

# 05/3 newsletter



Financial Services Authority

## Strengthening capital standards

Including feedback on CP189

January 2005

### About this newsletter

This newsletter provides a summary of FSA Consultation Paper 05/3.

This paper is particularly relevant for deposit-takers and investment firms (but see below for how other categories of firm may be affected).

- You can download CP05/3 from our website – see details below.

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- Or alternatively order online at <http://www.tso.co.uk/bookshop/bookstore.asp?FO=38383&DI=510778>.
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# Overview

This newsletter provides a summary of FSA Consultation Paper 05/3.

This is the first of two consultation papers (CP) planned for this year in connection with UK implementation of the Capital Requirements Directive (CRD). It is particularly relevant for deposit-takers and investment firms. A second CP will be published as soon as is practicable, following agreement of the final text of the CRD, and will contain a full set of implementing rules and guidance that will appear in the Handbook.

It is difficult to make definitive statements about the relevance of the CRD for all categories of UK-regulated firm at this stage. To guide small firms in their reading of the CP there is a box at the end of Chapter 1 which highlights the particular issues and chapters likely to be of most relevance to them. The position of small investment firms remains complex. Those firms are advised to read Chapter 1 (Overview) and Chapter 2 (Scope of application) of the CP particularly closely. Consultation later this year on the implementation of the Markets in Financial Instruments Directive (MiFID) should resolve the remaining uncertainties.

The position for three other categories of firm is as follows:

- 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 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.

## This Consultation Paper

In recognising the industry’s long lead time for systems changes, we are committed, in this CP, to providing firms with as much early clarity as possible on our plans to implement the changes to the existing capital adequacy regime. Firms need to be aware, however, that our proposed Handbook rules are subject to change, due to ongoing negotiations in the EU and in the Committee of European Banking Supervisors (CEBS).

In this CP, we set out the reasons underlying our proposed exercise of the national discretions in the Draft Directive, and areas where we propose to be superequivalent. In addition, the CP outlines a timetable for implementation and our proposals for firms to submit applications for the Internal Ratings Based Approach (IRB for credit risk) and the Advanced Measurement Approach (AMA for operational risk). We include application packs for IRB and AMA approvals.

## Background

The key aim of the CRD is to introduce a modern, risk-sensitive prudential framework for all deposit-takers and investment firms across the Member States of the EU. The European Commission published the draft text of the CRD on 14 July

2004. Our CP, and the draft rules and guidance contained within it, are based on that draft text. However, where the changes agreed by the EU Finance Ministers (ECOFIN) on 7 December 2004 are significant for the UK, we reflect these in the CP.

The CRD process is closely linked to the revised Basel Framework, which sets standards for internationally-active banks, and is based on the three Basel '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 needs to 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 requirements.

#### Overall policy approach

We wish to take a clear, forward-looking approach to our rules on strengthening capital adequacy standards. This will be particularly important in relation to the proposed advanced approaches to operational risk (AMA) and credit risk (IRB). For example, firms wishing to exploit the potential for reducing their capital under the advanced approaches will need to convince us that they have credible plans in place for improving systems that will deliver a step change in their risk management and monitoring.

It is important for firms to understand that we view the CRD/Basel Framework as a prudential tool to enable us to improve the risk-sensitivity of the capital standards of the industry as a whole in the coming years. It is not solely a means to ensure that a maximum number of firms operate the advanced approaches from the date the new rules first come into force.

#### Key policy issues

**Credit risk** In this CP, we provide clarification on the entry criteria for the IRB. Two issues of particular concern to firms are the role of stress testing and the treatment of low default portfolios (LDPs). We have suggested a way in which the CRD requirements on stress testing should be interpreted, including in relation to movements in the economic cycle. On LDPs, there are no specific references in the CRD and therefore no specific treatments for them. We believe that it should be possible to include firms' LDP portfolios in the IRB and are working with the industry on ways to achieve CRD requirements. We aim to complete this 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 of the CP)

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 lending. (Chapter 5 of the CP).

**Operational risk** 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 of the CP)

**Credit risk mitigation** 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, while 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 of the CP)

**Securitisation** 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 of the CP)

**Treatment of groups** 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. So we are 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. We intend allowing 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 of the CP)

**Individual capital assessments/Pillar 2** The draft CRD 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, to produce a fair and consistent regulatory standard. This will have to be repeated over several years. So we encourage firms to start work now on designing their internal processes based on the draft rules and guidance set out in the CP. 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 of the CP)

**Proposed treatment of investment firms** We propose to implement all of the draft CRD's national discretions that relate to 'limited licence' and 'limited activity' firms and their groups. Namely, 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 of the CP)

#### Next steps

The consultation on our first CP will close on 29 April 2005. Depending on the timing of the agreement of the final text of the CRD and therefore the timing of the second CP, we will either provide a formal feedback statement or reflect our feedback in the second CP.

In order to maintain momentum on implementation work between the two CPs, we will:

- intensify the work in the Standing Groups, placing a clear focus on the priority policy areas of each and full involvement of firms in the production of practically-focused 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 Accord Implementation Group 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 changes introduced by the CRD will be a particular challenge for small firms. So it is important that we engage with them and fully understand the issues they may be facing. We plan to do so through close dialogue with the relevant trade associations, including the British Bankers' Association (BBA), the Association of Private Client Investment Managers and Stockbrokers (APCIMS) and the Investment Managers Association (IMA).

The CRD provisions in themselves do not discriminate against small firms. However, we recognise that, in practice, it may be difficult for them 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 we are focusing on not increasing the 'penalty' for firms not on the advanced approaches where we have national discretion and no sound reason for doing so.

The overview to this CP lists the chapters of particular interest to small firms, depending on the type of business they do. For example, for most small firms the CRD will primarily require a move from the Basel 1 approach to the new standardised approach for credit risk (which firms may defer until 1 January 2008) and to the simpler approaches for operational risk. These standardised approaches are explained in the CP and do not involve firms submitting an application for approval to us.

## Consumers

The proposals in the CP will affect consumers only indirectly. However, the significant enhancements which we expect the CRD to bring to the prudential framework for deposit-takers and investment firms should make it less likely that institutions fail, thus maintaining market confidence and, more indirectly, protecting consumers.

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 ([www.fsa.gov.uk/pubs/cp/cp05\\_03\\_response.html](http://www.fsa.gov.uk/pubs/cp/cp05_03_response.html)).

Alternatively, please send comments in writing to:

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