

*Minutes*

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**Minutes of the first meeting of the  
PILLAR 2 STANDING GROUP  
Held on 11 March 2005  
At FSA**

Present:

Simon Hills (BBA)  
Diane Hilleard (LIBA)  
Uner Nabi (IMA)  
Chris French (BSA)  
Patrick Fell (PwC)  
Adrian Haynes(RBS)  
Peter Humphreys (HSBC)  
Mike Pollitt (Nationwide)  
Chris Chaloner (Man Group)  
Philip Gowman (JP Morgan/Cazenove)  
Tim Carroll ( SCB)  
Simon Neville (Collins Stewart)  
Hugh May (Ipswich Building Society)  
Steve Teather (Merrill Lynch)  
Andrew Podd (Barclays)

Rosemary Hilary (FSA, RRD) - Chair  
Marcia McFarlane (FSA, Pillar 2 Team, RRD) - Secretariat  
Keith Pooley (FSA Pillar 2 Team)  
Tom Crossland (FSA, Pillar 2 Team)  
Stephanie Courtin (FSA, Pillar 2 Team)  
Nick Devereux (FSA, Pillar 2 Team)  
Claire Haydon (FSA, MRGD)  
Eva Horacek (FSA, WFD)

Apologies:

Katherine Seal (LIBA)  
Helen Banks (APCIMS)  
Anthony Bellchambers (FOA)  
Graham Warner (JO Hambro Capital Management)

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**1. Introduction**

Rosemary Hilary, as chairman, welcomed everybody to the first meeting of the Pillar 2 Standing Group ('the Standing Group').

**2. Terms of Reference**

Rosemary Hilary invited members to comment on the draft Terms of Reference for the Standing Group. One member asked whether the 'examples of topics' set out in the Terms of Reference were listed in order of importance; it was confirmed that they were not. Another member wanted to know if the PSB Advisory Group referred to still existed. It was confirmed that it did not and reference to it in the Terms of Reference has been removed.

Rosemary invited members to submit any additional comments to the FSA by email.

**Members  
to send  
comments  
by email  
on the  
Terms of  
Reference  
to FSA**

**3. Relationship with existing FSA Standing & Expert Groups**

Keith Pooley explained the relationship between the Standing Group which would major on overarching Pillar 2 issues and existing FSA standing and expert groups which would be looking at specific technical issues within their scope which might have Pillar 2 implications. He mentioned that there would always be a cross-referencing of agendas across the groups to ensure a joined-up approach and adequate Pillar 2 representation. He confirmed that ultimately all questions relating to Pillar 2 would come to the Standing Group for good governance.

**4. CP05/3 Chapter 4 (GENPRU1.2/BIPRU2.2) – First reactions from Industry**

Tom Crossland invited the Standing Group to provide their initial reactions to CP05/3.

*Implementation Dates*

One member believed that there was uncertainty about when Pillar 2 would come into effect for firms on advanced approaches and for investment firms who remain on Basel 1.

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Keith Pooley explained that the FSA would be drawing a distinction between Pillar 2 reviews and giving Individual Capital Guidance (ICG).

Keith Pooley explained that it was currently the FSA's intention to commence Pillar 2 reviews on an informal ("shadow") basis for larger firms before the formal implementation of CRD, especially in relation to those firms which apply early for model approval – given that the FSA see's a close link between the model approval process and the review of Pillar 2.

For firms intending to apply to use advanced approaches and which have an existing Individual Capital Ratio ('ICR'), (banks only) or threshold ratio (building societies), ICG will be given during late 2007 to be effective from 1 January 2008. For investment firms which do not have an existing ICR the intention is to give ICG as soon as a Pillar 2 review has been conducted.

One member asked whether, if there were a move to a single implementation date of 1 January 2008, the FSA would support the idea that Pillar 2 commenced in 2008. Tom Crossland explained that Pillar 2 would be implemented in line with whatever was agreed for the overall implementation of CRD.

One member sought clarification regarding the nature of the reviews to be performed for investment firms which have not historically had ICRs. Keith Pooley noted that CP05/3 had been silent regarding investment firms and confirmed that the FSA is presently developing its policy which it will discuss with investment firms in due course.

#### *Prescription and Guidance*

Tom Crossland explained that it was FSA's perception that larger firms wanted less guidance whilst smaller firms wanted more. He asked members if they would prefer more or less guidance than is set out in the handbook material in the annexes to CP05/3.

One member suggested that the trade associations needed to think about industry-generated guidance.

One member felt that more guidance would be helpful, for example, on the steps that firms could consider following in producing the ICAAP and if having followed those steps, the circumstances in which ICG would be given. He felt that CP05/3

was fine but would like more detail on how the FSA would respond to the firm's ICAAP.

Tom Crossland explained that this was the purpose of seeking firms' involvement in a series of pilot discussions which required firms to have a stab at an ICAAP assessment based on the guidance in CP 05/3.

One member felt that prescription should be kept to a minimum to avoid the FSA usurping the role of firms in the development of their ICAAPs. Another member felt that firms should not confuse prescription with guidance; he felt that firms would benefit from guidance and that the FSA should communicate as early as possible the operational aspects of the SREP as it would be unhelpful to firms for the ICAAP and the SREP to be developing in different directions. In terms of the form the guidance should take, he felt that broad headings rather than a checklist would be preferable, recognising however that that larger firms may be more disposed to high level guidance compared with smaller firms which might prefer the certainty of more detailed guidance.

#### *Economic Capital Models(ECM)*

One member wanted clarification on whether the approach in developing an ICAAP was a choice between a) Pillar 1 plus - the 'plus' being additional capital required or b) substituting the Pillar 1 number with the firm's own economic capital number and seeking more information from firms on matters which concerned the FSA but which were not dealt with in the ECM.

Tom Crossland said that the FSA did not want to be prescriptive and dictate the use of either approach, and indeed other approaches were also possible, for instance less sophisticated firms not using ECMs could use stress tests and scenario analyses to estimate an adequate level of capital, which was not quite the same as the Pillar 1 plus add-on approach. The most appropriate approach (or consideration for approaches) depends on the complexity of the firm's business.

One member wanted clarification on the FSA's intended approach to ECMs and the possible use of confidence intervals for Pillar 2: if firms were being asked to apply a stated confidence interval to their ECMs was this not in effect turning them into regulatory models, when that was not their purpose?

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Tom Crossland explained that the FSA needed to understand the outputs of ECMs; the more the FSA was able to understand the difference between the firm's ECM result and the Pillar 1 result, the greater the reliance the FSA would be prepared to place on the output of an ECM if a firm used an ECM in its ICAAP.

Keith Pooley explained that whilst the FSA understood that not all firms would use an ECM, where firms did it was essential that the FSA understood the processes for producing the number. He believed that the dialogue with firms would help the FSA. The importance of this dialogue was emphasised by the Standing Group.

Keith Pooley explained that it would be important to road test the approaches being developed and the FSA intended to do this as part of two pilots to be undertaken this year.

Tom Crossland explained that the purpose of the pilots was to enable the FSA to understand how firms were constructing their ICAAPs, and further to understand the numbers that the ICAAPs were beginning to generate. Tom requested members to volunteer to participate. He explained that members would not be held to the numbers they provided as part of the pilot. Tom explained that there were two pillar 2 pilots, a pre-pilot scheduled to commence in April, for which six firms were required and a second to commence in September, for which approximately 12 firms were required.

Rosemary Hilary requested members of the Standing Group to consider volunteering to participate in the pilots.

*Groups*

One firm sought clarification on the application of Pillar 2 within a large group and felt that the next CP should make this more explicit.

Tom Crossland explained that Chapter 4 of CP05/3 referred to groups. A group member can develop an ICAAP based upon the consolidated position; however the group capital total needs to be analysed in sufficient detail for the FSA and individual firms to have an informed dialogue on such issues as diversification benefits/distribution of capital within groups. Individual Capital Guidance will be given both at a group level and also to each

**Members to consider volunteering for Pilots and to advise the FSA by email.**

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regulated entity within a group.

**5. Agenda 5 - Overview of project plan, and interaction with CEBS work on P2**

Keith Pooley presented the key timelines in the Pillar 2 project cycle.

Keith Pooley also explained the pilots that were being run this year, the purpose of which was to help the FSA to develop its understanding of firms' processes to ensure the development and implementation of appropriate and workable FSA policies and practices.

*Interaction with CEBS*

Keith Pooley explained that CEBS now occupied a major role in the implementation of the CRD and Pillar 2. He explained that, in April, CEBS intended to publish a paper which will address some of the questions not addressed in its CP03 and which would also cover other areas such as internal governance. Keith explained it is important that the FSA synchronises with what is happening in Europe. A second timeline document tabled by Keith Pooley illustrated what would be happening at CEBS over the course of the next six months.

One member asked Keith to clarify what the FSA was doing with non-European countries.

Keith Pooley explained that the AIG was aware of the work being undertaken by CEBS and was now engaging with this work.

**6. Agenda Item 6 - Specific items on forward agenda**

Rosemary Hilary asked members to consider issues that they would like to have discussed at future meetings and to advise the FSA by email.

**Members  
to action**

**7. FSA Pillar 2 Pilots – Discussed under Agenda item 4**

**8. Agenda Item 8 - Pillar 2 Quantitative Impact Cost Benefit Analysis**

Tom Crossland explained that Pillar 2 would not be included as part of QIS4 in the light of comments received from firms at a

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recent BBA meeting. Notwithstanding this the FSA was still minded to ask firms to submit some information on the impact of Pillar 2 on capital levels as, without this, FSA policy would only reflect supervisors' views about capital levels.

One member stated that comments made by his firms to LECG (consultants engaged in the CBA analysis for CP05/3) did not seem to be reflected in the final report which resulted in a loss of confidence in such surveys.

Another member expressed doubts whether this Pillar 2 information would be of any value and further whether this exercise would not be onerous for firms in the light of other surveys they were being asked to participate in.

Tom Crossland tabled a draft Pillar 2 Quantitative Impact Cost Benefit analysis workbook for members to review. He suggested that rather than wait until firms were in a position to provide accurate estimates of the amount of capital they thought adequate under Pillar 2 (which might not be until shortly before the CRD is implemented), firms should be invited to complete the workbook on the understanding that we sought only rough estimates at this stage.

Rosemary Hilary invited members to consider the papers tabled by Tom and to submit any comments to the FSA by email.

**Members  
to action**

**9. Agenda Item 9 - Future meeting dates**

Rosemary Hilary asked members to confirm that the future meeting dates and times were acceptable to them.

One member requested that the meetings be made slightly later in the day.

**10. Agenda Item 10 – Any Other Business**

Keith Pooley advised that, following the series of thematic visit meetings to a number of firms towards the end of last year, a summarised report of the visits would be presented to the Basel Advisory Group at its meeting on 24 March 2005.

The next meeting date was confirmed as 22 April 2005 at 3.00pm.