transitional provision for mortgages,¹¹⁸ there is no specific floor for LGD in the Draft Directive in the same way as for PD. In CP189,¹¹⁹ we stated that LGD under Advanced IRB for corporate, institution and sovereigns portfolios and Retail IRB should always be greater than zero. This would allow for cases where full recovery is not achieved because of defective documentation, inappropriate valuation and other cases. Responses were mixed - many accepting the principle, but others noting the specific floor in the Basel text relating to the LGD on mortgages. The CTF/AIG working group and CEBS work stream, mentioned above, may consider this question further. In the meantime, we intend to start our discussions presuming that LGDs are non-zero, but we do not intend to specify any guidance on this. The 10% LGD transitional floor for mortgages noted above will be copied out in the BIPRU text. We acknowledge that on a case-by-case basis there may be some circumstances where zero is appropriate, such as where an exposure is significantly over-collateralised with cash. However, even where this is the case, firms will still need to have regard to the Pillar 2 requirements for residual risk.

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

Discount rate for recoveries appropriate for defaulted assets

- 7.123 The IRB framework calls for an economic, rather than an accounting, definition of loss.¹²⁰ Where firms are using their own estimates of LGD, the selection of an appropriate discount rate for valuing recovery cash flows is one of the key decisions in constructing the economic loss estimate. There is an ongoing debate between supervisors and firms on the appropriate discount rate. This is pertinent to the debate on 'economic downturn LGDs' as the discount rate used is an integral part of analyses of the volatility of LGD across a cycle. We also expect this to be discussed in the AIG/CTF working group and CEBS, as mentioned above.
- 7.124 In CP189, we proposed that the discount rate should be appropriate for defaulted assets and should be neither a risk-free rate nor the contractual rate

118 10% LGD floor – BCD Article 154(2).

119 3.273 of Annex 3 to CP189.

120 BCD Article 4(26).

at which money has been lent. We currently intend continuing with this proposal but are not proposing to produce any guidance at this stage. We will review this decision to take account of the outcome of the deliberations in the AIG/CTF Group and/or of a consensus emerging on a converged EU approach through the CEBS process.

LGD on defaulted assets to include allowance for unexpected loss

- 7.125 In CP189,¹²¹ we proposed that estimates of LGDs on defaulted assets needed to include an additional buffer based on potential volatility over their recovery period. The buffer might be provided, in whole or in part, through demonstrably conservative provisioning. Respondents mainly accepted this principle, although some noted a potential divergence with accounting rules and overseas regulations.
- 7.126 This proposal has now been superseded by the Basel Framework, which requires the total capital charge on defaulted assets and on performing assets to be based on an economic downturn LGD. Although this is not incorporated into the Draft Directive, we expect it to be reflected in the final version (see paragraph 7.4).

Circumstances where LGD estimates need not be based on material drivers

- 7.127 The Draft Directive¹²² contains a general requirement that LGD estimates must be based on the material drivers of LGD. We recognise that the impacts of material drivers may sometimes be weak in advance of default. The draft BIPRU text¹²³ includes guidance on this and accepts that for some portfolios, particularly in the case of unsecured retail lending, firms are likely to find the Directive's requirements challenging. Notwithstanding, the burden is on the firm to demonstrate that its models are appropriate for the circumstances in which they are applied.
- 7.128 Industry practice in identifying material drivers of LGD is not as well advanced as for PD. This is partly related to the fact that recent UK experience has not included a period of economic downturn that would generate sufficient loss data. But it also reflects traditional approaches to modelling LGD, which have been quite mechanical in nature. We will keep our approach to defining drivers under review in the light of developments in the CTF/AIG working group on LGD, which is likely to report in mid-2005.

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?

121 3.275 of Annex 3 to CP189.

122 BCD Annex VII, Part 4, paragraph 49.

123 BIPRU 4.6.32.

Exposure at default

Facilities for which EAD must be estimated

- 7.129 The Draft Directive requires all assets and off-balance sheet items to be included. In line with this, firms using own estimates of EAD must consider all facility types that may result in an exposure when a borrower defaults, including uncommitted facilities and settlement exposures. The TBR is considering settlement risk and may exclude some settlement exposures from the scope of regulatory capital. However, the extent of this is not yet clear.
- 7.130 The Draft Directive is silent on the point at which a facility should be recorded. We have added guidance to the draft Handbook text¹²⁴ to the effect that the starting point of inclusion of a facility should be the earliest date at which a customer can make drawings under it. This may be earlier than the completion date of security and documentation. We believe that this guidance is not superequivalent to the Directive and that this approach promotes good risk management by ensuring a firm has a complete view of the risks that it is exposed to.
- 7.131 Where firms make multiple facilities available, they need to understand how exposures on one may be transferred into exposures in another on which the losses are ultimately incurred. For example, we have noted that overdraft exposures may change as a result of activity on other accounts with the same customer. We wish to avoid double-counting, but expect to discuss with firms how this interaction has affected capital requirements. We have provided guidance in the draft BIPRU text to this effect. While this guidance goes beyond the requirements of the Draft Directive, we consider this to be an effective and efficient method of ensuring that we understand how firms have addressed this issue.
- 7.132 Guidance on these issues is contained in BIPRU 4.3.89.

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

Minimum EAD value

- 7.133 Firms have frequently asked us whether EAD can be estimated at less than the current balance. We are aware that the active management of problem accounts can result in decreases in their balances prior to their default. Nevertheless, the regulatory framework follows the conservative convention of calling for capital to cover current drawings plus the possibility of additional drawing before default takes place. This is implicit in the Draft

124 BIPRU 4.3.89.

Directive. The general rule in the Draft Directive¹²⁵ is that the capital calculation is based on the accounting value (in practice this will not be less than the drawn amount less value adjustments). This means that the EAD cannot be less than the current drawings, including interest accrued to date, unless a provision has been taken.

- 7.134 Under the Retail IRB, where the focus is on pools rather than individual facilities, the requirement may be considered at the pool rather than at an account level.

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

Time horizon for estimation of EAD

- 7.135 Although the notion of applying capital against undrawn lines may be seen as implying an explicit period over which drawings may increase, the Draft Directive does not prescribe a specific time horizon. In particular, it does not require firms to calculate what EAD would be if default incurred at a specific date in the future, for example 12 months from the observation date.
- 7.136 However, it has become clear from our discussions with firms that usage - whether reflected in current balances or average drawings over a period - is widely considered to be an important factor in determining EAD. The inclusion of usage requires an explicit time period between the measurement date and the assumed default date to carry out the EAD calculations. Information to date suggests that firms' practices vary. Where usage is a factor in EAD estimates, we do not propose mandating a period, but are leaving it to firms to choose what period is most relevant. We have not included guidance in the draft Handbook text. We note that some firms propose doing this by linking the EAD horizon to that of PD. However, it is important that firms are able to interpret the information given to them by the 'reference data'.

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

Exposures to corporates, institutions and sovereigns

- 7.137 This section of the draft BIPRU text sets out the requirements specific to the corporate, institutions and sovereigns assets class. In particular it covers rating systems, data maintenance, definition of default, requirements specific to the foundation and advanced approaches and the capital calculation.

125 BCD Article 74(1) and Annex VII, Part 3, paragraph 1.

Probability of default

Material drivers

- 7.138 Building corporate borrower rating systems usually involves three sequential steps.
- The identification and assessment of the key drivers of default risk, or proxies for them.
 - The combination of these drivers in a way which consistently ranks borrowers according to their default risk. A rating system's ability to do this is known as its discriminative power.
 - The assignment of a probability of default to the borrowers in each rating grade/score.
- 7.139 The Draft Directive¹²⁶ requires a firm's estimates of its risk parameters to be based on the material drivers of default risk. In CP189, we identified the sensitivity of a rating approach to movements in the fundamental risk drivers as a desirable property of the rating approach. To approve an IRB approach, we will need to be satisfied that a firm's rating system meets this requirement. As corporate borrower rating systems are relatively well established, it is possible to identify a limited number of widely-accepted drivers of default for different types of portfolios. An illustration of how the approach might be applied to non-specialised corporate borrowers is given in paragraph 7.141.
- 7.140 We would not consider it necessary for a rating system to address each of the factors explicitly. Risk drivers may be considered together. However, we would expect firms to be able to explain how they have arrived at the drivers they have used and how they have addressed them in the rating system. A factor may also be addressed in a rating system using an external measure of default risk if a firm can provide evidence that this measure considers the factor in question. It is also possible to address factors through the use of controlled over-ride criteria, as opposed to directly in the core rating process.
- Q72: Do you agree with this approach to identifying material drivers of default risk?
- 7.141 There appears to be a consensus in the industry that the following are important criteria which, in general, drive the default risk of non-specialised corporate borrowers:
- borrower size;
 - borrower financial leverage (or gearing) and debt service capacity;

126 BCD Annex VII, Part 4, paragraph 49.

- borrower profitability
- borrower liquidity;
- management quality of the borrower;
- economic and political environment;
- structural features and prospects of the industry in which a borrower operates;
- a borrower's competitive position within its industry;
- age of borrower; and
- borrower's ability to obtain resources from other sources, such as financial markets and the wider group to which it belongs.

7.142 By way of example, it is possible to address borrower size through the use of different rating systems for different sized borrowers. Also, economic factors may be addressed through cyclical adjustments (which will vary with the philosophy of the rating system) rather than the rating assignment itself.

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?

Minimum criteria

7.143 In addition to the sensitivity to risk drivers we consulted upon some areas that we expected firms to address as part of the minimum criteria for borrower rating systems. These were:

- review of rating system;
- internal guidance for staff to facilitate appropriate and consistent allocation of exposures, when use of models would be appropriate or inappropriate; and
- how firms ensure that new or narrow rating systems are appropriate.

Most respondents agreed these proposals were reasonable. As a result, we have included high-level guidance in the draft Handbook text,¹²⁷ setting out our expectation that firms will consider these issues when implementing their rating systems. While this guidance goes beyond the minimum requirements of the Directive, we consider that these issues constitute good risk management practice already evident within the industry.

127 BIPRU 4.3.42.

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

- 7.144 In CP189,¹²⁸ we also consulted on how rating agency experience or the output of statistical default models could be used as primary components of PD estimation. While recognising the benefits of such an approach, we proposed that where this was the case firms would still need to make adjustments for other information - such as internal experience, conservatism and cyclical effects. Respondents generally welcomed the ability to use rating agency experience and the output of statistical models. As a result we have included guidance based on CP189 within the draft BIPRU text.¹²⁹

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

Loss given default

Factors that may constitute material drivers for LGD

- 7.145 The Draft Directive¹³⁰ requirement that a firm's estimates must be based on the material drivers of the risk in question applies to LGD as well as to PD. However, the industry has yet to develop LGD measurement to the same extent as PD. It is therefore too early to identify a definitive list of drivers, so we have not provided any guidance on this in the BIPRU text. The following summarises the main factors that firms we visited in mid-2004, were using or considered using, in deriving LGD estimates.
- 7.146 All firms said that the type and value of collateral and country-related features (for example, the local bankruptcy regime) were important. The latter factor may be addressed through country-specific models. Most firms mentioned the state of the economic cycle and seniority relative to other creditors. Clearly the possession of security is in itself a form of seniority. We propose discussing these drivers with firms as part of the application process.
- 7.147 All this should not be considered a definitive list of relevant drivers, and firms are encouraged to do further research to identify risk drivers which may be important in their portfolios. Numerous other factors were identified as (potentially) relevant by the firms - industry, borrower size and exposure size each received two mentions. We will expect firms to be able to discuss their drivers, including how they determined them, as part of the application process.

128 3.242 of Annex 3 to CP189.

129 BIPRU 4.4.25.

130 BCD Annex VII, Part 4, paragraph 49.

7.148 Some firms estimate LGD in a similar way as in the Foundation Approach; that is, by using haircuts to the value of the collateral. However, this is not explicitly forward-looking and tends to be based on relatively short runs of data with the implicit assumption that an average of these will be an adequate representation of the future. Collateral is widely accepted as a key factor in determining LGD, and the importance of other drivers is correspondingly weaker where collateral is held. We therefore believe that, in the case of secured exposures, a haircut approach based on validated realisation experience can be an acceptable basis of an Advanced IRB approach. However, we are likely to discuss with firms the level of conservatism they have built in to reflect the uncertainties. We have added guidance in the BIPRU text to this effect.¹³¹

Q77: Are there any other drivers of LGD that should be considered?

Exposure at default

Material drivers for EAD

7.149 In general, it appears that EAD estimation is presently less developed than LGD. There has also been little development by supervisors in other countries on their IRB requirements for EAD. So any guidance we issue now is particularly likely to change as the formal (through CEBS) and informal processes of supervisory convergence proceed.

7.150 As with PD and LGD, the Draft Directive¹³² requires EAD estimates to be based on the material drivers. We think that, conceptually, the drivers might be divided into four groups, although there will be interactions and overlaps between them:

- factors affecting the borrower's demand for funding/facilities;
- factors affecting the firm's willingness to supply funding/facilities;
- the attitude of third parties (for example, other financial firms, trade creditors, owners) whose alternative source of supply may increase or reduce the demand for funding/facilities for an individual firm; and
- the nature of the particular facility and the features built into it (for example, covenant protection).

7.151 We perceive a tension between the difficulty of providing guidance on a definitive list of EAD drivers given the relative state of development of EAD estimation, and the industry's understandable need for guidance on what we will consider acceptable. We have identified a small number of factors in our investigation to date which are considered below. However, we have not added

131 BIPRU 4.3.83.

132 BCD Annex VII, Part 4, paragraph 49.

guidance to the BIPRU text on these at this stage. We emphasise that we do not consider this as a comprehensive list of drivers, and we encourage firms to develop approaches which take account of a wider and more tailored set. We will not prescribe exactly how each driver should be used in the estimation approach. We would expect firms to be able to discuss how they have satisfied themselves that the drivers they have identified are appropriate.

7.152 We expect that all estimates of EAD vary with facility type and usage (see below). We have also identified the following factors and would like to discuss with firms how they take account of:

- the expected growth in a borrower's business (and accordingly rise in funding requirements);
- a borrower's access to other sources of funding; and
- protection built into documentation to control drawings if a borrower's creditworthiness improves.

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 have suggested?

Q79: What guidance on EAD drivers should we give in the Handbook text?

EAD on contingent exposures (including guarantees)

7.153 The Draft Directive does not prescribe how contingent exposures such as guarantee facilities should be treated where firms are using own estimates of EAD. Possible interpretations of EAD on such exposures are the amount of the facility, the amount expected to be outstanding under the facility at the time of default, or the amount expected to be claimed. Our view is that it is acceptable to calculate EAD on contingent exposures on the basis of the amount expected to be claimed (with a minimum of the amount to be claimed from the current outstandings), instead of the amount of the potential claim. We have added guidance in the draft Handbook text setting this out.¹³³

7.154 An example would be where a firm extended to an obligor a facility of £100 to issue guarantees. Upon default of the obligor, there might be £50 of guarantees actually outstanding which result in claims of £25. After recoveries from the customer, the eventual loss was £15. The EAD in this case would have proved to be 25, with a LGD of 60%.

7.155 The alternative treatment would have resulted in an EAD of 50 and LGD of 30%. And if the full facility amount had been used, the EAD would have

133 BIPRU 4.4.44.

been 100 and the LGD 15%, so the (£) Expected Loss (EL) would have been the same in each case. This treatment can therefore be seen as an application of the EAD-LGD indifference principle outlined in paragraph 7.116.

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

Explicit maturity adjustment

General discretion on the explicit maturity adjustment

- 7.156 The Draft Directive¹³⁴ provides us with the discretion to require firms adopting the Foundation IRB approach to calculate the effective maturity of all corporate, bank and sovereign exposure subject to certain floors and ceilings.¹³⁵ The maximum maturity is five years and the minimum one year, subject to certain exceptions yet to be defined that we refer to below. This would require all IRB firms calculating the effective maturity for their corporate, bank and sovereign exposures.
- 7.157 Industry practice shows that maturity is both an important consideration in firms' pricing and risk management decisions, and an important driver of credit risk. Additionally, we are aware of level playing field issues between firms on the Foundation and Advanced IRB approaches. As a result, we propose to implement this national discretion.¹³⁶
- 7.158 However, we are aware that firms on the Foundation IRB approach are likely to incur additional costs to develop their systems to incorporate this requirement and would like to explore the potential implications of this proposal.

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

Explicit maturity and small firms

- 7.159 The Draft Directive¹³⁷ also allows us to carve out exposures to smaller borrowers from the requirements to calculate maturity under Advanced IRB and Foundation IRB (if the discretion above has been exercised). Smaller borrowers are defined as situated within the European Union with consolidated sales and assets of less than €500 million.
- 7.160 In line with our proposal to apply maturity to Foundation firms and with our desire to take up the more risk-sensitive of options where available, we are not proposing to exclude exposures to smaller borrowers from the

134 BCD Annex VII, Part 2, paragraph 11.

135 BCD Annex VII, Part 2, paragraph 12.

136 BIPRU 4.4.65.

137 BCD Annex VII, Part 2, paragraph 14.

maturity adjustment. However, we are conscious of the systems implications this may have for smaller firms and would like to consult on the impact of taking up this proposal.

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

Instruments exempt from the one year floor on maturity

- 7.161 The Draft Directive¹³⁸ permits competent authorities to specify certain short-term exposures with a remaining maturity of less than one year to be exempted from the one year floor. The TBR is developing a collective list of short-term exposures to be applied internationally. We intend to implement the list produced by the TBR in the final BIPRU text. So we are not providing any guidance at this stage.

Transitional provision for the definition of default

- 7.162 The Draft Directive¹³⁹ contains a transitional provision for the days-past-due element of the definition of default for the corporate exposure class. This discretion allows us to set the days-past-due at a point between 90 and 180 days for a transitional period until the 31 December 2011. From that point on, the days-past-due will be 90 days.
- 7.163 This discretion, along with the other days-past-due discretions allows us to take account of local conditions for a transitional period. We are not aware of conditions in the UK market that would warrant a days-past-due higher than 90 days. Additionally, we consider that 90 days already accords with good risk management practice existing in this area. So we do not propose taking up this discretion, but will set days-past-due at 90 days.

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

Specialised lending

- 7.164 This section of the BIPRU sets out specific requirements of the draft Directive relating to the slotting approach available to specialised lending. Specialised lending is not a separate asset class but is a sub-set of the corporate asset class. So firms that are able to calculate capital requirements in the same way as the rest of its corporate asset class may do so, that is, by using Foundation or Advanced IRB. Where a firm is not able to use this approach, it may calculate capital requirements using the slotting approach.

138 BCD Annex VII, Part 2, paragraph 13.

139 BCD Article 154(4).

Specialised lending categories and the slotting approach

- 7.165 The Draft Directive¹⁴⁰ includes a definition of specialised lending - this includes that the exposure must be to a special purpose entity to finance or operate physical assets; gives the lender a significant amount of control; and that the primary source of repayment is income from the assets. The Draft Directive also provides IRB weights for broad risk categories (the ‘slotting approach’).¹⁴¹ But it gives little detail on how firms should allocate their exposures to these risk categories.¹⁴² However, it requires competent authorities to provide guidance to firms on how to allocate exposures to these risk categories.¹⁴³ To fulfil this obligation, we are proposing to base our approach on that set out in the Basel Framework. The alternative would have been to develop an approach ourselves. Developing guidance ourselves may have resulted in an approach that imposed less of a burden on firms for their UK exposures. However, we conclude that the benefits are outweighed by including an approach that is internationally recognised and therefore only requires firms to develop one system across their international activities. The Basel approach also meets our objective of being risk-sensitive and enables us to provide early guidance to firms on the basis on which to develop their systems. Additionally, our pre-consultation indicates it is an accepted approach to specialised lending.
- 7.166 Therefore, we will provide guidance on the types of specialised lending outlined in the Basel Framework, in particular the definitions of the specialised lending categories for project finance, income producing real estate exposures, object finance and commodities finance.¹⁴⁴ As a result, specialised lending may include certain PFI projects.¹⁴⁵ We do not propose using a ‘High Volatility Commercial Real Estate’ category (defined in the Basel Framework as the financing of commercial real estate that exhibits higher loss rate volatility compared to other types of specialised lending). This is because we have seen no evidence to suggest that such a category needs to be defined in the UK.
- 7.167 We propose to use the slotting criteria for each of the four types of specialised lending,¹⁴⁶ plus the additional default category from the Draft Directive. Therefore, ‘strong’ will correspond to category 1, ‘good’ to category 2 and so forth. We also propose adopting the Basel benchmark indicators in mapping the slotting criteria to the risk categories in the Draft Directive. This means that we will equate the following rating agency assessments to categories one to four:

140 BCD Article 86(6).

141 BCD Annex VII, Part 1, paragraph 5.

142 Firms may use the general corporate approach where they have the information to do so. The slotting approach is therefore one option for the treatment of specialised lending.

143 BCD Article 87(5).

144 The Basel Framework, paragraphs 221 to 226.

145 PFI projects may be treated in a number of ways depending on the structure of the transaction and the data that the firm has available. For example, they may be treated as corporate exposures, under the specialised lending slotting approach, guaranteed by central government or a PSE or within the securitisation framework.

146 The Basel Framework, Annex 4.

BBB- or better; BB+/BB; BB-/B+; B to C-; and default. We have included guidance on this in the draft BIPRU text.¹⁴⁷ We are not aware of any more complete work on mapping criteria and believe that adopting the Basel approach will aid international consistency.

- 7.168 We propose including the Basel guidance on slotting within the Handbook text, although we have not reproduced it in this CP.

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?

Preferential risk weights under the slotting approach

- 7.169 The Draft Directive¹⁴⁸ also permits us to approve firms to use preferential weightings for Specialised Lending exposures where firms' underwriting standards are 'substantially strong'. We propose to provide guidance¹⁴⁹ that firms will need to demonstrate that their standards exceed those of the slotting criteria and result in ratings that are stronger than the above benchmark if they wish to qualify for such recognition.

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

Retail exposures

- 7.170 This section of the draft Handbook text sets out the requirements relating specifically to retail portfolios. This section sets out the definition of the retail exposure class, rating systems, definition of default, own estimates of LGD and EAD, and calculation of risk weights, expected loss, PD, LGD and EAD.

Data windows and the use test

- 7.171 The Draft Directive¹⁵⁰ requires that estimation of loss characteristics must be based on an observation period of at least five years. A quantitative approach to assessing borrower risk is well established in retail banking but credit scoring models are typically built with short data windows (12 to 15 months) and are oriented towards determining profitability rather than solvency. The fact that established retail models are often built using less than five years of data presents a potential conflict. To resolve this conflict, many firms are thinking of building separate Basel PD models to

147 BIPRU 4.5.10.

148 BCD Annex VII, Part 1, paragraph 5.

149 BIPRU 4.5 (calculation of risk weighted exposure amounts).

150 BCD Annex VII, Part 4, paragraph 71.

which their standard scoring models would be inputs. This raises some questions in relation to the use test.

- 7.172 We recognised in CP189¹⁵¹ that in some areas firms may not use exactly the same definitions (and hence models) for internal purposes as for the calculation of regulatory capital. But we emphasised that we would expect firms to justify and explain any differences. Respondents tended not to comment on this particular aspect but focussed on our proposed use test scorecard. However, they welcomed the distinction between core and broader activities with its implication that some aspects were more critical than others.
- 7.173 If firms are using different models for internal and regulatory purposes, we propose that these models be based on a common core so that the infrastructure on which the regulatory capital models are built (including data sources, personnel, IT systems) is also being used in day-to-day risk management and therefore subject to continuous management attention. Firms would still be expected to explain any difference between models used for internal and regulatory purposes.
- 7.174 While we recognise the value for business management of shorter time horizons, we nevertheless re-emphasise that the performance of models or systems of models used to calculate regulatory capital needs to be demonstrated over a suitably long period. This includes the need to test that PD estimates for the calculation of regulatory capital are calibrated so as to be robust during periods of economic downturn, whether or not such a period has occurred within the data history used by the firm. Since firms are still developing their practice, we have not included any guidance within the draft Handbook text on this issue, but would like to consult on whether such guidance would be helpful to firms.

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

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

Definition of small and medium-sized enterprises eligible for retail treatment

- 7.175 The Draft Directive¹⁵² defines the retail exposure class as exposures to an individual¹⁵³ or a small or medium-sized entity (SME) which are limited to a maximum of €1m. The term SME is not defined in the Draft Directive but it is intended that this asset class should not include large corporates, even if the exposure amount is small. An exposure size of less than €1m is not a `

151 3.50 of Annex 3 to CP189.

152 BCD Article 86(4)(a).

153 This definition would include buy-to-let mortgages where the loan is made to an individual.

sufficient test in itself to qualify for retail SME treatment. We propose that firms should establish a policy on the types of exposures acceptable within this asset class and take reasonable steps to ensure that borrowers are limited to SMEs. The Draft Directive does not require firms to establish a policy of this nature, so this guidance is superequivalent. However, we consider it important that the boundary between the different sets of capital calculations is set in a clear and consistent manner and that we understand how firms have determined this so that we can ensure that implementation across firms is broadly consistent.

- 7.176 In deciding the reasonable steps in determining whether the aggregate exposures are less than €1m, our philosophy is that the calculation is not an end in itself. Its purpose is to separate a non-granular retail/SME portfolio from other business so that a separate capital calculation may be applied to that portfolio that takes into account its non-granularity.
- 7.177 The concepts of materiality and proportionality apply in deciding what is reasonable for these purposes. Calculation results must be fit for purpose and may be based on reasonable estimates. What is reasonable depends on the circumstances, including the additional costs that need to be incurred to improve accuracy and whether there is a risk of material misstatement if additional work is not performed. Adequate controls need to be in place to ensure that the inadvertent inclusion of non-eligible assets in the retail/SME portfolio is sufficiently immaterial not to result in significant distortion of the overall statistical characteristics of the sub-sets of that portfolio when the exposures are assigned to grades or pools. Cost considerations alone would not necessarily justify inclusion of non-eligible exposures if the effect would be material.
- 7.178 A firm could employ sample testing to demonstrate immateriality. This would identify whether the level of inadvertent contamination of the retail/SME portfolio with ineligible assets was low enough not to have a significant adverse effect on the homogeneity of the portfolio. We have provided guidance on our philosophy and possible methods of demonstrating immateriality within the draft BIPRU text.¹⁵⁴
- 7.179 In CP189,¹⁵⁵ we took the view that, we would not require ratings for exposures crossing the size boundary to comply with full corporate standards. This was in light of significant consequences of reclassifying exposures from retail to corporate or vice versa for a rating system and the management of the exposure. An exposure crossing the size boundary could be retained in a retail portfolio, so long as the firm was able to calculate the regulatory capital charge for that exposure under the corporate risk weight function. Under the Draft Directive text, it is no longer possible for

154 BIPRU 4.6.3.

155 3.227 of Annex 3 to CP189.

us to adopt this degree of flexibility. Exposures that do not meet the retail qualifying criteria must instead comply with the requirements of the corporate asset class. We are continuing to explore options to avoid this requirement becoming unduly onerous.

7.180 However, the Directive acknowledges¹⁵⁶ that instances of a firm ceasing to comply with the requirements may occur and can be permitted provided the firm demonstrates that the impact is immaterial. This applies to the overall impact of non-compliance rather than to that of individual exposures or pools. To the extent that this issue relates to small numbers of exceptional cases, we would not expect a material impact to arise. The practical implications of applying the retail SME definition are also being considered by a CEBS working group who may provide further clarification in early 2005.

7.181 In addition, in determining whether an SME exposure falls below €1m we will, as indicated in CP189 and within the constraints imposed by the Draft Directive, be flexible in terms of the exchange rate parameters used for exposures that cross the retail/corporate boundary. However, we have not included specific guidance on this issue in the draft Handbook text.

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?

7.182 Another aspect of the definition of the retail exposure class is the condition that exposures should not be managed individually in a way comparable to corporate exposures.¹⁵⁷ During the pre-consultation phase, we have been asked what our interpretation of this condition would be, particularly relating to SME exposures. We do not believe it is necessary to manage these exposures on a pooled basis at all times, provided they are managed consistently over time and in a similar manner to other retail exposures. In considering whether individual management is appropriate in a pre-default environment firms should consider whether that management¹⁵⁸ is:

- sufficiently insignificant not to disrupt the homogeneity of the pool;

156 BCD Article 84(5).

157 BCD Article 86(4)(c).

158 BIPRU 4.6.3.

- consistent with the management of other exposures in the same retail exposure pool; and
- significantly different in extent from the individual management that occurs for large corporate exposures, looked at as a whole.

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

Refreshing of risk parameters

- 7.183 The Draft Directive¹⁵⁹ requires that a firm shall at least annually update obligor and facility assignments or review the loss characteristics and delinquency status of each identified risk pool, as applicable. A credit institution must also review in a representative sample the status of individual exposures within each pool to ensure that exposures continue to be assigned to the correct pool at least annually.¹⁶⁰
- 7.184 While annual rescoring of all obligations clearly would be sufficient to meet this requirement, we do not propose to require firms to do so. We consider that the extent of updating and review should be guided by the materiality of the portfolio being considered and the likely impact on capital requirements of any resulting changes. However, in line with the requirements of the Draft Directive above, we would not expect a portfolio to qualify for IRB, where no regular re-assessment of borrower risk was undertaken. We have included guidance in the draft Handbook text¹⁶¹ to this effect.

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

Definition of default

- 7.185 A specific part of the definition of default relates to the number of days an account is past due for triggering default. In CP189, we adopted a flexible stance - allowing firms to determine this for themselves with an upper limit of 180 days. The Draft Directive¹⁶² requires that we should set a fixed number of days-past-due that should be used by all firms. We intend to set this figure at 180 days for all products with the exception of retail SME business where the number will be 90 days.¹⁶³ While the definition of days-past-due for retail SMEs is not the highest available under the Draft Directive, it aligns the treatment with the corporate approach, with which

159 BCD Annex VII, Part 4, paragraph 28.

160 BCD Annex VII, Part 4, paragraph 30.

161 BIPRU 4.6.14.

162 BCD Annex VII, Part 4, paragraph 48.

163 BIPRU 4.6.19.

these exposures have many similarities. So we consider it to be an appropriately risk-sensitive approach. Where firms have exposures in other EEA States, firms will be able to use the definition of default used in those countries.

7.186 Additionally, we have proposed these limits on the basis that days-past-due is intended to act as a backstop to the definition of default. These limits would appear to offer firms the maximum flexibility provided by the draft Directive around their existing practice as it is likely that other elements of the definition will be triggered before this.

7.187 We will consider a flexible approach on the point at which the counting of days-past-due starts. In CP189, we set out the following preferences:

- the date at which a limit was breached for overdrafts;
- the billing date for other revolving credit facilities; and
- the payment date for fixed repayment loans.¹⁶⁴

7.188 Where firms normally count on a different basis, we will consider their proposals provided the firm has estimated the impact that any divergence from the standard will have on its capital calculation and can make an adjustment if the impact is material. We have not included any guidance on the point from which days-past-due should be counted, but would like to consult on whether adding such guidance would be helpful to firms.

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?

All relevant information

7.189 It is common in retail banking for risk assessments to be product rather than obligor-based. The definition of default in the Draft Directive¹⁶⁵ may be applied at facility level. However, this does not mean that risk assessment can be applied at an obligation level throughout the retail IRB requirements. For example, firms are also required to include in their rating systems ‘all relevant obligor and transaction characteristics’.¹⁶⁶ Default by a customer on one facility does not of itself constitute default on any other. But we think that knowledge of that default is relevant information and should influence the PD assigned to that customer on other facilities.

164 3.201 of Annex 3 to CP189.

165 BCD Annex VII, Part 4, paragraphs 44 to 48.

166 BCD Annex VII, Part 4, paragraph 14.

- 7.190 We consulted on this point in CP189. Few respondents disagreed with the principle but several noted (but did not quantify) the potential cost of combining default information across product lines. Respondents suggested that firms should have the opportunity to argue for an exemption from this requirement on materiality grounds.
- 7.191 As we still consider default on another facility important in determining PD for an obligor we have included guidance within the draft BIPRU text.¹⁶⁷ We do not consider this to be superequivalent to the Directive, given the requirements to consider all material relevant information. However, we recognise the existence of systems constraints, especially with recently acquired businesses, and that required changes may be costly. We will therefore consider proposals from firms to exclude portfolios from this requirement if the use of the additional information would not make a material difference to their capital calculations or achieve compliance within a reasonable timescale.
- 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?

Qualifying Revolving Retail Exposures

- 7.192 The Draft Directive¹⁶⁸ defines Qualifying Revolving Retail Exposures (QRRE) as exposures to individuals which are revolving, unsecured¹⁶⁹ and unconditionally cancellable to the maximum extent permitted by law. It also imposes a maximum of €100,000 for exposures to a single individual within this sub-portfolio. QRRE is also intended for portfolios that can be relied upon to exhibit low volatility of loss rates. The Draft Directive does not define low volatility of loss rate.
- 7.193 We do not propose defining low volatility of loss rates at this time. However, firms will need to collect and analyse loss data to demonstrate that their QRRE portfolios do show low loss volatility relative to their average loss rates, especially within the low PD bands.
- 7.194 The Draft Directive¹⁷⁰ also requires us to collect loss rate volatility data to share with other supervisors. The Basel Committee intends to collect and compare loss volatility figures across jurisdictions. As yet, we are unaware of the timetable for compiling these statistics. However, to help firms prepare,

¹⁶⁷ BIPRU 4.6.21.

¹⁶⁸ BCD Annex VII, Part 1, paragraph 11.

¹⁶⁹ Therefore, this would not include revolving mortgage products.

¹⁷⁰ BCD Annex VII, Part 1, paragraph 11(d).

we would like to understand how firms define a ‘low volatility of loss rates’, to provide a provisional view on this in the near future. We will not be able to take a final decision until convergence in this area is completed.

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?

Segmentation

- 7.195 The Retail IRB approach is based on the allocation of exposures to homogeneous pools (or segments) based on their risk.¹⁷¹ Producing homogeneous pools is important because it is good risk management, and also because credit risk may be mis-stated through the use of averages of exposures that are not sufficiently homogeneous. For these reasons, it is important that firms achieve adequate segmentation to deliver robust estimates of LGD and EAD, as well as PD.
- 7.196 Our discussion in CP189 was not prescriptive about segmentation, but indicated that we would normally expect credit scoring to play a role. Some respondents felt that even that would not always be the case. The process of assigning exposures to pools should, as the Draft Directive requires, ‘capture all relevant obligor and transaction characteristics’.¹⁷² The purpose is to provide for ‘a meaningful differentiation of risk, (...) a grouping of sufficiently homogenous exposures and (...) accurate and consistent estimation of loss characteristics at grade or pool level’. We propose to be flexible on how a firm achieves that purpose, provided the firm can demonstrate it has been achieved.
- 7.197 We do not intend to set maximum or minimum sizes for risk pools. The number and size of pools should be determined with the objective of establishing homogeneous risk. Pools need to be of sufficient size to permit the production of robust risk estimates, but should not be so large that they obscure variations in quality. For example, in well-seasoned, low LTV mortgage businesses, some individual pools could probably constitute a large share of a firm’s portfolio. We agree that there is no real benefit in requiring finer degrees of segmentation simply to meet an arbitrary numerical criterion. We will be prepared to accept single segments containing a significant share of a portfolio, provided they are

171 BCD Annex VII, Part 4, paragraph 16.

172 BCD Annex VII, Part 4, paragraph 14.

restricted to low risk areas and are homogeneous. We have provided guidance on this subject in the draft Handbook text.¹⁷³

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

Equity

- 7.198 The Draft Directive¹⁷⁴ gives us the discretion to exempt equity exposures from the IRB approach for a transitional period. This discretion acts as a grandfathering provision to permit IRB firms to exempt equity holdings already held prior to 31 December 2007 from the IRB approach and apply the standardised approach equity risk weights until 31 December 2017. Exercising this discretion would mean that any equity exposures acquired following implementation would be required to be rolled-out onto either the standardised approach where total equity exposures are considered not to be material (that is, less than 10% of own funds) or onto one of the IRB approaches where the total equity exposures are considered material. So, firms may need to operate two systems for their equity exposures where their exposures are material. Additionally, where firms have material equity exposures we believe - in keeping with our philosophy of adopting the more risk-sensitive approaches where possible - that firms should use the IRB approach. As a result, we do not intend to explicitly include this discretion in the draft Handbook text. However, this should not affect firms whose total equity exposures are considered immaterial as the discretion to exempt equity exposures of less than 10% of own funds¹⁷⁵ is sufficient for this discretion not to be necessary. Additionally, firms with total equity exposures in excess of 10% of own funds may approach us on a case-by-case basis as part of their IRB application to reconsider this issue.

Credit risk mitigation in IRB

- 7.199 This section of the draft Handbook text is almost entirely copy-out of the elements of CRM relating to the IRB approaches. We recognise that the relationship with the CRM in general is complex. We have not had time to prepare a flow diagram of the CRM requirements for IRB for this CP, but are considering whether to develop one for our next CP.

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

173 BIPRU 4.6.7.

174 BCD Article 154(3).

175 BCD Article 89(1)(c) and 89(2).

The choice between use of the PD and LGD approaches for guarantees and credit derivatives

- 7.200 The Draft Directive¹⁷⁶ allows firms to recognise unfunded credit protection by adjusting either PD or LGD depending on the approval of the competent authorities. We have observed that good practice in firms is to adjust PD where the guarantee reduces the possibility of a default occurring (for example, cross-group guarantees) and to adjust LGD where the guarantee does not reduce the possibility of default but provides a higher recovery to the lender (for example, credit derivatives).
- 7.201 Furthermore, in assessing compliance with the use test the use of different approaches to guarantees and similar mitigants for internal and regulatory purposes may be considered an acceptable divergence. We have not included these comments on the use of PD versus LGD adjustment for unfunded protection in the draft Handbook text and so they do not have the official status of guidance.

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?

LGD adjustment approach for guarantees and credit derivatives

- 7.202 Under the Foundation IRB approach, guarantees and similar instruments reduce the regulatory capital requirement only by substituting the rating of the guarantor for that of the primary obligor, and therefore assigning a lower PD. Under the Advanced and Retail IRB¹⁷⁷ approaches, the impact of a guarantee may instead reduce the LGD estimate, provided the resulting risk weight of the asset is not lower than that of a direct exposure to the guarantor.¹⁷⁸ Our interpretation of this condition is that the risk weight used in the comparison may also take account of other factors - such as collateral associated with the particular transaction. This would result in a lower LGD than that of a direct unsecured exposure to the guarantor.
- 7.203 The purpose of the above condition is to prevent the recognition of double default effects. Discussions are taking place in a Basel group which may result in some allowance for double default effects. We expect these to be reflected in the final Directive. We will review our approach to the treatment of guarantees to take account of such changes.

176 BCD Annex VII, Part 2, paragraphs 10 and 21.

177 As conditional guarantees are also acceptable, this could include mortgage indemnity insurance.

178 BCD Annex VII, Part 2, paragraphs 10 and 21.

Determination of other physical collateral under Foundation IRB

- 7.204 The Draft Directive¹⁷⁹ gives us the discretion to allow firms adopting Foundation IRB to recognise types of physical collateral in addition to real estate and receivables where liquid markets and publicly available market prices for the collateral exist.
- 7.205 We propose exercising this discretion, but do not intend prescribing a list of physical items that would satisfy the criteria. Firms will be required to satisfy themselves that the additional physical collateral they intend to recognise meets the relevant recognition criteria subject to supervisory review.
- 7.206 We would like to consult on how the determination of collateral meeting the requirements of the Directive is incorporated into the application process and administered on an ongoing basis.

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?

Reduction of supervisory LGDs for senior Commercial Real Estate and equipment leasing exposures for a transitional period

- 7.207 The Draft Directive¹⁸⁰ includes a discretion that allows firms, subject to certain indicated levels of collateralisation, to assign a 30% and 35% LGD for senior exposures in the form of Commercial Real Estate (CRE) leasing and equipment leasing, respectively, until 31 December 2012.
- 7.208 We are proposing not to exercise this discretion. We do not consider that the risk to firms is materially lower on leasing transactions than on transactions which are similar in economic substance but structured as secured lending. Furthermore, we are aware that adopting this discretion may cause distortions between the two markets.

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?

179 BCD Annex VIII, Part 1, paragraph 21.

180 BCD Annex VIII, Part 3, paragraph 73.

Waiver of requirement for repayment to depend on cash flow for CRE

- 7.209 The Draft Directive¹⁸¹ permits national authorities to waive the qualifying requirement under Foundation IRB that repayment of an exposure secured by commercial real estate collateral does not depend materially on the cash flow generated by the collateral. This waiver is subject to conditions that (i) losses on lending of up to 50% of the market value do not exceed 0.3% of the outstanding loans secured by commercial real estate in any given year and (ii) that overall losses stemming from lending secured by commercial real estate do not exceed 0.5% of the outstanding loans in any given year. We do not believe that the loss history of UK commercial property lending would justify adopting this discretion. However, we would like to consult on the impact of us not taking up this discretion.
- 7.210 We do, however, intend adopting the discretion¹⁸² to recognise as eligible commercial real estate property that has been recognised as eligible in another EEA Member State. This is in line with our general principle of allowing firms to compete on an equal basis in other Member States' markets.

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?

Discretion to permit 50% weighting for RRE or CRE exposure to the extent that it is fully collateralised subject to certain conditions

- 7.211 The Draft Directive contains a discretion¹⁸³ to permit firms to assign a standard 50% risk weighting to the part of an exposure that is fully and completely collateralised by either residential or commercial real estate situated within the territory of the Member State rather than to use the IRB method of calculation. The discretion is counter to the philosophy of the IRB approach, as it specifically carves out certain collateralised exposures from the IRB capital calculation and assigns a less risk-sensitive capital requirement. As our philosophy is to adopt the most risk-sensitive approach available, we do not propose to exercise this discretion. There tends to be more data available for residential real estate backed exposures, which negates the need for such a provision in the IRB. And the risk weight for residential mortgage exposures under this discretion would be higher than the risk weight for residential mortgages fully secured by a substantial margin in the standardised

181 BCD Annex VIII, Part 1, paragraph 17.

182 BCD Annex VIII, Part 1, paragraph 19.

183 BCD Annex VIII, Part 3, paragraphs 74 and 76.

approach. Additionally, for CRE, a 50% risk weight is not currently available to firms, so we do not consider there to be any adverse impacts compared to our implementation of Basel 1. We also do not propose making a 50% risk weight for CRE available to firms on the standardised approach and therefore we do not consider that there are competitive issues. However, where other member states have implemented this discretion, we will recognise this to allow firms to compete on equal terms in other markets.

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?

Residual risks in credit risk mitigation techniques

- 7.212 Residual risks arise if a firm is unable to realise the proceeds it expects from credit protection arrangements. These risks are present in both collateralised transactions and guarantees/credit derivatives. The proceeds from the collateral may be less than expected due to fluctuations in the market prices that underlies the collateral, while guarantees/credit derivatives may not pay out if the protection seller defaults. However, these risks are already taken into account in the regulatory capital credit risk framework. Residual risks are the risks that may result in lower recoveries for other reasons. Examples of such risks include shortcomings in operating processes and legal problems in enforcing collateral. The Draft Directive requires that LGD takes account of the potential inability of firms to expeditiously gain control of their collateral and liquidate it. To the extent that Pillar 1 takes account of residual risk, we do not expect firms to address this in Pillar 2. We have included guidance on this within the draft BIPRU text.¹⁸⁴

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

8 Concentration risk

Introduction

- 8.1 The concentration risk rules will apply to all firms adopting the standardised approach to credit risk, and the Foundation IRB and Advanced IRB approaches.
- 8.2 The majority of the Draft Directive text for large exposures¹⁸⁵ remains unchanged from the BCD. But certain provisions amend the BCD and CAD requirements for large exposures to account for the new, more risk-sensitive approaches to credit risk and credit risk mitigation. This chapter should be read in conjunction with Chapter 13 on credit risk mitigation (CRM) which explains our implementation of the new approaches to collateral.

Proposed approach to the draft Handbook chapter on concentration risk

- 8.3 The European Commission did not undertake a full review of the large exposures regime as part of revising the capital standards. However, the Commission reviewed the large exposures provisions of the BCD and the CAD with a view to introducing necessary consistency changes arising from the standardised approach and IRB approaches. As a result, there is a large amount of ‘white’ text within this section of the Draft Directive (see paragraph 1.32 for an explanation of the distinction between ‘white’ text and ‘grey’ text).
- 8.4 The primary changes relate to the recognition for large exposures for the purposes of the new CRM framework. This is the area where ‘grey’ text is most prevalent.
- 8.5 As part of the domestic implementation of the BCD and the CAD, the FSA and its predecessor organisations provided additional guidance on the

185 The Draft Directive requirements that underpin the proposed concentration risk rules are detailed in BCD Articles 106 to 118 and BCD Articles 28 to 32 and CAD Annex VI.

large exposures requirements. This material was harmonised in our CP97 proposals. As the concentration risk requirements in the Draft Directive are largely unchanged and since the Commission is proposing to review them by 2007, we believe that much of this material is still relevant and useful. So, in implementing concentration risk, we have used the Draft Directive, the recast CAD, and CP97 as source texts for the draft Handbook text on concentration risk (BIPRU 10 in Appendix 1). We have incorporated into the Handbook text the changes we said we would make in CP115 and during pre-consultation with the industry.

8.6 Our proposed approach to implementing the Draft Directive's concentration risk requirements is:

- to apply a copy-out approach to the 'grey' text areas of the Draft Directive;
- not to copy out the 'white' text areas of the Draft Directive but to use the proposed Handbook text from CP97¹⁸⁶ which was based on the BCD; and
- to amend the CP97 material to reflect the changes we undertook to make previously (see paragraph 8.5), and to ensure consistency with new requirements of the Draft Directive.

8.7 The key areas for which CP97 is the source text comprise: integrated groups; definitional issues (such as counterparties); connected counterparties; items that do not constitute an exposure; calculation of an exposure; definition of capital resources for the purposes of limits; and exemptions.

8.8 The 'white' text/'grey' text distinction is also an important determinant of our proposed approach to concentration risk national discretions. Where a national discretion falls within the 'white' text in the Draft Directive, we have generally carried forward the approach proposed in CP97. Where a national discretion falls within the 'grey' text, we have made a new choice based on the following: what we consider to be prudentially appropriate; the cost-benefit implications; and the views expressed by the industry during the pre-consultation process. We have also revisited certain 'white' text discretions where there has been a significant change to the capital requirements framework that affects the exposures generated for concentration risk purposes. A list of our choices on each concentration risk national discretion within the Draft Directive may be found in Annex 4.

186 PRCR 5.

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

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

8.9 Our consultation is therefore focussed on areas where we have amended our approach from CP97 or where we are consulting on new material. We are not specifically consulting on ‘white’ text material although we would welcome feedback from firms on the concentration risk chapter more widely. We are consulting on the following key issues arising from the draft concentration risk rules:

- integrated groups;
- intra-group sale and repurchase and securities lending and borrowing transactions;
- the treatment of options;
- financial collateral for firms on Advanced IRB approaches;
- stress testing for large exposures purposes of the extent of collateral coverage where own estimates of collateral haircuts are used; and
- other national discretions.

Integrated Groups

8.10 This section should be read in conjunction with Chapter 2, which provides an overview of the integrated groups regime, Chapter 5, which explains the conditions for UK integrated group membership, and Chapter 7, which explains permanent exemptions from IRB approaches. Detailed rules for integrated groups may be found at BIPRU 10.7. Flow charts and examples illustrating the way the regime works may be found in Annex 8.

8.11 We propose using the national discretions under BCD Article 111(2) and Article 113 to give effect to an integrated group regime within the concentration risk framework. Where a firm is eligible for an integrated groups regime, we propose that the concentration risk rules applicable to the firm may be modified to recognise the nature of the management of the firm’s connected exposures. The integrated groups regime represents partial exercise of the discretion available to us to exempt group exposures from concentration risk limits. The specifics of our use of the exemptions available to us are discussed below.

UK integrated group

- 8.12 Exposures between members of a UK integrated group are exempt from all large exposures limits, and the requirement to calculate a concentration risk capital component.
- 8.13 To qualify for membership of a UK integrated group, a firm must meet the UK integrated group conditions from the standardised approach (see Chapter 5, and BIPRU 10.7 SA 1 R). A firm must also have notified us that it satisfies the conditions, and intends to apply the regime.
- 8.14 The Draft Directive¹⁸⁷ does not require that these conditions be met before the FSA is able to exercise its national discretion to exempt from large exposures limits intra-group exposures to certain connected counterparties. However, in exercising this national discretion, we believe it is prudentially appropriate to apply the same conditions for an exemption for concentration risk purposes as for a zero-risk weighting for capital purposes.

Wider integrated group

- 8.15 Once a firm has formed a UK integrated group, a firm may also seek to form a wider integrated group. The successful formation of a wider integrated group results in a further modification to the large exposures limits that are applied to exposures to certain connected counterparties incorporated outside the UK. The Draft Directive allows us to fully or partially exempt intra-group exposures provided that the entities within the group are subject to consolidated supervision either by us, another EEA state or an equivalent supervisor outside the EEA.
- 8.16 The following paragraphs explain the conditions for forming a wider integrated group and the effect of, and the process for, doing so. Flow charts and examples illustrating these concepts can be found in Annex 8.

Minimum conditions

- 8.17 The wider integrated group comprises counterparties connected to the firm that are incorporated outside the UK – that is, in the EEA or non-EEA. To be included in a wider integrated group, a counterparty must satisfy the same conditions as for a UK integrated group, except that there is no requirement for the counterparty to be UK incorporated, and where subject to EU insolvency regulation, to have its main interests in the UK.

187 BCD Article 113(2).

Diverse blocks

- 8.18 We proposed in CP97 that members of a wider integrated group be allocated to a discrete number of ‘diverse blocks’. This is a way of grouping together exposures of certain types of connected counterparty to modify the solo large exposures treatment of them. Diverse blocks may be defined according to geography, business or a combination of both. For example, they could include wider integrated group members in a particular country or region, a particular type of business, or some combination of the two. The number of diverse blocks within a firm’s wider integrated group determines the overall extent of intra-group lending possible between the UK integrated group and the wider integrated group.

Process

- 8.19 A firm that has notified us that it meets the conditions to establish a UK integrated group may apply to us to form a wider integrated group.
- 8.20 The membership of the wider integrated group, the number of diverse blocks and the nature and scale of the diverse blocks shall be agreed by the firm with the FSA as part of a waiver process. In general, we would expect the number of diverse blocks within a wider integrated group to be limited to four. However, where warranted by the nature and scale of a group, we would be prepared to consider increasing this number beyond four.

Effect on large exposures limits of forming a wider integrated group

- 8.21 Where a waiver is granted, the FSA will set conditions under which exposures of UK integrated group members to each diverse block of the wider integrated group would be exempt from solo large exposures limits. However, aggregate exposures of the UK integrated group to diverse blocks within the wider integrated group would be subject to large exposures limits. But these limits would be applied to the capital resources of the UK integrated group, rather than to those of the solo firm. This effectively increases the scope of lending as compared to the solo position of members of the UK integrated group to the firm’s parent, or subsidiary of the firm’s parent, or to a subsidiary of the firm outside the UK and wider integrated groups. This treatment differs from the proposals set out in CP97 as we have limited it to intra-group lending to the firm’s parent, subsidiary of the firm’s parent, or a subsidiary of the firm. The reason for this change is to ensure adequate implementation of the Draft Directive.

8.22 Annex 8 includes examples which illustrate the way in which large exposures limits would apply to connected exposures:

- in the absence of an integrated group;
- where a UK integrated group has been formed, but a waiver for a wider integrated group has not been granted; and
- where a UK and a wider integrated group have been formed.

8.23 Flow charts showing the operation of the UK and wider integrated groups may also be found at Annex 8.

Interaction of treasury concessions and integrated groups

8.24 Non-trading book connected exposures of a UK and a wider integrated group may also be eligible for a treasury concession. The basis for this treatment is derived from the national discretion contained within BCD Article 113(2). This creates an additional large exposures exemption for the connected exposures of the UK and the wider integrated group. In order for an intra-group exposure to qualify for a treasury concession, it must satisfy the conditions in BIPRU 10.6.7. Three of the key conditions, one of which must be met to qualify, are that the intra-group exposure:

- is a loan made by a firm in the integrated group with a maturity of one year or less in the course of the firm carrying on a treasury role for other members of its group; or
- is a loan to the parent of the firm in the integrated group made in the course of a business carried on by the firm of lending to its parent cash that is surplus to the needs of the firm, provided that the amount of that surplus fluctuates regularly; or
- arises from the firm in the integrated group or a counterparty connected to the firm operating a central risk management function for exposures arising from derivative contracts.

8.25 The following table highlights the relevant capital resources to which a treasury concession would apply under the range of integrated group assumptions:

Connected exposure from/to	Assumptions	Treasury concession exemption	Aggregate capital resources to which 50% limit applies
UK integrated group to outside the UK integrated group (that is, to the firm's parent, or subsidiary of the firm's parent, or to a subsidiary of the firm)	UK integrated group formed. No wider integrated group. Treasury concession conditions met.	Up to a limit of 50%, exposures that meet conditions are exempt from the 25% non-trading book limit applying to connected counterparties outside the UK integrated group.	UK integrated group
UK integrated group to diverse block in wider integrated group	UK integrated group and wider integrated group have been formed. Treasury concession conditions met.	Up to a limit of 50%, exposures that meet conditions are exempt from the 25% non-trading book limit applying to UK integrated group exposures to each diverse block.	UK integrated group
UK integrated group to the firm's parent, or subsidiary of the firm's parent, or to a subsidiary of the firm outside the UK and wider integrated groups	UK integrated group and wider integrated group have been formed. Treasury concession conditions met.	Up to a limit of 50%, exposures that meet conditions are exempt from the 25% non-trading book limit applying to aggregate exposures of the UK and wider integrated groups to connected counterparties outside the UK and wider integrated groups.	UK + wider integrated group

The interaction between treasury concessions and integrated groups is explained more fully in Annex 8.

Reporting

- 8.26 The integrated groups regime would require additional reporting.¹⁸⁸ At this time, we cannot provide details on the basis of this reporting. However, we propose developing our work in this area to focus on information that should be available to a firm whose risk management and control is carried out on an integrated basis. We will consult on the nature and frequency of this reporting.

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?

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

- 8.27 The comprehensive method for collateral introduces new rules for collateralised transactions (see Chapter 13 on CRM). Under the comprehensive method, a firm must apply a volatility adjustment to the value of collateral to discount its value. It must also apply a volatility adjustment to the exposure to account for potential increases in the asset's value. Subject to meeting certain conditions, firms may calculate their own estimates of collateral haircuts and volatility adjustments. Otherwise, supervisory volatility adjustments must be used. Other things being equal, one effect of these volatility adjustments is to increase the magnitude of unsecured portions of a partially secured exposure.
- 8.28 During pre-consultation, investment firms suggested the unintended consequence of applying the comprehensive method would be a material increase in the capital charge on certain secured intra-group transactions - that is, in the credit risk, counterparty risk and concentration risk capital components. To eliminate this increased exposure, it would be necessary to require additional collateral, or to restructure significantly the investment firms' businesses. Both routes could have significant cost implications.
- 8.29 Investment firms stated that the greatest impact would be upon investment firms undertaking a significant amount of intra-group sale and repurchase and securities lending and borrowing transactions with members of their group to facilitate customer transactions. For example, this could occur where European customers want to borrow - through a European incorporated investment firm - securities held by a US firm connected to the European investment firm.

188 At the UK or UK and wider integrated groups levels, depending on whether a wider integrated group had also been established.

8.30 The Draft Directive includes a national discretion to exempt from concentration risk limits all exposures to institutions with a maturity of one year or less. Under IPRU(Bank) and IPRU(Inv), we have limited the scope of this exemption to exposures with a maturity of one year or less to counterparties not connected to the firm.¹⁸⁹ In CP97, we proposed to apply this treatment to banks, investment firms and building societies. Annex 4 explains our approach to this national discretion. We propose to continue with this approach to ensure the consistency and integrity of the proposed integrated groups regime. Therefore, this exemption could not be applied to exposures arising from intra-group sale and repurchase, and securities lending and borrowing transactions.

8.31 However, we recognise the significance of this issue for investment firms, and the need for it to be addressed. So, we propose treating as exempt from concentration risk limits (and from the calculation of the concentration risk capital component) unsecured exposures arising directly from intra-group sale and repurchase and securities lending and borrowing transactions, subject to the following two conditions:

- the counterparty is subject to the consolidated supervision of the competent authorities of another Member State, or the competent authorities of a third country that operate an equivalent regime (for this purpose, an equivalent regime would be one that qualified as equivalent under the Financial Groups Directive); and
- in the absence of volatility adjustments applied under the comprehensive approach to collateral, the exposure would be no less than 90 % collateralised at all times.

8.32 These conditions are not taken from the Draft Directive. We developed them in response to discussion of these issues with the industry. We consider them necessary from a prudential perspective to minimise simultaneously the potential adverse impact of the revised approaches to collateral upon intra-group repo and securities lending and borrowing business, and to ensure that the scope of this exemption is limited to such transactions with connected counterparties that are already subject to consolidated supervision equivalent to that applied in the UK. At this time, we have not included this treatment within rules and guidance for concentration risk. Ultimately, we propose including this treatment within BIPRU 10. We intend to review this proposed policy in light of the results of the Trading Book Review.

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

189 In IPRU(BSoc) the exemption is not limited in this way.

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

Treatment of options

- 8.33 Like the BCD, the Draft Directive provides no guidance on how an issuer's risk exposure is determined for options. This is an area of 'white' text and our approach has been informed by the policy we consulted upon in CP97, amended in light of the responses we received to that consultation.
- 8.34 In CP97 we proposed that a written put option should be treated as a long position in the underlying valued at the strike price; a purchased put should be treated as a short position in the underlying valued at the strike price; and a purchased call should be treated as a long position in the underlying equal to the book value, provided the contract has been given a book value. We also noted that a written call does not generate issuer exposure.
- 8.35 In the light of comments we received on the use of strike price rather than market price, we have amended the proposal, so that:
- a written put should be treated as a long position valued at the lower of the strike price or the current market price;
 - a purchased put should be treated as a short position valued at the lower of the strike price and the current market price;
 - the treatment of purchased and written calls remains unchanged.

For put options, this assumes a delta equal to one in calculating the exposure. We intend to review concentration risk in the context of models more widely (since the Draft Directive is silent on how concentration risk should be captured). So we are considering whether it is appropriate to allow firms to use a delta-weighted value of the underlying generated by an internal model (as outlined in IPRU(Inv) Appendices 10 and 11, and IPRU(Bank) Chapters TS and TV). We would like to consult with firms on this proposal. This treatment is currently available to investment firms, but not to credit institutions.

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?

Financial collateral on Advanced IRB approaches

Treatment of financial collateral

- 8.36 The Draft Directive¹⁹⁰ gives us the national discretion to permit firms on Advanced IRB approaches that are able to our satisfaction to estimate the effects of financial collateral on their exposures separately from other LGD-relevant aspects, to recognise these effects for the purposes of comparing the secured exposure value to concentration risk limits.
- 8.37 We propose exercising this national discretion (see Annex 4). However, we do not propose to provide additional guidance on what would be necessary for a firm to demonstrate it could estimate the effects of financial collateral separately from other LGD-relevant aspects. Instead, we propose addressing this issue as part of the IRB approvals process. We will revisit this in light of our ongoing discussions with firms and as a result of the consultation and future pre-consultation processes.

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

Scope of use of own estimates

- 8.38 The Draft Directive¹⁹¹ includes a provision requiring firms adopting an Advanced IRB approach that use own estimates of the effects of financial collateral to apply this approach to all large exposures. As currently drafted, this would mean applying an Advanced IRB approach to estimating the effects of collateral to all exposures, irrespective of whether they were on an Advanced IRB approach. We believe this to be a drafting error. We are seeking the amendment of this requirement through the European legislative process to restrict it to exposures that are on an Advanced IRB approach.

Stress testing of collateral

- 8.39 The Draft Directive¹⁹² requires that firms using their own estimates of volatility adjustments of collateral and exposures periodically stress test collateral values, to assess concentrations to collateral issuers, and the impact on the realisable value of collateral in stressed situations. In particular, the Draft Directive requires that the results of these stress tests should determine the level of collateral a firm may recognise for the purposes of concentration risk. The Draft Directive does not specify the form that such stress tests should take.
- 8.40 Our work has revealed that firms are still developing their approaches to stress testing. So we propose considering the issue of stress testing for concentration

190 BCD Article 114(2).

191 BCD Article 114(2).

192 BCD Article 114(3).

risk purposes as part of the IRB approvals process. We do not propose to provide guidance in the draft Handbook text on concentration risk at this stage.

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?

Other national discretions

Reporting of exposures to issuers of collateral

8.41 The Draft Directive¹⁹³ allows us to require firms to report to us concentrated exposures to collateral issuers. The Draft Directive does not propose a frequency for this reporting. This national discretion was introduced as a result of the significant broadening of the range of eligible collateral. We consider it important that firms report this information to us, so we can understand on an on-going basis the extent of concentration of firms' holdings of collateral. We propose using this information as an input into the Arrow process.

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?

Application of limits when firms have collateral

8.42 The Draft Directive¹⁹⁴ gives us the national discretion to allow firms to report exposures secured by a third party's collateral securities as an exposure to the third party, rather than the underlying borrower. We have not implemented this national discretion in our current prudential regimes, and did not propose doing this in CP97. We believe that implementing this discretion would introduce complications to the collateral regime that would not be justified by the materiality of the overall effect of doing so, as exposures secured by eligible collateral would already be exempt from concentration risk limits.

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

193 BCD Article 110(3).

194 BCD Article 117.

Exemptions for collateralised exposures

- 8.43 The Draft Directive¹⁹⁵ sets out a number of potential exemptions from the large exposures limits for exposures secured by particular types of collateral. These exemptions have been brought forward from the current BCD and (with the exception of paragraph (o)) were implemented within our current prudential regimes. However, the introduction of the new CRM requirements (see Chapter 13 for further details), and the broader range of eligible collateral available under the simple and comprehensive methods renders these exemptions redundant. Therefore, we do not believe it is necessary to exercise these national discretions to deliver large exposures exemptions for holding collateral. In addition, we believe that exercising them would introduce an unnecessary level of complication and inconsistency in applying the new collateral methods to large exposures.

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

Exposures backed by commercial real estate

- 8.44 The Draft Directive¹⁹⁶ introduces a new national discretion to allow competent authorities to afford a partial exemption of 50% to exposures secured by particular items (mortgages on offices or other commercial premises, shares in Finnish housing companies and exposures related to property leasing transactions concerning offices or other commercial premises) that receive a 50% risk weighting under the standardised approach (see Chapter 5 for further details).
- 8.45 We do not propose exercising the national discretion for the 50% partial exemption (see Annex 4 and Chapter 5 on the standardised approach), as we do not propose exercising the related national discretion in the standardised approach to afford a 50% risk weighting (see paragraphs 5.17 to 5.20). This is in line with our current risk weighting and large exposures treatments of such transactions.

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

Partial exemption of certain exposures

- 8.46 The Draft Directive¹⁹⁷ gives Member States the national discretion, subject to certain conditions, to apply a 20% weighting for concentration risk purposes to asset items and other exposures to institutions with a maturity of more than one

195 BCD Article 113.

196 BCD Article 113(3)(q).

197 BCD Article 115(2) and BCD Article 116.

but not more than three years, and a 50% weighting to asset items constituting claims on institutions with a maturity of more than three years.

8.47 As an alternative to the national discretions in paragraph 8.46 above, we may apply a 20% weighting to be applied to exposures to credit institutions, irrespective of their maturity.¹⁹⁸

8.48 These national discretions have been carried forward unchanged from the current BCD. We exercised them under IPRU(Inv), but not IPRU(Bank) or IPRU(BSoc). We proposed not to implement them in CP97, on the basis that we were seeking to harmonise exemptions and believed the balance of exemptions in CP97 to be appropriate. We propose to continue with this approach, as we believe this balance is still appropriate.

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

198 BCD Article 116.

9 Interest rate risk in the non-trading book

Context

- 9.1 Under the individual capital adequacy standards framework, firms should develop and maintain an ICAAP that identifies the risks they are or might be exposed to and allocates adequate financial resources against those risks (see paragraphs 4.9 to 4.28). We review and evaluate the firm's ICAAP as part of our ongoing SREP. Interest rate risk is one of the risks that will be considered as part of this process.
- 9.2 Our proposed approach to interest rate risk will be based essentially on the Basel Committee's publication 'Principles for the Management and Supervision of Interest Rate Risk' of July 2004 (the Basel Interest Rate CP) for banks, building societies and investment firms within the scope of the CAD and the BCD.
- 9.3 However, the Draft Directive¹⁹⁹ specifically requires 'measures' to be taken by the competent authorities in the case of firms whose economic value declines by more than 20% of own funds as a result of sudden and unexpected change in interest rates (the size of which shall be prescribed by the competent authorities and must be consistent across firms). Although not specified in the Draft Directive, the possibility of a standard test across the EU is under discussion through CEBS.

Sources and effects of interest rate risk

- 9.4 Interest rate risk is the exposure of a firm's financial condition to adverse movements in interest rates. The primary sources of interest rate risk which firms are typically exposed to are repricing risk, yield curve risk, basis risk and optionality.
- 9.5 Changes in interest rates affect a firm's earnings by changing its net interest income and the level of other interest-sensitive income and operating

199 BCD Article 124(5).

expenses. They also affect the underlying value of the firm's assets, liabilities and off-balance sheet instruments through the changes caused to the present value of future cash flows (and in some cases, the cash flows themselves).

- 9.6 The two most common perspectives for assessing a firm's interest rate risk exposure are the earnings perspective and the economic value perspective. The earnings perspective focuses on the impact of interest rate changes on a firm's near-term earnings, while the economic value perspective focuses on the value of a firm's net cash flows.

Our proposed framework

- 9.7 With the exception of the gap reporting requirements for building societies, our current rules and guidance do not cover *how* interest-rate risk in the non-trading book should be measured.
- 9.8 To implement the Draft Directive and in line with the Basel Interest Rate CP, we propose that all firms should apply interest rate risk measurement systems and techniques that assess the effects of rate changes on both earnings and economic value. These should be proportionate to the complexity and range of the firms' activities and business. We believe that, where interest rate risk is material, firms already have similar processes in place, so there should not be significant implementation costs.
- 9.9 Such internal systems should be capable of assessing the impact on economic value of a standardised interest rate shock. The Basel Interest Rate CP notes that this could either be based on a +/- 200 basis point parallel movement or on a 1st or 99th percentile change, using a one-year holding period and minimum five years of observations.

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?

- 9.10 One of the simplest techniques to measure interest rate risk is through computing a sensitivity gap analysis. This is based on analysing assets and liabilities by re-pricing maturity buckets, estimating sensitivity to rate changes of each risk bucket, and summing the results. However, there is scope for considerable variation in how this basic approach is implemented. For example, customer behavioural assumptions, capital and reserves, pipeline risk and optionality may be treated in different ways.
- 9.11 We would expect larger firms, and those with more complex interest rate profiles, to apply additional and complementary risk management measures such as more advanced behavioural modelling, dynamic earning volatility analysis, and the ability to approximate the behaviour of non-linear products.

- 9.12 Firms should also be able to measure their vulnerability to loss under other stressful market conditions – including the breakdown of key assumptions – and consider those results when establishing and reviewing their policies and limits for interest rate risk.

Supervisory Review Process

- 9.13 Under the individual capital adequacy standards framework, the SREP will evaluate whether a firm's internal measurement systems and techniques for identifying and measuring interest rate risk in the non-trading book, including the allocation of capital, are adequate.
- 9.14 For the purposes of our SREP, we can ask firms to provide the results of their internal measurement systems, expressed in terms of internal economic capital using a standardised interest rate shock as noted in paragraph 9.9. Where this shock causes the economic value of the firm to fall by more than 20% of own funds, we would consider whether individual capital guidance, as described in Chapter 4, is appropriate.
- 9.15 This approach under the individual capital adequacy standards framework will leave firms to develop bespoke methodologies rather than prescribe a particular approach. Accordingly, it will be difficult for us to compare the outcomes across firms to ensure that the regulatory treatment is fair and consistent. Therefore, although firms could meet the minimum Basel requirements using their internal measurement systems, and we appreciate that some firms may use more sophisticated techniques to measure interest rate risk that are likely to provide a more accurate reflection of risk, we propose to implement a basic indicator approach for supervisory reporting purposes only. The proposed approach, which would be applied to those firms that have material interest rate risk in their non trading book, is based on the sensitivity gap analysis noted above. The aim would be to help supervisors:
- make peer group comparisons;
 - spot changes in individual firms on a more systematic basis;
 - identify industry wide risk concentration;
 - compare the behavioural and other assumptions of different firms; and
 - compare internal measurement systems with a basic approach.
- 9.16 Further details on the proposed standardised format for the basic indicator approach will be in our DP on regulatory reporting due to be published in January 2005. In summary, we are proposing:

- Allocation by currency of all material future cashflows or interest rate sensitivities to pre-defined maturity buckets, monthly up to one year and then yearly out to the maximum maturity of the book.
- Both assets and liabilities split out to include balance sheet items based on contractual re-pricing dates, an adjustment for expected re-pricing (based on the firm's behavioural assumptions), linear off-balance sheet items and pipeline products. Liabilities would also include capital and reserves net of fixed other non-monetary assets.
- Assets and liabilities with explicit option features would also be separately captured. While the same split would be used as for standard positions, the contractual re-pricing date would be adjusted using a simplified assumption based on whether the option was in the money (when it would be allocated a maturity equal to the expiry date of the contract) or out of the money (when it would be placed in the overnight bucket) by more than the standardised interest shock. Those positions falling within the interest shock in or out of the money range would be allocated a re-pricing date based on a simple straight line interpolation between the overnight band and the contract expiry date. While we acknowledge that this approach is a simplification of the actual position, we believe that given the low materiality of net positions with option features, it is more appropriate than requiring firms to calculate delta equivalent positions.
- Firms would also be expected to provide the results of any internal measurement systems and be able to provide explanations of significant differences with the basic indicator approach if requested.

9.17 It is not our intention to capture all firms under this basic indicator approach. We are considering what threshold test would be appropriate. Such a threshold would be determined using a ratio with the non-trading book assets as the numerator and the total adjusted assets as the denominator.²⁰⁰ Where the ratio is greater than 15%, the basic sensitivity gap analysis would apply. We believe that most firms for whom interest rate risk is material are already capturing the information required for the basic indicator approach, albeit as building blocks for a more sophisticated approach.

9.18 The framework will be clarified once agreement is reached in CEBS.

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

200 Total adjusted assets = Total Assets - segregated cash - goodwill - other intangibles - own premises - property - plant & equipment.

- 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?
- 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 capture those firms that have got material interest rate risk?
- Q133: Is our approach to interest rate risk in the non-trading book reasonably clear and appropriate?

10 Operational risk requirements

Context

- 10.1 The purpose of operational risk requirements (ORR) is to ensure that firms have adequate capital to meet losses resulting from inadequate or failed internal processes, people and systems, or from external events, including legal risk. There are currently no explicit requirements for credit institutions and investment firms to hold capital specifically to cover such operational risk losses. In Basel 1, operational risk (OR) is implicitly covered through the treatment of credit and market risk. However, OR is an important risk facing authorised firms. Firms therefore need to hold capital specifically to protect against losses arising from it. In this CP we refer to ORR as both the requirement to hold capital to cover operational risk losses and the requirement to have appropriate systems and controls in place to manage operational risk. We refer to OR capital requirements as the requirement to hold capital to cover OR losses.
- 10.2 The proposed ORR set out in BIPRU 6.1 to BIPRU 6.6 of the draft Handbook text in Appendix 1 implement ‘Minimum own funds requirements for operational risk’ for credit institutions and investment firms as set out in the recast BCD²⁰¹ and CAD.²⁰²
- 10.3 The proposed ORR set out in this chapter apply on a solo basis. Chapter 12 sets out group ORR.

Operational risk measurement methodologies

- 10.4 The proposed rules provide three main methods for calculating the OR capital requirement. These are:
- the Basic Indicator Approach (BIA) set out in BIPRU 6.4;

201 BCD Article 75 (d) and Annex X.

202 CAD Article 13.

- the Standardised Approach (TSA) set out in BIPRU 6.5; and
- the Advanced Measurement Approaches (AMA) set out in BIPRU 6.6.

10.5 In this chapter, we cover proposals to use national discretions and areas of superequivalence. We also flag the major BIA/TSA issues on which we are awaiting finalisation of the Draft Directive. Issues that are still under consideration for AMA are covered in Chapter 11.

BIA

10.6 The OR capital requirement under the BIA is calculated as 15% of a firm's three year average net interest income and net non-interest income. No specific entry criteria have to be met to use this approach apart from the general risk management standards set out in the Draft Directive.²⁰³ All firms will be required to comply with these general risk management standards.²⁰⁴ These require robust governance arrangements for all risks including operational risk and set out processes and mechanisms that need to be included in those arrangements. These requirements also state that the actual content of the arrangements, processes and mechanisms needs to be comprehensive and proportionate to the nature, scale and complexity of a firms' activities.

10.7 We have not produced draft Handbook text setting out the general standards for risk management systems and controls in this CP. We need first to identify the most efficient and user-friendly way to implement the Draft Directive. At the same time we need to implement the corresponding standards deriving from the MiFID for investment firms, recognising the substantial overlap between the scope of the two Directives. Our initial analysis indicates there is a large degree of commonality between the high-level standards for risk management and the systems and controls required under the two Directives. We therefore think the right answer may be a common platform of standards applying to firms subject to both Directives, with further differentiation as necessary. Work by both CEBS and CESR on how these standards will be supplemented by Level 2 and Level 3 measures is still on-going. We wish to take this work into consideration in our implementation. We expect this work to be sufficiently advanced for us to produce draft Handbook text for consultation in either the CP on the MiFID or in the second CP on the CRD.

203 BCD Article 22 and CAD Article 34.

204 BCD Article 22 and BCD Annex V.

TSA

- 10.8 To be eligible to use TSA, firms must meet specific qualifying criteria set out in BIPRU 6.5.1 in addition to the general risk management standards set out in the Draft Directive.²⁰⁵ These qualifying criteria set out minimum requirements on the assessment, management and independent review of operational risk management systems, the need for those systems to be closely integrated into the risk management process and for a system of operational risk management reporting to be put in place. These need to include procedures for taking appropriate action based on that reporting. In our view, these requirements for the TSA approach represent good business practice. However, we acknowledge the importance of proportionality, and would consider it appropriate that larger, more complex firms who use the TSA approach to calculate their OR capital requirements should have risk management systems that are more sophisticated and advanced than those of the simpler firms (such as small investment firms who do not trade on own account). We consider it is the role of senior management, in line with their senior management responsibilities, to determine what is appropriate for each particular firm, subject to our subsequent review.
- 10.9 The OR capital requirement under TSA is a three-stage calculation process. First, the firm maps its previous three years of net interest income and net non-interest income to the eight business lines set out in BIPRU 6.5.8. Second, individual business line OR capital requirements are calculated by multiplying the firm's three-year average net interest income and net non-interest income in each business line by the percentage assigned to that business line. These percentages range from 12% to 18% and are set out in BIPRU 6.5.8. Finally, the total OR capital requirement is calculated as the sum of the individual business line OR capital requirements.
- 10.10 There are specific rules set out in BIPRU 6.4.2 and BIPRU 6.5.6 respectively for the treatment of negative income figures under BIA and TSA.

The alternative standardised approach

- 10.11 The alternative standardised approach (ASA) is a subset of TSA which uses alternative indicators for certain business lines. To be eligible to use the ASA, firms must meet the conditions set out in BIPRU 6.5.12. These conditions require, among other things, that a firm must be predominantly active in retail and/or commercial banking activities. These activities must account for at least 90% of its income indicator. A firm must demonstrate that a significant proportion of its retail and/or commercial banking activities comprise loans associated with a high probability of default. The ASA must also offer an improved basis for assessing operational risk. This requires the

205 BCD Article 22 and CAD Article 34.

firm to demonstrate that the TSA itself would lead to significant double-counting. The OR capital calculation under the ASA is the same as under TSA, except for the calculation of the OR capital requirement for the retail and commercial banking business lines. For these business lines, the relevant indicator is not based on income. Instead, it is calculated as the three-year average of the total nominal amount of loans and advances for each business line multiplied by 0.035 and then by the appropriate percentage applying to the respective business lines as set out in BIPRU 6.5.8.

AMA

- 10.12 To be eligible to use AMA, firms must meet specific qualitative and quantitative standards set out in BIPRU 6.6.2 and BIPRU 6.6.4 respectively in addition to the general risk management standards set out in the Draft Directive.²⁰⁶ The OR capital requirement under AMA is derived from the firm's or group's own internal measurement system. The use of AMA is subject to our approval, and such approval would be in the form of a waiver from the requirement to calculate the OR capital requirement by either BIA or TSA (see BIPRU 6.6.1). Chapter 11 provides more detail on the AMA.

Partial use – a combination of approaches

- 10.13 The draft rules and guidance in BIPRU 6.3.7 to 6.3.11 set out when and whether a firm can use a combination of these different methodologies.

Proposed use of national discretions

Exemption from OR capital requirements for certain types of investment firm.

- 10.14 The Draft Directive²⁰⁷ proposes to apply ORR to all investment firms. There are currently no explicit requirements for investment firms to hold capital specifically to cover operational risk losses, as these are implicitly covered in their current regulatory capital requirements. Articles 20(2) and 20(3) of the re-cast CAD allow us to exempt certain types of investment firm from the requirement to hold capital to cover operational risk, provided certain conditions are satisfied. These investment firms are limited licence firms in the case of Article 20(2) and limited activity firms in the case of Article 20(3). For firms to be eligible for this exemption under Article 20(2), they must not be authorised to deal on own account and not 'underwrite financial instruments and/or place financial instruments on a firm commitment basis.' Article 20(3) specifies that

206 BCD Article 22 and CAD Article 34.

207 CAD Article 20(1).

investment firms permitted to deal on own account would be eligible for a similar exemption providing the conditions laid down in Article 20(3) are satisfied.

10.15 We propose exercising these national discretions and exempting limited licence and limited activity investment firms from the OR capital requirements. One reason for this is that the nature of the services provided by these firms may make capital less effective in mitigating operational risk. Another reason is that the amount of own funds required to be held by the firms in Articles 20(2) and (3) (a) includes a reasonable buffer to cover the operational risks these firms are exposed to. We are not convinced that increasing regulatory capital requirements is the most appropriate way of achieving operational risk mitigation for these firms. We consider that the use of conduct of business rules might be a more effective means of mitigating operational risk. We think that imposing OR capital requirements for these types of firms would be disproportionate to the risks they pose to the UK financial system. In the case of Article 20(3) (b) we believe there are no UK firms falling within this definition. All investment firms, however, will be required to comply with the general risk management standards set out in the Draft Directive.²⁰⁸

10.16 We propose to implement these national discretions using a Handbook rule rather than an individual waiver process as this provides the most cost effective method of implementation both for us and firms. We acknowledge this removes choice in that investment firms falling within Article 20(2) and (3) cannot opt to calculate OR capital requirements. However, requiring all investment firms falling within Article 20(2) and (3) to apply for individual waivers would be burdensome for institutions and for us. Investment firms falling within Article 20(2) and 20 (3), who can justify to us that an OR capital requirements would be more appropriate to them could consider applying for a waiver from the fixed overheads requirement (FOR). This may, for example, be appropriate for an investment firm falling under a group AMA. Our proposed rules for CRR and FOR are in Appendix 1 in GENPRU 2.1.

The use of the ASA

10.17 The Draft Directive²⁰⁹ allows us to authorise a credit institution or investment firm to calculate its OR capital requirements using the ASA provided certain conditions are satisfied.

208 CAD Article 34.

209 BCD Annex X, Part 2, paragraph 7.

- 10.18 We propose exercising this national discretion and make the ASA approach available to UK firms provided the conditions set out in BIPRU 6.5.12 are met.

Transitional reduction in the percentage used for Trading and Sales business line in TSA

- 10.19 The Draft Directive²¹⁰ allows us until 31 December 2012 to apply a percentage of 15% to the business line ‘trading and sales’ (rather than 18%), provided the income from this business line represents at least 50% of a firm’s total income over the TSA calculation period of three years.

- 10.20 We propose exercising this national discretion and making the lower percentage available to all eligible credit institutions and investment firms meeting the condition set out above. The reasons for this are:

- Based on present data we believe the use of the lower percentage provides adequate capital to cover the operational risk these predominantly trading organisations are exposed to.
- We also believe that offering the lower percentage substantially removes the existing disincentive for these types of firm to move from BIA to TSA. The move from BIA to TSA - with its associated requirement to meet additional qualifying criteria - is something we wish to encourage.

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?

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

Q136: Do you agree with our proposal to use the national discretion to allow the ASA? Do you consider many firms will adopt this approach?

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

210 BCD Article 155 and CAD Article 45.

Other Issues

Treatment of outsourcing

10.21 The current methodology for calculating the relevant indicator in the re-cast BCD²¹¹ allows fees paid for outsourcing services to reduce a firm's gross income while fees received by a firm for providing such services increase its gross income.

10.22 The CRD as currently drafted would result in outsourcing, in effect, becoming a risk-transfer product. This would allow the full transfer of operational risk to be recognised in a reduction in the gross income figure of the outsourcing firm. This could pose risks to our objectives as it would result in:

- a reduction of systemic capital in the banking system when the outsourcing service provider is unauthorised;
- incentivising the use of outsourcing purely for regulatory capital reduction purposes, rather than strategic reasons - which may result in increased operational risk both individually and at a systemic level;
- an unlevel playing field between firms which outsource and firms which decide to keep the same service in-house.

To mitigate these risks we propose that fees paid for outsourcing services to a third party, other than a regulated affiliated company, should be treated as operating expenses (see BIPRU 6.4.7). As a result, these fees will not be deducted from the income indicator of the outsourcing firm. The effect of our proposal is that there will be:

- no transfer of OR capital requirements due to outsourcing for the outsourcing firm;
- no reduction in systemic capital in the banking system if an unauthorised service provider was used;
- parity of treatment between a firm that outsources a service and a firm that decides to retain the service in-house; and
- removal of the incentive to outsource purely for regulatory capital reduction purposes.

10.23 We acknowledge that the result could be an increase in overall capital in the system if an authorised, non-affiliate third party outsourcing service provider is used.

211 BCD Annex X, Part 1.

- 10.24 The proposal will not apply to fees paid for outsourcing services by one regulated group company to another within the same group. In this case, the group company paying for outsourcing services will be able to reduce their income indicator by the amount of fees paid, while the group company providing outsourcing services will have to increase their income indicator by the amount of fees received. While our proposed treatment of outsourcing would be superequivalent to the requirements in the Draft Directive, it is in line with the ECOFIN text.

Interpreting the Draft Directive for implementation purposes

- 10.25 In certain areas we propose additional rules and guidance where we believe further clarification of the purpose of the Draft Directive is required.
- 10.26 To clarify BIPRU 6.5.12 (3)²¹² we have added a condition at 6.5.12 (4) and new guidance at 6.5.13. The new condition requires firms wishing to use alternative indicators to calculate their OR capital requirement to use an IRB approach for calculating their credit risk capital requirement. We do not believe this is superequivalent but an inevitable knock-on requirement in order to satisfy the condition set out in BIPRU 6.5.12(3). The new guidance in BIPRU 6.5.13 quantifies what we consider to be a high probability of default for the purposes of satisfying BIPRU 6.5.12 (3). The percentage of 3.5% was chosen as this represents the percentage multiplier used in the OR capital calculation for these business lines.

The use of the ASA in combination with either the BIA or TSA

- 10.27 We propose to allow the use of the ASA. So we believe it would be helpful to clarify our position regarding the use of the ASA in combination with either the BIA or TSA.
- 10.28 The Draft Directive treats the ASA as a subset of the TSA, therefore the same rules that apply to combining TSA and BIA will apply to combining ASA with BIA. That is, combining BIA with ASA lines will only be allowed in exceptional circumstances. As with combining TSA and BIA, the Draft Directive would not allow the permanent use of a combination of BIA and ASA purely on the basis of those entities using BIA being immaterial. The 'exceptional circumstances' are more a temporary matter – for example in dealing with a merger between a BIA firm and one using ASA. This is set out in BIPRU 6.3.10.

212 The *firm* must be able to demonstrate that a significant proportion of its retail and/or commercial banking activities comprises loans associated with a high probability of default, and that the ASA provides an improved basis for assessing operational risk.

- 10.29 The conditions relevant to the use of the ASA in the Draft Directive²¹³ make clear that it can only be applied to both the commercial and retail banking business lines together. There is no option to split either of these business lines into a portion that uses the alternative indicator, while the other part of the business line would remain on the income indicator.

Treatment of intra-group income

- 10.30 The Draft Directive²¹⁴ sets out the elements to be included in the relevant indicator calculation. We have identified an issue for firms using either BIA or TSA concerning the treatment of intra-group dividends in calculating the relevant indicator at a legal entity level which could result in potential double counting of intra-group income streams. This is perhaps most easily illustrated using a stylised example of the effect of intra-group dividends payments on two firms in the same group using BIA.

	Firm A	Firm B
Gross income derived from own assets	£20m	£100m
Intra-group dividend income	£80m (from Firm B)	0
OR capital requirement	£100m x 15% = £15m	£100m x 15% = £15m

- 10.31 The OR capital requirement for Firm A is levied on the total income (including dividend income as in item 3 of the Bank Accounts Directive 86/635/EEC (BAD)). This gives a capital requirement of £15m. However, the dividend income would already have been subject to the OR charge in the gross income of Firm B. The total charge for the group (aggregating Firm A and B) would be £30m instead of £18m.
- 10.32 Stripping out intra-group income flows at legal entity as well as group level clearly would avoid this potential double counting. However, as reflected in BIPRU 6.4.5, the Draft Directive does not allow this approach.

213 BCD Annex X, Part 2, paragraph 7.

214 BCD Annex X, Part 1, paragraph 5.

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?

Calculating OR capital requirements under TSA

- 10.33 The Basel Framework and the Draft Directive differ in their treatment of negative income in calculating the OR capital requirement by TSA. Under TSA, the Basel Framework permits the netting of positive and negative capital charges across business lines within a given year. The Draft Directive does not allow netting of income across business lines within a given observation period, but income is calculated for each business line individually. The value zero is assigned to any negative income figure in an observation period and included in the averaging calculation.
- 10.34 The main consequence of this is that under the Draft Directive, where a firm suffers a period of negative gross income in one of its business lines during the calculation period, the firm may have an OR capital requirement that is higher using TSA than under the BIA, purely because of the mechanics of the Draft Directive's TSA methodology. An example of the different approaches and their consequences are set out in Annex 12. Our draft Handbook proposals are in BIPRU 6.5.2 to BIPRU 6.5.6.

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

Calculating the relevant income indicator for firms not covered by BAD

- 10.35 The recast BCD requires that gross income is calculated based on the definitions of items 1 - 7 in Article 27 of the Bank Accounts Directive (BAD). However, firms not covered by BAD are required to calculate the relevant indicator 'on the basis of data that best reflect the above definition'.²¹⁵ This language raises the question whether firms captured by this provision²¹⁶ should populate the seven BAD-based income indicator components on a 'best efforts' basis, or adopt the same approach as firms covered by BAD and use the specific BAD definitions applying to each of the seven components. To remove this ambiguity, we propose to add guidance in BIPRU 6.4.11 stating that a firm falling within this provision should have regard to the definitions in BAD in determining what should be included in each of the relevant indicator elements. We do not believe this would be superequivalent. The purpose of this is to retain consistency

215 BCD Annex X, Part 1, paragraph 9.

216 BCD Annex X, Part 1, paragraph 9.

in the way the relevant indicator is calculated between the firms covered by BAD and those who are not, the latter being primarily investment firms.

- 10.36 We propose to include examples of the relevant indicator calculation under BIA and a business line relevant indicator calculation for TSA in the Handbook text on the basis that the inclusion of examples will be helpful to firms and will reduce requests for individual guidance on this issue. These examples reflect the Draft Directive, but we would update them to reflect any future amendments regarding these calculations.

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?

11 Advanced Measurement Approaches to operational risk

Introduction

- 11.1 This chapter outlines issues in relation to the Advanced Measurement Approaches (AMA) which are still under consideration by us, CEBS or the industry. We explain the policy options we have for these issues and our preferred approaches. We are particularly interested to know whether firms would prefer the certainty of detailed guidance or more high-level guidance. While high-level guidance would provide more flexibility for firms, our review of the suitability of their implementation would then need to be rigorous. We do not propose to provide any guidance on the methodologies that are possible under AMA.
- 11.2 We refer to a number of areas where we are not yet ready to propose draft Handbook text. Before doing so, we want to consider the views submitted in response to this CP. This will help us to develop our thinking and prepare our approach to the forthcoming CEBS discussions, which are designed to increase the consistency of approaches between Member States. To avoid having to modify our approach as a result of CEBS' work, we have not included guidance on the topics it will review, but intend doing so once CEBS has consulted on them.
- 11.3 The Draft Directive²¹⁷ allows firms to use an AMA based on their own internal risk measurement systems, provided we expressly approve the use of the models concerned for calculating the own funds requirement. It also requires firms to satisfy us that they meet the qualifying criteria set out in the Draft Directive.²¹⁸ Where this does not reduce the robustness of the OR risk management framework, we may allow some of the qualifying criteria to be met at group level.²¹⁹ The purpose of these qualifying criteria is to ensure that a firm only adopts an AMA approach where, in our view, it is competent to do so, and to guard against the risk

217 BCD Article 105.

218 BCD Annex X, Part 3.

219 BCD Article 105 (4).

that a firm miscalculates its OR capital requirement by applying the AMA inappropriately.

- 11.4 Chapter 17 outlines our proposed approvals process for AMA applications, while Annex 10 sets out the initial information we propose to seek from firms to assess their AMA applications. If approval is given, this will be in the form of a waiver from the rule to calculate the OR capital requirement using BIA or TSA.

Qualitative Standards

The ‘use’ test

- 11.5 The Draft Directive²²⁰ requires that an AMA applicant must closely integrate its internal operational risk measurement system into its day-to-day risk management processes (the ‘use’ test). This is so that the inputs, techniques and practices used in measuring operational risk are used in improving operational risk management processes and practices within the firm.
- 11.6 The Draft Directive provides high-level requirements which by definition do not explain how a firm should demonstrate this integration of systems and processes. We therefore need to decide whether to communicate this through detailed guidance or high-level principles.
- 11.7 Our preferred approach for communicating expectations on the ‘use’ test to industry is through guidance in the form of high-level principles. This is based on the importance we attach to firms demonstrating that they have an embedded culture of sound risk management and are committed to improving their risk management systems over time. This method also has a number of advantages in that it would recognise proportionality and allow firms to retain flexibility in determining how to comply with the ‘use’ test, subject to our subsequent review. Alternatively, we could communicate our expectations through more detailed guidance. This would provide firms with earlier and greater certainty, but could take the initiative away from firms.
- 11.8 Our proposed high-level principles for reviewing whether firms meet the ‘use’ test are as follows:
- The purpose and use of the risk measurement system is not limited to determining regulatory capital.
 - The risk measurement system should continually evolve as the institution develops experience of risk management techniques and solutions.
 - The operational risk framework brings together the measurement and management of operational risk within an organisation.

220 BCD Annex X, Part 3, paragraph 2.

- The use of an operational risk measurement system should provide tangible benefits to the organisation.

We intend to include these in our Handbook once we have considered the responses to this chapter of the CP.

- 11.9 A firm also needs to have a credible risk measurement system. To demonstrate that the risk measurement system is credible, and not created purely for regulatory purposes, a firm should be able to show that the assumptions, techniques and practices used are appropriate and relevant to managing operational risk in the business. The firm should also be able to show how the individual parts of the risk measurement system (whether inputs or outputs) are used in the management of operational risk. In order to demonstrate ‘use’, a firm should be able to show a thorough understanding of all aspects of its approach to managing operational risk.
- 11.10 We are still considering whether we will provide examples of the types of activities that could help firms demonstrate compliance with the ‘use’ test. Our current thinking is that this could provide further clarity. However, we realise that this approach may prove too prescriptive and could take the initiative away from the firm.

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

Data integrity, completeness and accuracy

- 11.11 As part of the AMA waiver application process, a firm must be able to demonstrate that data inputs are accurate, reliable and credible and its validation techniques are robust. We see the quantity, quality and reliability of data being input into the risk measurement system as being fundamental to the AMA approaches. Once again, we consider that we have two possible policy options:
- To issue guidance to industry as to what we would consider are minimum standards for data integrity, completeness and accuracy; or
 - Not to issue any guidance and allow firms to determine their own data standards for their risk measurement system, subject to our subsequent review.
- 11.12 Our preferred policy option is to issue guidance. We think that it is important to communicate minimum expectations to industry on data integrity, relevance and sufficiency. This should provide clarity and reduce ambiguity. Explicit minimum data standards are also necessary to provide some form of consistency for the validation process, and could provide additional support for a firm’s AMA application. Our approach to data standards is consistent with the importance that we place on the credibility of the risk measurement system.

11.13 We presented the following high-level principles on data standards to the Operational Risk Standing Group:

- Firms should establish credible, transparent, and verifiable processes to collect relevant data on the four elements (internal loss data, external data, scenario analysis and business environment and control factors) on an on-going basis.
- Firms should demonstrate appropriate experience (that is, track record) in the collection of data from all four elements and its use in the model.
- Firms should explicitly establish appropriate standards of data integrity (that is, completeness, accuracy, validity, and consistency) for the data that is considered for use in its model.
- Firms should collect data across a reasonable observation period to support any assumptions regarding relevance and sufficiency of data within the model.
- Firms should collect data across the four elements using a common metric and consistent categorisation.

Members of the Standing Group raised concerns that we were seeking a higher standard than other regulators. We have agreed to consider the key issues of data integrity, relevance and sufficiency further over the coming months. Our view remains that we need to set high standards, though we acknowledge that they should be sufficiently flexible to take account of firms' individual circumstances.

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 to be appropriate?

Documentation issues

11.14 The qualitative criteria for the AMA require that risk management systems are well documented.²²¹ Appropriate documentation can contribute to the efficiency of a firm's business and may reduce the level of operational risk to which the firm is exposed. It facilitates staff awareness and understanding of responsibilities, thereby playing a key role in a wide range of areas such as:

- internal governance – clearly documented reporting lines are required as part of a credible system of corporate governance;
- internal control – decision-making processes must be clear, transparent and documented to facilitate an acceptable level of internal control;

221 BCD Annex X, Part 3, paragraph 5

- compliance – clear records enable both firms and supervisors to ensure that the firm is in compliance with all relevant requirements;
- internal capital and own funds – documentation of strategies and policies governing internal capital and own funds should be thorough and should cover the type of own funds (core or additional) which may be used; and
- internal audit – to be effective, internal audit must have access to all relevant documents as well as the appropriate reporting lines.

11.15 As a result, a firm should consider the adequacy of its internal documentation for managing its operational risks, including how documentation is developed, maintained, and distributed. For the AMA in particular, documentation is central and should be considered throughout the design and implementation of the firm's AMA model. We would expect to see evidence of this as part of the AMA waiver application and again during the period of parallel running and as part of the 'use' test. While documentation is especially important for a successful AMA model, all firms would benefit from adopting these sound practices.

11.16 These issues relating to documentation continue to be discussed at CEBS. As CEBS will consult on these proposals separately, we do not propose to provide guidance until after that consultation has taken place.

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

Other qualitative issues

11.17 The AMA qualitative standards in the Draft Directive²²² require firms to have an independent risk management function for operational risk. We do not propose to prescribe a formal definition of what this means, but consider that a crucial element of demonstrating 'independence' is the firm's ability to demonstrate an absence of conflicts of interest and that the risk management function is carried out effectively and impartially. We intend to include high-level guidance to that effect in our Handbook once the extent of EU supervisory convergence in this area is clearer.

11.18 The Draft Directive²²³ requires us to validate the operational risk measurement system. As part of the validation process, we will review the accuracy, relevance and use of the four key elements that the operational risk measurement system must include (internal loss data, external data, scenario

222 BCD Annex X, Part 3, paragraph 3.

223 BCD Annex X, Part 3, paragraph 7.

analysis and business environment and control factors). This will help us assess the quality of the risk measurement system. As part of this validation process we also need to understand the work undertaken by the firm to validate its model and integrate it into its risk management framework.

- 11.19 Both CEBS and AIG have set up validation groups and we are closely involved in them. Although their focus is primarily on the validation of the advanced credit risk approaches, some of the high-level principles, set out below, are also relevant for the validation of AMA models:
- Firms themselves have primary responsibility for validation.
 - Validation is an iterative process.
 - There is no single validation method.
 - Validation should encompass both quantitative and qualitative elements.
 - Validation processes and outcomes should be subject to independent review.
- 11.20 These qualitative issues continue to be discussed at CEBS and AIG, and will be consulted upon accordingly. We do not therefore propose to provide additional guidance on them at present.

Quantitative standards

Expected loss

- 11.21 The Draft Directive²²⁴ requires firms to include both expected loss and unexpected loss in their OR capital requirement calculation, unless they can demonstrate that expected loss is adequately captured in their ‘internal business practices’. We therefore need to consider which types of internal business practices adequately capture expected loss.
- 11.22 If we restrict the use of internal business practices so that only current capital protection can be used to capture expected loss (for example, by provisioning) then this would be consistent with our definition of capital and with the treatment of the expected loss component of the IRB capital charge. However, such a narrow definition would likely result in firms not being able to offset expected loss to any significant degree. This is because, under existing UK accounting rules, provisions cannot generally be established for potential operational risk events that have not yet occurred.
- 11.23 Alternatively we could permit firms to use other internal business practices such as budgeting and pricing to capture expected loss. Allowing such practices would require us to assess whether the risks

224 BCD Annex X, Part 3, paragraph 8.

posed to our objectives (in allowing future income estimates to be treated as current capital in offsetting expected loss) are outweighed by the potential benefits which flow from giving firms an incentive to manage, monitor and control expected operational losses proactively. Theoretically, this option would allow firms to offset more of their expected loss.

- 11.24 Our current thinking is that we will not be prescriptive in what we consider to be acceptable internal business practices. If a firm considers that it captures expected loss in its internal business practices, it will be for that firm fully to justify its assumptions. The firm will be required to demonstrate that its mechanisms for forecasting are conceptually sound, implemented with integrity and applied consistently over time. We would expect that assumptions are credible and transparent and that the firm reviews them periodically. Our view is that at present it would be a significant challenge for firms to demonstrate that future income, when calculated based on budgeting and pricing assumptions, clearly recognises and accounts for expected loss. We intend to include high-level guidance to this effect in our Handbook once we have considered reactions to this issue.

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?

Other quantitative issues

- 11.25 The Draft Directive²²⁵ requires a soundness standard comparable to a 99.9% confidence interval over a one-year period. We intend to be flexible in our interpretation of the requirements around confidence levels. A firm must choose a method to achieve a ‘comparable’ outcome to a 99.9% confidence level, and, as with other aspects of an AMA, the onus is on the firm to justify this. For example a firm may demonstrate a 95% confidence level and achieve a 99.9% confidence level by adding additional conservatism to the model. It may, for example, validate its conservatism using scenario analysis. We intend to propose high-level guidance to that effect in our Handbook once we have considered the responses to the CP in this area.
- 11.26 To meet the AMA quantitative standards outlined in the Draft Directive,²²⁶ an operational risk measurement system under AMA must include the four elements (internal data, external data, scenario analysis and business environment and control factors). We propose not to prescribe how firms should use each of these elements, however we are clear that firms must consider all of these four elements in their OR measurement system but they

225 BCD Annex X, Part 3, paragraph 8.

226 BCD Annex X, Part 3, paragraphs 8 to 24.

do not need to consider them in the same way, or give them equal weight. This is necessary to underpin the credibility of the model. For example, a firm may find that external data may not be highly relevant to its operations, in which case it could place more reliance on scenario analysis. We would expect, however, that a firm is able fully to justify the approach it has taken. We intend to propose high-level guidance to that effect in our Handbook once we have considered the responses to the CP in this area.

- 11.27 We consider that correlation and dependency referred to under AMA quantitative standards in the Draft Directive²²⁷ will have to be approved by supervisors. Our current thinking is that it is for each firm to determine what correlation assumptions it wishes to use in its AMA model. The firm then has to satisfy itself that these are appropriate and should then be able to demonstrate to us why this is the case. We would expect that the firm clearly articulates the assumptions that it makes, uses sound analysis and all available information to support these assumptions and applies these consistently over time. We intend to include high-level guidance to that effect in our Handbook in due course.
- 11.28 Under the quantitative standards in the Draft Directive²²⁸ there are a number of requirements for internal data. The AMA aspirant is required to have an appropriate minimum internal threshold for collecting internal loss data. We do not intend to be prescriptive on this because we believe that a firm needs to consider and identify appropriate thresholds for internal loss capture, and demonstrate that these are appropriate for operational risk management and measurement principles. We intend to include high-level guidance to that effect in our Handbook in due course.
- 11.29 Under the requirements for internal data in the Draft Directive²²⁹ internally generated operational risk measures shall be based on a minimum period of five years. This requirement does, however, allow a three year historical observation period when a firm first moves to AMA. Our view is that as the firm moves into its second year of AMA a four year period is required, leading to the five year requirement being achieved in the firm's third year on the AMA. Our current thinking on validating internal loss data is that firms may ultimately demonstrate that the data is accurate by reconciling individual losses to the general ledger. Alternatively, if another method is used, the firm will need to be confident that it can demonstrate to us that loss capture coverage is as complete and accurate as would be attained if a firm reconciled individual losses to the general ledger. We intend to include high-level guidance to that effect in our Handbook in due course.

227 BCD Annex X, Part 3.

228 BCD Annex X, Part 3, paragraphs 13 to 18.

229 BCD Annex X, Part 3, paragraph 13.

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

Implementation issues

- 11.30 The Draft Directive²³⁰ allows us to apply additional conditions to credit institutions and investment firms wanting to use the AMA in combination with other approaches. We reserve the right to impose additional conditions on firms on a case-by-case basis. The reason for this is prudence - while we presently do not envisage applying these additional conditions at a solo level we wish to retain the right to apply them should a firm's individual circumstances warrant it. The assessment of when this is warranted will be undertaken as part of the waiver process for the AMA.
- 11.31 Firms who adopt the AMA at the first available opportunity will formally commence on this approach from 1 January 2008. Firms adopting the simpler approaches will commence these one year earlier (from 1 January 2007). To ensure that AMA firms have capital to support operational risk exposures throughout 2007, the Draft Directive requires such firms to adopt one of the simpler approaches, until their use of an AMA approach is approved. Should a firm remain on Basel 1 for at least some of its credit risk capital calculation during 2007, the Draft Directive provides a proportionate reduction in its operational risk capital calculation.²³¹
- 11.32 We remain in discussion with industry and other regulators on many additional issues relating to the AMA, such as the treatment of insurance in AMA, the criteria for the selection, use and scaling of external data and diversification effects. The draft Handbook text on AMA does not yet include any additional guidance on these topics.

230 BCD Annex X, Part 4, paragraph 2 (a) and (b).

231 BCD Article 152 (10).

12 Capital requirements for groups

Introduction

- 12.1 In general terms, the Draft Directive's provisions on group capital requirements are similar to those in the existing directives. But they are described differently in some areas. The main changes of substance are:
- The introduction of capital adequacy and concentration risk requirements at the level of a sub-group if it includes at least one third-country²³² credit institution, investment firm, financial institution or asset management company.²³³ We have no option but to introduce these requirements, so they are not discussed in this CP.
 - Modification of the terms of the exemption from consolidated supervision available to certain investment firm groups.
 - The introduction of national discretions to apply alternative group capital resources requirements to some investment firm groups.

We do not expect the Draft Directive's provisions on group capital requirements to change significantly as a result of the agreement reached by ECOFIN on 7 December 2004.

- 12.2 In this chapter, we outline our overall approach to calculating group capital resources and requirements. Where relevant, we explain the changes we propose making to our current approach and to the proposals set out in CP97. And we discuss how we propose implementing the various options the Draft Directive contains for investment firm groups.

232 Third-country credit institution, investment firm, financial institution or asset management company – an entity that is established outside the EEA but would, if it were established within the EEA, meet the definition of credit institution, investment firm, financial institution or asset management company as appropriate.

233 Asset management company – a management company within the meaning of Article 1a(2) of the UCITS Directive, or the third-country equivalent.

Scope of consolidation

- 12.3 In CP04/17, we consulted on proposed amendments to the IPRUs in response to the introduction of International Financial Reporting Standards for some firms from 2005. One series of amendments was designed to clarify the scope of consolidation under the existing directives.
- 12.4 The draft rules and guidance in this CP propose the same scope of regulatory consolidation as in CP04/17. But we intend to carry out further work to investigate whether our requirements capture properly the risks that unconsolidated entities may pose to firms. We may therefore make further proposals on this subject in our second CP.

Methods of consolidation

- 12.5 In general terms, the Draft Directive does not prescribe the mechanics for calculating group capital resources and requirements. But there are some exceptions; for instance, market risk positions cannot be offset across different entities in the group unless certain conditions are met.
- 12.6 We propose that group capital resources should be calculated using the accounting consolidation method (see BIPRU 8.5). So the starting point will be the amounts shown in the group's consolidated financial statements. This is the method we currently apply to banks, building societies and investment firms. We think that this proposal therefore represents the most cost-effective approach for firms, and we can see no strong prudential grounds for requiring a different method.
- 12.7 As for the calculation of the group capital resources requirement, we proposed in CP97 that 'modified aggregation' should be the norm. So the group requirement would be the sum of the individual requirements of the entities in the group after adjustments for intra-group transactions. Some respondents suggested we should allow firms a free choice of methods. Others argued that we should retain the current 'line-by-line' approach (referred to in this CP as 'consolidation') to calculating the non-trading book requirements of deposit-taking groups. So the group requirement would be calculated by applying the relevant rules to the exposures and positions of the group as a whole. We recognised in our feedback to CP97 that there was a case for more flexibility.
- 12.8 We have re-considered the calculation of the group capital resources requirement in the context of the Draft Directive. We now propose allowing firms more freedom in the approaches they adopt for these calculations. To some extent, this is inevitable given the variety of mixed approaches and roll-out plans that we expect to see from firms moving towards the IRB and/or AMA approaches. But we have also concluded that there is little to be gained from prescribing aggregation as the only method.

12.9 Our proposed rules and guidance for calculating the group capital resources requirement are in BIPRU 8.6. These are inevitably more complex than they would have been under a simple aggregation approach. In summary, firms will have the following options:

- Group credit risk requirement: aggregation, consolidation or a mixed method. If a firm chooses aggregation: (i) requirements relating to intra-group exposures to other entities in the group may be excluded; and (ii) individual concentration risk charges should be excluded and a group concentration risk charge calculated instead.
- Group market risk requirement: aggregation. We will permit offsetting of positions between entities in the group – a form of consolidation – if the relevant conditions in the Draft Directive are met;
- Group operational risk requirement: aggregation, consolidation or a mixed method. If a firm chooses aggregation, it will be able to eliminate charges arising from intra-group transactions, provided that both entities are within the scope of regulatory consolidation. If a firm chooses to consolidate under the BIA, we will require an adjustment for any entity in the group that has a negative value for the relevant income indicator. We intend restricting the allowable combinations of operational risk approaches²³⁴ in a group in a similar way as for an individual firm.

12.10 A firm will need to obtain a rule waiver if it wishes to include in group capital resources requirements any amounts resulting from the use of IRB approaches (credit risk), risk aggregation, pricing or value at risk models (market risk) or an AMA (operational risk). Some limited exceptions may result from the operation of the home-host provisions in the Draft Directive (see paragraphs 1.45 to 1.51). But we are not yet able to make firm proposals, so the draft Handbook text in this CP does not contain proposed guidance on such ‘group-level’ waivers. We will consult on this subject in our second CP.

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?

Q147: We will need to include lists of the non-EEA regulators whose credit, market and operational risk requirements

234 BIA, TSA, ASA and AMA. The FOR is not an operational risk approach and can only be included as part of the group capital resources requirement as described in paragraphs 12.17 to 12.19

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?

Proposals applying only to investment firm groups

The exemption from consolidated supervision

- 12.11 The CAD already allows us to disapply consolidated supervision requirements for some investment firm groups. We have implemented this option in Chapter 14 of IPRU (Inv). The Draft Directive contains a similar national discretion,²³⁵ although it is modified in some ways. In particular:
- We can exercise this option 'on a case-by-case basis'.
 - All investment firms in the group must be limited licence or limited activity firms. This condition extends to third-country investment firms.
 - The financial holding company parent of the group must pass a form of capital adequacy test.
- 12.12 We propose implementing this national discretion. But, in contrast to the current notification approach, we intend to make it available by waiver. So firms will have to demonstrate that their application for exemption meets the conditions in section 148 of FSMA, as well as those set out in the Draft Directive. We believe that the 'case-by-case basis' language in the Draft Directive requires us to take this approach. But we also consider it sound prudential policy to take account of the conditions in FSMA in deciding whether or not to grant an exemption from consolidated supervision.
- 12.13 An investment firm will not be able to apply for a waiver from consolidated supervision if its group contains either a credit institution or an investment firm that is not 'limited'.²³⁶ For this purpose, the Draft Directive extends the definition of 'investment firm' to include third-country investment firms. In consequence, a firm will not be able to apply for the waiver if its group contains a third-country investment firm whose activities are not limited. Again, we consider this sound prudential policy; our market confidence and consumer protection objectives could be undermined if we were not able to assess the potential for contagion

235 CAD Article 22.

236 The term 'limited' is used here to mean an investment firm whose business falls within the limited licence or limited activity definition.

arising from third-country own-account dealers and underwriters in the group. We do not expect this to affect a significant number of groups.

- 12.14 Under the Draft Directive, it is a condition of the exemption from consolidated supervision that the financial holding company at the head of the group has a certain level of capital. The starting point is that the holding company should have own funds – before deductions – sufficient to cover: its investments in the capital instruments of subsidiary investment firms, financial institutions, asset management companies and ancillary services undertakings; and any contingent liabilities in favour of those entities. Alternatively, we can set a lower requirement for the financial holding company. But there is a ‘floor’ equal to the sum of the capital requirements of the entities in the group, plus the holding company’s contingent liabilities in their favour.
- 12.15 When we consider applications from firms for the waiver from consolidated supervision, our starting point will be that the financial holding company must have enough capital (as defined) to cover the aggregate requirements of entities in the group plus intra-group contingent liabilities. But, depending on the circumstances, we may determine that the holding company should have more capital than the minimum specified under the Draft Directive. We might, for instance, want to increase the requirements to reflect particular features of the wider worldwide group. Ideally, we would do this assessment alongside the SREP, which will apply at a solo level to firms benefiting from the consolidated supervision exemption.
- 12.16 The draft guidance that explains our proposed policy on the exemption from consolidated supervision is in BIPRU 8.3.6G to 8.3.9G.

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

Alternative group capital resources requirements for ‘limited’ groups

- 12.17 The usual group capital resources requirement is the sum of the group’s credit risk, market risk and operational risk requirements. But the Draft Directive contains two national discretions²³⁷ that allow us to apply alternative group requirements. These are not available if the group contains a credit institution or an investment firm that is not ‘limited’.
- 12.18 For groups containing only ‘limited’ investment firms, we can apply the following modified requirements:

237 CAD Articles 24 and 25.

- the higher of: group market and credit risk requirements; and the group FOR requirement, if the group contains only limited licence investment firms; or
- the sum of group market, credit and FOR requirements if the group contains limited activity firms.

12.19 We think that these national discretions represent a proportionate response for ‘limited’ investment firm groups. So we propose implementing both of them. The relevant draft rules are in the decision tree at BIPRU 8 Annex 1R.

13 Credit risk mitigation

Overview and context

- 13.1 This chapter considers those credit risk mitigation (CRM) issues common to the standardised and Foundation IRB approaches.²³⁸ Any CRM issues that relate only to the IRB Approach are considered in Chapter 7.
- 13.2 The Draft Directive establishes eligible forms of CRM, identifies eligible providers of unfunded credit protection and details the methods for calculating the impact of CRM on a firm's risk-weighted exposures. There are a number of new approaches for calculating the impact of CRM, the definition of eligible collateral is broader, and the rules on guarantees and credit derivatives are more detailed than in our current rules.
- 13.3 The Draft Directive distinguishes between funded CRM (netting, collateral and credit linked notes to the extent of their cash funding) and unfunded CRM (guarantees and credit derivatives), and this is reflected in the structure of this chapter.

Funded CRM

Definition of Core Market Participant

- 13.4 A Core Market Participant (CMP) will attract a volatility adjustment of 0% for repurchase transactions or securities lending or borrowing transactions that meet certain conditions under the comprehensive method.²³⁹
- 13.5 The Draft Directive sets out a list of those entities that we may recognise as CMPs.²⁴⁰ We propose to adopt the full list on the grounds that to do otherwise would put UK regulated firms at a competitive disadvantage.

238 BCD Articles 90 to 93 and Annex VIII.

239 BCD Annex VIII, Part 3, paragraph 59.

240 BCD Annex VIII, Part 3, paragraph 59(h).

This would be inconsistent with our general duty to minimise the adverse effects of our rule-making on competition.²⁴¹

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

Home-host permission for firms to apply a volatility adjustment of 0%

- 13.6 Where firms are permitted by a host supervisor to apply a volatility adjustment of 0% for repurchase transactions or securities lending or borrowing transactions for securities issued by that country's domestic government, we have the discretion to allow UK regulated firms to adopt the same approach for the same transactions entered into here.²⁴²
- 13.7 We propose allowing a volatility adjustment of 0% in these circumstances on the grounds that to do otherwise would put UK regulated firms at a competitive disadvantage. This would be inconsistent with our general duty to minimise the adverse effects of our rule-making on competition.

Q150: What are your views on our proposal to allow a volatility adjustment of 0% in these circumstances?

Internal models

- 13.8 One of the approaches now available to firms for funded CRM for repurchase transactions or securities lending or borrowing transactions is the use of internal models²⁴³ in calculating the effects of CRM. While other approaches apply volatility adjustments to each leg of the transaction, an internal model is able to take account of other risk factors, most notably the correlation between security positions subject to a master netting agreement.²⁴⁴
- 13.9 The Draft Directive requires firms to apply to the competent authority for supervisory recognition²⁴⁵ prior to using such a model for this purpose. Where a firm already has recognition for internal risk-measurement models²⁴⁶ then a waiver application should be made to extend the model scope. Firms wishing to use this approach that do not have existing model recognition will need to submit a stand-alone application for model recognition, which we propose they will also do via the waiver process.

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

241 S. 2(3)(f) of FSMA.

242 BCD Annex VIII, Part 3, paragraphs 59 to 60.

243 BCD Annex VIII, Part 3, paragraphs 12 to 24.

244 BCD Annex VIII, Part 3, paragraph 12.

245 BCD Annex VIII, Part 3, paragraphs 14 to 15.

246 BCD Annex VIII, Part 3, paragraph 14 and CAD Annex V.

Unfunded CRM and Credit Linked Notes

Extending the list of eligible protection providers

- 13.10 The list of eligible protection providers for unfunded credit protection²⁴⁷ may be extended to include other financial institutions which are authorised and supervised in the UK, and which are subject to prudential requirements equivalent to those applied to credit institutions.²⁴⁸
- 13.11 Exercising this discretion would allow financial institutions which are unrated or which have a credit assessment by a recognised ECAI of below credit quality step 2 to provide credit protection.²⁴⁹ However, as the calculation of the effects of unfunded CRM is based on a substitution approach,²⁵⁰ protection buyers will benefit from a reduction in the capital requirement only where the protection provider is more highly rated than the underlying exposure. We have decided not to exercise this discretion as we have not identified any good reasons to justify doing so.

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?

Treatment of sovereign guarantees

- 13.12 We have the discretion to extend the treatment for exposures in the national currency of the borrower, to other exposures, or portions of exposures, guaranteed by the central government or central bank, provided that the guarantee is denominated in the domestic currency of the borrower and the exposure is funded in that currency.²⁵¹ Such a treatment may result in a more favourable risk weight being assigned to the exposure than would otherwise be allowed by reference to the relevant credit quality step.
- 13.13 In view of the robustness of protection provided by sovereign guarantees, and given that this approach will be consistent with the standardised approach for credit risk,²⁵² we propose extending this treatment to sovereign guarantees meeting the conditions above, provided these guarantees meet all other requirements for recognition.

247 BCD Annex VIII, Part 1, paragraph 26.

248 BCD Annex VIII, Part 1, paragraph 28.

249 Credit quality step 2 in the Draft Directive equates to an A- rating (from Standard & Poors for illustrative purposes - for more information on these issues see Chapter 6 of this CP).

250 The ongoing review of the proposals for the Trading Book may lead to this approach being modified or superseded.

251 BCD Annex VIII, Part 3, paragraph 90.

252 Chapter 5 of this CP.

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

Non-payment of monies due from the protection buyer

- 13.14 One of the key principles of the new CRM proposals for credit derivatives is to ensure that the protection provider is not able to cancel the protection unilaterally. However, where the protection buyer fails to pay monies due (for example, premiums or other payments under the contract) we believe that the protection provider would be justified in cancelling the contract. We believe that in this case it would be unduly burdensome to require that the contract not be unilaterally revocable by the protection provider.
- 13.15 We intend allowing the protection provider to cancel the contract if a protection buyer fails to pay monies due under the contract, subject to an appropriate grace period, and still recognise the credit derivative as eligible protection for the purposes of capital relief.

Q155: What are your views on our proposal that, in this case, the protection provider should be entitled to cancel the credit protection contract?

Q156: At what stage should this right become exercisable?

Treatment of restructuring

- 13.16 Restructuring is defined in this context as the forgiveness or postponement of principal, interest or fees resulting in a credit loss.²⁵³ Where restructuring is excluded from the list of credit events in the contract, the recognised value of the protection (that is, the amount that the protection seller has undertaken to pay on the occurrence of a credit event) shall be reduced by 40%.
- 13.17 While we agree with the need to limit recognition of the risk mitigating effect of a credit derivative contract which excludes restructuring, our opinion is that this treatment does not go far enough, as it is still possible to hedge the underlying exposure completely by over-hedging using bought credit protection.
- 13.18 For this reason we propose that where restructuring is excluded as a credit event, the amount of unfunded CRM recognised will be capped at 60% of the underlying exposure being hedged.

253 BCD Annex VIII, Part 2, paragraph 19(a)(iii).

Q157: What are your views on our proposal to introduce such a cap?

Default correlations

- 13.19 The Draft Directive states that for funded CRM the correlation between the assets being relied upon for protection and the credit quality of the borrower must not be undue.²⁵⁴ The Draft Directive goes on to state that for financial collateral and gold the credit quality of the obligor and the value of the collateral must not have a material positive correlation.²⁵⁵
- 13.20 While the current IPRU(Bank)²⁵⁶ requires something similar for credit derivatives, the Draft Directive does not address this issue for unfunded CRM. It is proposed that the correlation requirements for funded CRM be carried across to unfunded CRM. For both guarantees and credit derivatives this will include correlation between the underlying exposure and the protection provider. For credit derivatives this will also include the correlation between the reference asset and the protection provider.

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

Eligibility criteria – cash funded Credit Linked Notes

- 13.21 Our view is that it is necessary to provide further guidance on the treatment of cash funded CLNs given where they appear in the Draft Directive. Such CLNs, to the extent of their cash funding, will be treated as funded CRM, even though listed as an eligible form of unfunded CRM, that is, as a credit derivative.²⁵⁷
- 13.22 We therefore intend clarifying that there are no eligibility requirements relating to the provider of protection through a cash funded CLN where that CLN meets all other requirements for the recognition of credit derivatives.

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

Legal certainty

- 13.23 The Draft Directive states that unfunded CRM must be ‘legally enforceable in all relevant jurisdictions’.²⁵⁸ This requirement is the same for funded CRM.

254 BCD Article 92(4).

255 BCD Annex VIII, Part 2, paragraph 6(a).

256 IPRU(Bank) Chapter CD 3.2(3).

257 BCD Annex VIII, Part 1, paragraph 29.

258 BCD Annex VIII, Part 2, paragraph 14(d).

13.24 In addition to this, legal reviews must be conducted for funded CRM²⁵⁹ whereas for unfunded CRM this is not a requirement. We propose that the legal review requirement be extended to include unfunded CRM. We consider such reviews a necessary requirement for ensuring that unfunded CRM continues to be legally enforceable in all relevant jurisdictions. This would also mean that the legal certainty requirements for funded and unfunded CRM would be consistent.

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

259 BCD Annex VIII, Part 2, paragraph 6(b).

14 Securitisation

Overview and context

- 14.1 The Draft Directive sets out the minimum requirements for excluding securitised exposures from the calculation of risk-weighted exposure amounts and the methods for calculating such amounts for securitisation positions.
- 14.2 Draft BIPRU rules and guidance are set out in Appendix 1.

Implementation date

- 14.3 The Draft Directive²⁶⁰ gives us discretion to allow those firms not applying the standardised approach to credit risk on 1 January 2007²⁶¹ to continue to use our current securitisation framework²⁶² for the calendar year 2007, rather than apply the standardised approach to securitisations set out in the Draft Directive.
- 14.4 We propose implementing this discretion.

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

Scope

- 14.5 The Draft Directive will apply to those structures that explicitly meet the definition of a securitisation.²⁶³ However, we do intend that the rules be applied based on the economic substance of a structure, for example the transfer and/or tranching of credit risk, rather than its strict legal form. As such there is a flexibility regarding the type of exposures that the securitisation rules may be applied to.

²⁶⁰ BCD Article 152(9)(b).

²⁶¹ As provided for in BCD Article 152(7).

²⁶² Our current approach, as shown in IPRU: Banks Chapter SE, reflects Articles 42 to 46 of Directive 2000/12/EC that is referred to in BCD Article 152(7).

²⁶³ BCD Article 4(36).

14.6 The scope is included in the overview section of the draft rules²⁶⁴ and is based, in part, on the Basel Framework.

14.7 These rules apply to the non-trading book.²⁶⁵

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

14.8 The Draft Directive will replace the current regulatory framework for securitisations and asset transfers.²⁶⁶ We have carried forward several of the current high-level requirements on understanding risks assumed or retained, ongoing risk monitoring, capital planning and impact of securitisation on remaining exposures.²⁶⁷

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

Implicit support

Definition

14.9 The Draft Directive defines implicit support as an originating firm providing support to a securitisation transaction which is beyond its contractual obligations with the view of preventing actual or potential losses to investors.²⁶⁸ Such support is prohibited as it would result in both risk and regulatory capital being understated. We propose to allow support which is explicitly set out in the contractual terms - and which is either support the firm is obliged to give (such as forms of credit enhancement), or support which the firm may give (for example waiving rights to future income).

14.10 The regulatory capital required for support that may be given will be based on the assumption that it will be given. As such, where support may be given, for example by waiving rights to future margin income that cannot be recognised as an asset, the regulatory capital impact will be zero.²⁶⁹

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

264 BIPRU 9.1.5 to 9.1.6.

265 BIPRU 9.1.10.

266 For example IPRU (Banks), Chapter SE.

267 BIPRU 9.1.8 to 9.1.9.

268 BCD Article 101.

269 BIPRU 9.2.7 to 9.2.8.

Buy-back

- 14.11 Buying back securitised exposures and/or securitisation positions ('buy-back') is prohibited under the current framework, to prevent implicit support.²⁷⁰ This prohibition would be superequivalent to the Draft Directive.
- 14.12 However, buy-back may allow a firm to provide implicit support. In order to prevent this, we propose adding guidance on the internal controls expected around buy-back, in particular those on fair value and record-keeping.

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

Regulatory action

- 14.13 The Draft Directive requires us to take appropriate measures after more than one instance of implicit support is found, to reflect any increased expectation that a firm will provide future support to its securitisations.²⁷¹ We will consider taking appropriate measures after the first instance of implicit support is found. We believe this is consistent with the Draft Directive (which does not prevent early action) and with the principles of good regulation. In summary, we do not believe the proposed approach is superequivalent.

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

Public disclosure

- 14.14 Firms are required publicly to disclose any instances of implicit support.²⁷² We propose that any such instances of implicit support should be disclosed in accordance with the general and technical requirements on public disclosure, more commonly known as Pillar 3.²⁷³ Explanatory guidance has been included in the draft rules.²⁷⁴

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

Significant risk transfer

- 14.15 A firm will be required to transfer significant credit risk associated with the securitised exposures to third parties before those exposures can be excluded from its calculation of risk-weighted exposure amounts.²⁷⁵

270 IPRU (Banks) Chapter SE 6.4. These rules would also apply to regulated non-banking firms acting as originator in a securitisation.

271 BCD Annex XI, paragraph 2.

272 BCD Article 101(2).

273 As set out in BCD Articles 145 to 149 and Annex XII.

274 BIPRU 9.2.4.

275 BCD Annex IX, Part 2.

- 14.16 The credit risk transfer will only be considered significant under the Draft Directive when the proportion transferred is commensurate with - or exceeds - the proportionate reduction in regulatory capital when comparing the firm's securitisation positions and the underlying exposures. We have included explanatory guidance on the interpretation of significant credit risk transfer in the draft rules.²⁷⁶

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

ECAIs

- 14.17 ECAI recognition, nomination and ratings mapping are consulted on in Chapter 6 and include securitisation.

Standardised Approach

Unrated securitisation positions

- 14.18 For unrated securitisation positions we propose to allow firms to apply the weighted average risk-weight that would be applied to the securitised exposures, multiplied by a concentration ratio²⁷⁷ where the pool of securitised exposures is 'known at all times'.
- 14.19 For the pool of securitised exposures to be known at all times, we would require that the composition of the pool²⁷⁸ be known at the time of purchase, any change to the composition during the life of the transaction be either:
- prohibited by the documentation; or
 - included in the firm's calculations. Where necessary we consider it reasonable to have the composition of the pool reported at least daily, via information service providers, secure web-sites or other appropriate sources.

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?

²⁷⁶ BIPRU 9.4.2 to 9.4.5.

²⁷⁷ BCD Annex IX, Part 4, paragraph 11.

²⁷⁸ The composition should be known sufficiently to accurately calculate a capital requirement under the standardised approach to credit risk, as set out in BCD Articles 77 to 83. See also BIPRU 9.10.8.

IRB Approach

The Supervisory Formula Method (SFM) for investors

- 14.20 Where no other method is available to calculate regulatory capital, we propose to allow firms investing in unrated securitisation positions to use the SFM where it can adequately be demonstrated that the minimum requirements for calculating K_{IRB} and LGD under the IRB approach²⁷⁹ are met.

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

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

Inputs in the SFM

- 14.21 We propose to allow the SFM inputs h and v ²⁸⁰ to be set at zero for securitisations of retail exposures, on the basis that the calculation is not materially changed when N ²⁸¹ is sufficiently large, this being a common feature of such securitisations. Where a securitisation of retail exposures has a sufficiently low value of N such that the above simplification would result in a material change in the capital charge, we would expect firms to contact us to discuss the suitability of using it.²⁸²

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

The Internal Assessment Approach (IAA)

- 14.22 The requirement that a publicly available ECAI methodology be used can be waived where it can be shown that none can reasonably be made available.²⁸³ We will consider applications to waive this requirement as part of the IAA recognition process.

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

279 As set out in BCD Articles 84 to 89.

280 Interim calculations in the Supervisory Formula.

281 The number of securitised exposures.

282 BIPRU 9.11.23

283 BCD Annex IX, Part 4, paragraph 42.

Fallback solution for liquidity facilities

- 14.23 Under the Draft Directive, firms using the IRB approach to securitisations can make use of the standardised approach for eligible liquidity facilities²⁸⁴ as a short-term interim solution where it is not practical to calculate K_{IRB} ²⁸⁵ and the IAA is not available.
- 14.24 We propose that a firm intending to use this approach must obtain a waiver. Factors usually taken into consideration when granting such a waiver include, but are not restricted to (a) unduly burdensome to use SFM; (b) limited time period; and (c) adequacy of capital calculation after time period elapsed.

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

Early amortisation provisions

- 14.25 Under the Draft Directive, securitisations of revolving exposures with an early amortisation provision triggered by either the three-month average excess spread or a similar quantitative value are subject to an additional capital charge.
- 14.26 When the early amortisation is triggered by a quantitative value that is not the three-month average excess spread we propose allowing, via a waiver, a treatment that approximates closely to the treatment specified for those amortisations triggered by the three-month average excess spread, in accordance with the Draft Directive.²⁸⁶ We will require firms to apply for a waiver to obtain the modified treatment and we may issue general guidance if a trigger is used widely, although the specific treatment is under review in CEBS, and cannot be consulted on at this stage.

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.

Re-structuring the text

- 14.27 We have copied out the Draft Directive, but have restructured the text to clarify it and make navigation easier. We have:
- deleted any duplication of text arising from the merging of Articles and Annex;
 - added a scope paragraph;²⁸⁷

284 BCD Annex IX, Part 4, paragraph 57.

285 As defined in BCD Annex IX, Part 1.

286 BCD Article 100(3).

287 Taken from the Basel Framework, paragraph 538.

- moved the rules on implicit support ahead of the significant risk transfer requirements. This section will include additional guidance on buy-back and public disclosure;
- moved the text on the IAA to follow the Ratings Based Method; and
- included as separate sections the additional provisions for securitisations of revolving exposures with early amortisation provisions, recognition of CRM on securitisation positions and reduction in risk-weighted exposure amounts. We have chosen not to duplicate the requirements that apply to both the standardised and IRB approaches to securitisation.

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

15 Rules of disclosure

Overview

- 15.1 In this chapter, we outline our approach to Chapter 5 (Disclosure by Credit Institutions) BCD Articles 145 to 149, and BCD Annex XII (Technical criteria on disclosure) of the Draft Directive. These provisions reflect Pillar 3 of the Basel Framework. The scope of application of disclosures is covered in BCD Article 72 of the Draft Directive.
- 15.2 Disclosures are to be made to the market for the benefit of the market, and the intention is that they will enhance market disciplines. The disclosure requirements aim to complement the minimum capital requirements and are designed to provide market participants with key pieces of information on risk exposures and the risk assessment processes of a firm. The use of metrics, taken from the minimum capital requirements framework (Pillar 1), is a means to achieve the risk disclosures.
- 15.3 International Accounting Standards are still under negotiation. We will consider how the relevant standard interacts with the Draft Directive once the standard is agreed, which we expect to be mid-2005.

Our approach

- 15.4 We intend to adopt a risk-based approach to monitoring and enforcing firms' compliance with the market discipline disclosure requirements. Disclosure is a key element of the Draft Directive but not an end in itself. We intend to follow the approach set out in Discussion Paper 13²⁸⁸ (DP13), reiterated in the DP13 feedback contained in CP189. We expect the market to play a key role in monitoring and enforcing compliance with the disclosure requirements.
- 15.5 Although our Handbook will eventually contain rules and guidance relating to all of the Directive disclosure requirements, we do not intend

288 *UK implementation of the new Basel and EU capital adequacy standards*, July 2002

to make all the disclosures formally reportable to us. We will continue to capture data following a risk-based approach. So we will collect data that we have decided we require to complete our supervision process in an effective and efficient manner. Reporting requirements under the Draft Directive are discussed in more detail in our DP on regulatory reporting due to be published in January 2005.

- 15.6 Given the continuing uncertainty, set out in more detail below, we have not included draft Handbook text in this CP. However, it is currently envisaged that the Handbook text will copy out the text of the Directive.

Continuing uncertainty – relationship with accounting standards

- 15.7 In DP13, we discussed the potential relationship between disclosures required under accounting standards and those required under the regulatory regime and the desire that, in some areas, they should be mutually supportive. At that time, there were uncertainties in both areas. However, subsequently, the disclosure requirements of both the accounting standards and the Draft Directive have become clearer, although not yet finalised. It is emerging that a number of the regulatory disclosure requirements will be covered by the accounting standards. So compliance with our Handbook will be achieved through compliance with the accounting standards and vice versa.
- 15.8 In July 2004, the International Accounting Standards Board (IASB) issued its Exposure Draft on Financial Instruments: Disclosures (ED7). In line with its stated aim of converging UK accounting standards with International Accounting Standards (IASs) the Accounting Standards Board (ASB) issued Financial Reporting Exposure Draft (FRED) 33 in July 2004 which presented proposals for a UK standard based on ED7. The consultation period for the UK FRED mirrored that of ED7 and we are waiting for both the IASB's and ASB's responses to comment letters received on their respective exposure drafts.
- 15.9 It is anticipated that final accounting standards on disclosure will be published in mid-2005 with an implementation date of accounting periods beginning on or after 1 January 2007. However, both the IASB and ASB have stated that they will permit early adoption of the standard. This timetable complements the CRD implementation timetable.
- 15.10 We intend to continue working with other international regulators on disclosure requirements and monitor possible interactions between the accounting standards and the Directive disclosure requirements.

Areas of discretion

- 15.11 The Draft Directive allows us discretion in a number of areas with respect to the disclosure requirements.

Scope of application

- 15.12 The Draft Directive²⁸⁹ allows us to disapply the disclosure requirements in full or in part where comparable disclosures are provided on a consolidated basis by a parent undertaking in a third country. We do not intend to implement this discretion as a wholesale exemption by country. Instead, a firm should be able to prove that the disclosures it wishes to rely on in a third country are comparable and notify us of the location of the comparable disclosures.

‘Materiality’²⁹⁰

- 15.13 It will be the responsibility of firms’ senior management to determine the level of disclosure having due regard to BCD Annex XII Part 1 paragraph 1 which defines materiality in respect of disclosures.

‘Proprietary and confidential’²⁹¹

- 15.14 It will also be the responsibility of firms’ senior management to determine whether information falls into either the proprietary or confidential category. In reaching their decision they should have due regard to the criteria set out in BCD Annex XII Part 1 paragraphs 2 and 3.
- 15.15 In the case of non-disclosure for proprietary and confidential reasons, the specific disclosures should be replaced by the disclosures set out in BCD Article 146(3).

Frequency of publication²⁹²

- 15.16 We do not intend requiring firms to routinely publish their disclosures more regularly than annually, or to set deadlines for the publication of such information. However, we do expect disclosures to be issued on a timely basis and with due regard to the criterion²⁹³ which assists firms in deciding whether they need to publish some or all of the disclosures more frequently than annually.

289 BCD Articles 72(3).

290 BCD Article 146(1).

291 BCD Article 146(2).

292 BCD Article 147(2).

293 BCD Annex XII, Part 1, paragraph 4.

Media and location of publication²⁹⁴

- 15.17 We expect the location and medium of disclosure to be decided by a firm's senior management. Their decisions in this area may be influenced by interaction with the accounting standards disclosure requirements. However, if all disclosures are not located together, we do expect firms to indicate - clearly - the location and medium of the remaining disclosure items.

Verification of disclosures

- 15.18 We do not currently intend to issue formal guidance on the level of verification to be applied to disclosures which will not be covered by statutory audit.

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

294 BCD Article 148.

16 Summary of cost benefit issues

Introduction

- 16.1 We will be required under the FSMA to undertake a full cost benefit analysis (CBA) on the UK implementation of the CRD when we publish the full set of draft rules and guidance for consultation in the second CP. For the purpose of this initial consultation we appointed LECG, an economics consultancy firm, to prepare a fit-for-purpose market impact analysis. We asked LECG to assess the impact of our proposed implementation of the CRD on firms' behaviour in selected financial markets, and on the UK economy as a whole. LECG's study is survey-based and provides an initial assessment of the impacts of the CRD. This has proved helpful in informing our implementation work to date. We also expect that the LECG study will help firms in responding to this consultation. However, given the preliminary nature of this consultation, we remain open-minded as to the cost benefit implications of the CRD and would welcome constructive and, wherever possible, evidence-based responses to the questions at the end of this chapter.
- 16.2 LECG's report is being published as part of this CP.²⁹⁵ This chapter provides our view on the main impacts of CRD implementation in the UK. It is based on LECG's work, limited in-house research and discussions with stakeholders.

Main impacts of CRD

Risk management

- 16.3 LECG's research suggests that a significant effect of the CRD is to provide firms with incentives to improve their risk management. In our approach to implementation work we do indeed look to encourage firms to address the range of options set out in the Draft Directive according to their level of sophistication and risk profile. LECG notes that, although some of the major

295 See Annex 2.

firms had started to use more sophisticated approaches to risk management independently of the CRD and market forces could be expected to have encouraged further such progress through time, the Directive has influenced the speed with which this has happened and the number of firms involved.

- 16.4 The faster and more widespread improvements in risk management techniques resulting from CRD implementation have, and will continue to generate, incremental benefits in terms of enhancing the soundness of the financial system. More sophisticated risk management techniques will also allow more risk-sensitive pricing, improving the allocation of resources in the economy. There will also be incremental compliance costs for firms. However, firms may experience reduced costs from running a single system for estimating regulatory and economic capital. These cost impacts will be considered in the subsequent CP.

Pillar 1 capital requirements

- 16.5 The new rules will inevitably produce changes in the capital requirements of many firms. For Pillar 1, the impact will in part depend on the firm's choice of methodology (standardised or advanced approaches to capital requirements calculations) and, more than in the past, on its risk profile and business mix. This is in line with our objectives - in particular with the need to improve the risk sensitivity of prudential rules. LECG estimates that capital requirements might decrease slightly for larger credit institutions in the UK. This is based on the prevalence of retail business in the portfolios of some of the large banks and the expectation that large firms in particular will continue to develop their risk management capabilities and provide robust responses to the challenges posed by the advanced approaches. On the other hand, we recognise that trading firms that are not credit institutions might experience increases in their regulatory capital under the CRD proposals. The outcome of the Trading Book Review (which aims to address any disproportionate impacts of the new rules on trading firms) will be relevant in that context. LECG's survey notes that investment firms are particularly concerned about the impact of the new operational risk requirements on their business. For smaller players using the standardised approach, including banks, building societies and non-trading investment firms (brokers, asset managers), our expectation is that Pillar 1 capital requirements should not be significantly different from current Pillar 1-equivalent capital requirements.

Pillar 2

- 16.6 LECG has identified this as a key area for our policy development. Lacking detailed information on how we intend to implement this part of the Directive, firms interviewed by LECG voiced concerns about the impacts that Pillar 2 implementation could have. The proposals put forward in this CP on

Pillar 2 are designed to be proportionate and risk-sensitive and should help to address such concerns. We will consider the impact of Pillar 2 implementation on overall costs and benefits in the second CP as we finalise our proposals.

Pillar 3

- 16.7 Firms found it difficult to express views and formulate expectations on the impacts of Pillar 3 at this stage. This aspect too will receive further consideration in the second CP.

Pricing, volumes and market behaviour

- 16.8 We asked LECG to consider the impact of the CRD on prices and volumes of financial services and on firms' market shares. The study concludes that, based on firms' expectations, there will be only modest changes as a direct result of the CRD. The reasons for this include: (i) LECG's research strongly suggests that regulatory capital is not a major determinant of overall costs and is thus not a major determinant of prices²⁹⁶ and (ii) the changes in actual capital are expected to be modest (as discussed below). Nevertheless, in some markets small changes in suppliers' costs can give rise to significant benefits and costs. The ability to price risks more accurately, for example, may change the way some firms target consumers and reduce the use of other, blunter, techniques for risk management. The impact of more cost-reflective pricing on competition and sub-sets of consumers could in principle be significant although LECG did not at this stage identify any major impacts of that kind.

Actual capital

- 16.9 In assessing the impact of the CRD on firms' behaviour and market strategies, the relationship between actual and regulatory capital is important. A recent FSA study²⁹⁷ concluded that actual capital does change in response to changes in regulatory capital, but that this change is not one-to-one as there are a number of drivers of actual capital holdings of which regulatory capital is one, albeit often a binding one. Firms tend to be more responsive to increases rather than decreases in their capital requirements.²⁹⁸ The research also found that firms with comparatively lower capital buffers – which will tend to include most major firms – are likely to be more sensitive to changes in regulatory capital requirements. The results of the LECG survey are consistent with this research. While the firms interviewed by

296 This derives from the high gearing of banks, which means that changes in capital typically affect only a small fraction of the overall funding cost.

297 I. Alfón, I. Argimon, P. Bascuñana-Ambrós, 'What determines how much capital is held by UK banks and building societies?' Occasional Paper Series 22, FSA, July 2004.

298 The FSA study calculates that banks that have experienced a decrease in their requirements reduce their actual capital ratio by 20% whereas banks that have experienced an increase raise their actual capital ratio by 50% in the short term and nearly 71% in the long term.

LECG generally did not expect to adjust their actual capital in response to CRD, they were mostly firms with large capital buffers or an expectation of a reduction in their capital requirements.

Further work

- 16.10 We intend to develop our analysis further ahead of the second CP. We want to look more closely at the impacts on a market-by-market basis as the CRD is likely to affect different markets differently depending, for example, on their structure and the interaction of competition forces. And within these markets, different firms (small and large, mono-line and multi-product) are likely to be affected differently. We consider that the changes introduced by the CRD will take time to materialise; and expectations on the impacts on pricing, volumes and market shares will become clearer as implementation progresses. We are also confident that the consultation process, and the progress made by firms in preparation for the CRD, will bring fresh input to this analysis. While some firms are fairly advanced in their preparations, others are not; and the LECG study shows that firms reckon more work is needed in areas such as IT systems and database/data integrity. LECG notes that improved risk management techniques can result in greater price dispersion and higher prices for higher-risk borrowers. We intend to explore the implications of this in more detail.
- 16.11 LECG did not find any evidence to suggest that, overall, there will be a significant negative impact on small firms as a result of CRD implementation. This relies in part on their assumption, based on the research that they conducted, that the new rules will have a small impact on actual levels of capital, and small firms tend to have large capital buffers. LECG estimated the likely difference in funding costs for a small credit institution on the standardised approach and a large credit institution on the advanced approach and considered that the difference in these costs was small enough to be unlikely to ‘create competitive disadvantage for the smaller firm sufficient to justify the transaction costs and disruption effects of a takeover’. Additionally, LECG notes that some small firms intend to target advanced status over time. We are aware that more work is needed on small firms’ ability to satisfy the requirements for the more advanced approaches, and we plan to explore further the impact on small firms, taking account of the specifics of the markets in which they operate, any potential for increased merger/acquisition activity and implications for market exits (and entry). While small changes in regulatory capital in isolation may have insignificant effects, in the context of a market where competitors are experiencing a decrease in regulatory capital, the competition effects could be significant.

Procyclicality

- 16.12 According to LECG, the CRD is not expected to have a marked procyclical effect. The rationale is that firms on the advanced approaches will have incentives to make better use of credit risk mitigation techniques. The stress and scenario testing techniques that will form a part of the advanced approaches will also be expected to take cyclical factors into account. As policy is developed further, we will review this issue in more detail.

FSA policy options

- 16.13 The comments above all refer to a CRD baseline, as defined in the LECG report, representing the most likely approach to UK implementation. As part of the consultancy project, LECG explored the high-level economic impacts, including on firms' behaviour and market sectors, of a number of options around that baseline. Firms are aware that our final position on these issues will be important in terms of costs and benefits. Nevertheless, as the policy options were at an early stage of development and firms were asked to consider some complex scenarios, it was difficult for them to identify which options were likely to change their behaviour or compliance costs significantly, or to have longer-term implications for the wider economy.

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.

- 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.
- 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.

17 Approval process for IRB and AMA applications

Introduction

- 17.1 This chapter outlines the draft timetable for firms' Basel / CRD applications, including Advanced IRB and AMA approaches.^{299, 300}
- 17.2 Key features of the proposed timetable are the dialogue and on-site work before firms submit formal applications and our willingness to consider early applications.

Summary of the approval process

- 17.3 The approval process is based on eight waves of applications, covering applications from firms who wish to use their chosen approach in Pillar 1 capital calculations from the earliest opportunity or up to a year after the earliest opportunity. Waves 1 to 5 cover applications for Retail and Foundation Corporate, Bank and Sovereign applications; Wave 6 covers conversions from Foundation IRB to Advanced IRB; Wave 7 covers Advanced IRB applications where no Foundation IRB application has previously been made; and Wave 8 covers AMA applications for operational risk. Each wave contains an application window with a definite cut-off date, an indication of when decisions will be made and a date under which firms can make first use of the chosen approach. Waves 1 to 5 are staggered by three or six months. A firm applying for the Retail or Foundation IRB should select just one of these waves.

299 The word 'firm' is intended to cover groups which contain firms that are subject to the CRD.

300 In addition, the Internal Models Approach for repo under the standardised approach to credit risk may be implemented by us using a waiver regime. If so, we will come forward with proposals for the approval process for repo models at a later date.

- 17.4 Firms applying for the Retail or Foundation IRB later than Wave 5 should make initial contact with us no later than 18 months before they first use their chosen approach in capital calculations. And they should make an application no less than 12 months beforehand.
- 17.5 The details of the proposal are set out and illustrated in Annexes 10 and 11.
- 17.6 One key feature of the proposed timetable is that we encourage firms to submit applications as early as possible. And we commit to give early consideration to such applications, while also making clear that there is a definite cut-off point for each wave. Firms wishing to use a Retail and / or Foundation IRB approach from a specific date in 2007 may find that there is more than one wave that they can use. Firms are free to choose the wave that best suits them; the advantage for firms putting in an application for an earlier wave is that they can expect a correspondingly earlier decision.
- 17.7 For Waves 6 to 8 covering Advanced IRB and AMA applications, each Wave indicates a window of Q4 2006 for all applications. In practice, firms are free to submit an application earlier if they consider themselves sufficiently prepared. We would hope to reach a decision on such applications more quickly, in particular where the level of preparedness is high. But at this stage we cannot offer firm promises or definite timescales. The advantage to a firm of applying early is the possibility of being able to undertake remedial action in time to use their chosen approach by their chosen date.

Implementation date

- 17.8 As we explained in Chapter 1, the Draft Directive sets out the implementation dates as 1 January 2007 for the Retail and Foundation IRB Approaches, and 1 January 2008 for the Advanced IRB Approach and AMA. Accordingly, the timeline references these dates as the implementation dates. If the implementation dates change or further guidance is forthcoming on the interpretation of these dates, we will alter the timeline as required.

Parallel running

- 17.9 Firms will need to demonstrate a period of parallel running before a decision is taken. Details of our parallel running proposals are set out in papers of the Basel / CRD Implementation Advisory Group available on our website.³⁰¹ As parallel running is currently being debated in Basel and CEBS, we will take account of the views emerging from these discussions in due course.

301 http://www.fsa.gov.uk/international/papers_basel.html.

Changes after applications have been made

- 17.10 It is likely that many firms will wish to continue improving their methodology and strengthening their adherence to the qualitative standards, even after formal applications have been made. We understand this and do not want firms to delay making improvements if their application is under consideration.

Pillar 2

- 17.11 The detailed approach to Pillar 2 implementation is presently being defined and in the coming months we will be able to specify how the relationship between Pillar 1 and Pillar 2 will work in practice. At this stage, we know that the information gained through the models approval process will be relevant to the Pillar 2 assessment of a firm's ICAAP (as part of Arrow), and therefore that it is essential for the two processes to run in tandem.

Application review process

Prioritisation

- 17.12 We expect to give priority in the application process to firms that are most advanced in their preparations. As explained in CP189, we will take a risk-based approach to processing applications. Other considerations affecting prioritisation will be our wish to undertake reviews on a thematic basis, and the need for us to perform review work in line with plans developed by colleges for international groups (see paragraphs 1.45 to 1.51).

Pre-application work

- 17.13 Our pre-application work will include:
- information gathering (for example, seeking information on firms' timetables and on their intended approaches; asking firms to complete parts of the application pack on a draft basis and to submit documentation);
 - planning of our review work through our relationship management teams in liaison with the firms;
 - initiation of firm-specific review work – firms should expect visits from us to review their IRB or AMA approaches even before they have submitted a signed application; and
 - thematic asset class reviews and other cross-firm work.

Information required from firms as part of the application process

- 17.14 The information we require from firms as part of the application process for IRB and AMA approaches is set out in the draft Application Pack included in Annex 10.
- 17.15 We will expect firms to be in a good state of readiness when they apply - including having a clear and realistic roll-out plan covering all portfolios for inclusion in the intermediate/advanced approaches. We will rely where possible on work carried out by the firms themselves. Key to this is the involvement of senior management in the approach being considered, including a requirement that the information provided is signed off by the firm's chief executive.

On-site visits

- 17.16 Review of applications is likely to involve on-site visits by our staff. The number of visits will depend on the size and complexity of the firm. If we do make an on-site visit, a single visit of a few days may suffice in the case of a small firm with a single line of business. We are likely to require more time for firms that are larger and have a wider range of business lines, more rating systems, more complex governance structures, and/or more sophisticated rating approaches.
- 17.17 Our on-site work will involve a variety of regulatory resources: as well as staff from relationship management teams, the review work is likely - in many cases - to use risk review staff who are specialists in the field of credit risk, operational risk, systems and modelling.
- 17.18 In planning our review work and reaching decisions, we will take account of work already undertaken (including visits conducted as part of asset class thematic reviews) and information we already hold. This will minimise the implementation costs for us and on firms. Special attention will be given as to whether that information was provided on a provisional basis and whether the information remains a good representation of practices employed at the firm in question.
- 17.19 With the exception of Wave 1, the timeline leaves an interval of at least six months between us reaching a decision and the date of first intended use. If we decide to turn an application down, the firm has an interval in which to arrange an alternative method of capital calculation, if one is needed. In Wave 1, we consider that the option to make use of Basel 1 capital calculations or the standardised approach for credit risk will allow firms to manage the consequence of us turning an application down.

Communication

- 17.20 We will seek to communicate in a clear and timely fashion with firms during the application review within the constraints of the decision-making process. This will include feedback - particularly on areas where achieving the standards is in doubt. Equally, it will give firms the opportunity to provide additional information or take corrective action.

Shadow and formal waiver processes

- 17.21 Our current plans are to implement the IRB and AMA approaches by a waiver from our rules. In formal terms, the rules have to have been made before the waiver can be granted. Our current plan is to make the rules in October 2006, following consultation on the final Directive text and publication of near final rules. However, to allow firms to use the Retail or Foundation IRB approaches from the first day the Basel regime comes into force (1 January 2007), and to allow us enough time to review applications, we wish to facilitate firms' applying to use the Retail or Foundation IRB approaches. Accordingly, where signed applications are made before our final rules are made, such applications will be 'shadow' applications, as the final rules will not yet have been made. This is the case for applications made under Waves 1 to 4. So, as well as submitting a shadow application for Retail or Foundation IRB in 2005, firms will have to submit a formal application for a waiver once the rules have been made. As that formal application will be formalising what we have already agreed, firms will not need to make a full new application, and may apply by a short pro forma letter.
- 17.22 Furthermore, in Waves 1 and 2, we expect to make decisions before October 2006. In formal terms, our response to a shadow application made under Waves 1 or 2 is a firm assurance of how we will respond to the formal application – unless there is a change in circumstances or information. This assurance will have the status of individual guidance. We may give our response on the shadow application when either the Directive is still under negotiation or our implementation of it is still open for consultation or being finalised. If so, our response will be subject to any changes in the Directive or our Handbook text. However, in such a case we will inform the firm of any such alteration.

Fees

- 17.23 All waiver applications will require firms to pay a fee. Formal applications made after the making of rules and for which there was no preceding shadow application will require payment at the time the firm makes the application. For shadow applications, the firm will have to pay a fee with the application on the basis that the firm is seeking individual

guidance from us; we will use our powers to charge a fee for responding to requests for individual guidance.

17.24 In addition, a special project fee (SPF) will be charged to the largest banks and securities firms during 2005-06 to cover a part of our costs of implementing Basel. The fees will be set at a level which will recover a total of £2 million. The method of calculating the fees for individual firms will be broadly similar to that for 2004-5. Broadly speaking, the groups of firms affected will also be the same.

17.25 We will consult on the method of determining application fees and special project fees as part of our annual consultation on fees published in January 2005.

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

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?

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