

Pillar 2: Project Update

July 2006

1. This note gives a brief update on preparations for the implementation of Pillar 2 requirements under the CRD.

Pillar 2 project status

2. The project is on track to deliver the following ahead of the implementation of the Pillar 2 framework on 1 January 2007:
 - a first version of an internal procedures manual for supervisors which is fully incorporated into ARROW; and
 - FSA handbook guidance for deposit-takers and investment firms covered by CRD.

Pillar 2 policy development

3. Recent months have seen progress on several key areas reflecting continuing dialogue with the industry:
 - **Cyclicality** – discussions continue in the Credit Risk Expert Group (CREG). The Pillar 2 team is liaising closely with the credit risk team and the CREG on how the eventual outcome of these discussions will be reflected in Pillar 2.
 - **Stress-testing** – a key element of Pillar 2 is the forward-looking nature of the ICAAP, and the role of stress testing and scenario analysis, in assessing both the adequacy of internal models and whether the minimum regulatory capital requirement can be maintained through a downturn. Work is progressing on how best to express this while ensuring consistency with the approach to cyclicality. In this context, CEBS issued on 9 June a Consultative Paper (CP12), Stress Testing under the Supervisory Review Process, to which the FSA actively contributed.
 - **Concentration risk** – firms are expected to address concentration risk in their ICAAPs, bearing in mind that Basel 2/CRD Pillar 1 is deemed to be calibrated to large internationally diversified firms. Work is progressing on developing a framework for supervisors to assess the adequacy of provision for concentration risk through Pillar 1 and/or Pillar 2.
 - **Expressing Individual Capital Guidance** – using the pilot reviews, we are testing an approach to giving ICG which expresses the overall capital requirement under Pillar 2 in relation to the Pillar 1 minimum capital requirement, plus a separate line-item (where applicable) for any cyclical adjustment.

Work on practical implementation

4. In parallel with the further development of policy, there has been a drive towards preparing for implementation:
 - A pilot exercise involving a cross-section of nine firms is now in progress and due to run until the autumn. This is testing the general Pillar 2 framework that has been designed.
 - An IT module to support Pillar 2 has been developed and integrated into the overall ARROW framework.
 - A preliminary draft of the procedures manual has been made available internally for the use of those supervisors currently involved in the pilot exercise.
 - Planning for ICAAP reviews has involved: defining the level of specialist support which can be provided to supervisors by the Pillar 2 team within Risk Review Department; identifying when ICAAP reviews/visits might occur, taking into account factors such as the likely timings of Pillar 1 waver applications (where applicable) and ARROW schedules; and producing agreed visit schedules. This work continues.
 - The development of training courses is progressing, with delivery beginning in September. Courses will be tailored to meet the separate needs of supervisors of firms on advanced and standardised approaches, and those responsible for different types of investment firm.
 - The further development of how a qualitative ‘factor’ might be applied so that the ICG reflects the supervisory assessment of the overall quality of oversight and internal governance.

Pillar 2 Standing Group

5. The Pillar 2 Standing Group continues to be a key mechanism for us both to share the FSA’s thinking with the industry and to engage in discussion and exchange views. It has also been kept abreast of CEBS’ progress as it has developed its relevant CPs: The Supervisory Review Process, Interest Rate Risk in the Banking Book, Concentration Risk and Stress Testing. It has also discussed the Groupe de Contact Discussion Paper on Pillar 2 and Small Firms.

Other matters arising in responses to CP06/3 Chapter 4: Pillar 2

6. We acknowledge that more discussion is needed to explore whether there might be a better expression of the degree of severity expected for stress testing, without being unduly prescriptive. We have accepted the suggestions that there should be changes relating to the prescriptiveness of rules covering both the list of risks to be considered and the composition of capital allocated to individual solo entities.

Home and host issues

7. We recognise that there are major challenges facing industry in implementing the new Basel framework on a cross-border basis, both from a home-to-host and host-to-home perspective. We are particularly conscious of the concerns of global groups with subsidiaries in the UK about meeting their UK Pillar 2 obligations, and of uncertainty about how extensive or elaborate the Pillar 2 processes need to be to meet supervisory objectives. Moreover, we recognise that a firm for which we are a host supervisor may be managed along global lines rather than by legal entity or by geographic units and may therefore utilise centralised risk management processes not specific to the UK. This poses a challenge to the firm which of course still has a legal requirement to demonstrate to FSA how it assesses its risks and determines an appropriate level of capital.
8. We are committed to taking a proportionate approach to the ICAAP and our SREP dependent on the scale and nature of the firm's activities in the UK. We will aim to avoid both imposing unnecessary systems and processes on firms and causing unnecessary duplication of work undertaken by parent supervisors. For example if a group-wide stress test adequately identifies the risks and consequences of an economic downturn on UK operations, then we would not require a specific local stress test. These solutions require a dialogue between supervisory authorities to provide firms with clarity of supervisory expectations; and between supervisory authorities and firms to understand the practical realities and constraints in developing an ICAAP.
9. The AIG provides advice and guidance to regulators globally whilst, within the EEA, CEBS has provided a framework within which to achieve certain of these objectives. We intend to be consistent with the advice and guidance produced by these bodies. Moreover, we will continue to play a full role within both CEBS and the AIG as they seek to develop and promote an efficient, effective and harmonised Pillar 2 process.
10. We have recently entered into a dialogue with various firms under LIBA auspices to understand better the practical issues. One possibility, subject to further discussions with the Pillar 2 Standing Group, is to draw up, in co-operation with industry, case-study illustrations which can be lodged on the 'practical issues' section of our web site.
11. We are in high level discussions with our counterparts in other jurisdictions to explore the extent to which supervisors may have different views on what Pillar 2 and an ICAAP means; and how we can get more benefit from each other's review processes and minimise duplication. These discussions are planned to intensify as we progress towards full implementation of pillar 2.