

Basel 2/CRD implementation in other jurisdictions and the FSA's work in EU and Global Committees

1. We decided earlier this year that it would be helpful both for FSA and industry to research whether the CRD and Basel 2 are being implemented in a consistent and effective way across selected jurisdictions. This paper summarises the main findings from our initial review of selected aspects of implementation of the CRD and Basel 2 in Germany, France, Spain, the Netherlands, the US and Japan. We also provide an overview of the FSA's work in EU and global committees dealing with the CRD and Basel 2.

Background

2. One of the strategic objectives of the Basel 2 / CRD Implementation Advisory Group is that the FSA's application of the standards in the CRD should take account of how Basel 2 is being implemented in other key jurisdictions, in part to minimise the potential for regulatory arbitrage and inequality.
3. In generating standards the FSA must implement Directive requirements effectively – we also have a statutory duty to have regard to the 'international character of financial services and markets and the desirability of maintaining the competitive position of the UK'. So we need to address the practical problems that arise for multi-national groups that have to apply Basel 2 in several jurisdictions.
4. Between May and August 2005, we conducted interviews with regulatory colleagues at the BaFin, the Banca de España, the Commission bancaire and the Nederlandsche Bank (DNB), and studied their implementation documents, where available. We also used international meetings and consultation documents to find out more about the approach of the Japanese and US regulatory authorities. We focussed on key issues, including the overall process and timetable for implementing the CRD, important concepts in the IRB and AMA (such as the use test, senior management responsibility and the procyclicality stress test), and Pillar 2.

The papers and meetings of the group are intended to encourage useful discussion of the issues rather than to present a comprehensive account of the matters concerned or a set of agreed conclusions. The minutes of the meetings report the discussions of the group, but neither the papers or minutes nor any reported remarks by anyone present at one of those meetings should be read as representing formal positions of the institutions represented or of the FSA. The FSA's Handbook proposals will be subject to consultation in the normal way.

Key findings

Transparency and consultation process within the EU

5. The transparency of the consultation process is one of the key differences between the UK and the EU member states considered. This is largely due to legal differences. Most European supervisors do not have the FSA's obligations to consult publicly, and many have less extensive powers to implement legislation. For example, a large part of the transposition of the CRD in Germany, France and the Netherlands will be done through primary and secondary legislation rather than rules issued by the regulator.

Although such legislation may be subject to informal consultation with the industry, it is not usually publicly available until it is considered in Parliament, so at a very late stage. Nevertheless, the BaFin is consulting publicly on guidelines it plans to issue, and has also published the results of its industry working groups. The DNB has also consulted on its approach to many topics and plans to consult on its regulations (covering, in particular, credit and operational risk) this October. Some jurisdictions will also place a considerable amount of material in internal supervisory handbooks, which remain confidential.

6. It is fair to say that, in Europe, the FSA is probably conducting the most transparent policy development process.

Key policy differences at this stage

7. It is important to recognise that there is already a large degree of convergence between the European regulators in implementing the CRD. The CEBS consultation papers, for example on validation, are driving European standards in the same direction. The FSA's January consultation paper (CP05/3) also played a role as it was among the earliest consultations exposing the Handbook text we propose to implement. To a certain degree, it is therefore working as a reference source for other regulators.
8. At this stage, potential differences between Member States may emerge in the areas of the ratings migration stress test (procyclicality stress test) and Pillar 2.
9. For the ratings migration stress test, European regulators have not yet concluded on whether to require additional capital to be held if the capital requirement arising under the stress test scenario is higher than under the non-stress scenario. Most European regulators seem to plan merely to copy out the Directive text or to wait for the outcome of work in CEBS and the Basel Committee. The US have yet to take a final decision on their approach.
10. The CRD contains little detail on how Pillar 2 is to be implemented, and discussions continue both bilaterally with our regulatory counterparts and at CEBS. The FSA considers that the quantitative and qualitative elements of Pillar 2 are equally important. But our starting point is that the Pillar 1 capital requirements have been calibrated for large, well-controlled and well-diversified banks. Consequently, we expect that smaller, less well-diversified banks will have higher individual capital requirements under Pillar 2. The emphasis in Pillar 2 in some continental jurisdictions seems to be focussed primarily on systems and controls, in particular for smaller banks. For example, the German

implementation of the Pillar 2 requirements in the CRD (through regulatory guidelines, currently under consultation) focusses on risk management arrangements.¹ Conversely, we understand the US to remain committed to their well-capitalised banks regime.

Difficulty of drawing firm conclusions

11. However, it is difficult at this stage to determine whether current differences of approach will remain as much is still fluid. On the ratings migration stress test, we have stated in our Feedback Statement that we will subject our proposals to further cost-benefit consideration. Further discussion of the ratings migration stress test is also likely in CEBS. There is also continuing work on Pillar 2 within CEBS. Finally, the US Notice of Proposed Rulemaking (NPR) has been delayed at least until autumn 2005.
12. Other differences may emerge later. For example, differences in approach between EU regulators may become apparent once they begin to implement the CRD on the ground, by taking decisions on institutions' IRB applications and by validating models.
13. This re-emphasises the pivotal role of the international committees working towards convergence, such as CEBS and AIG. They are ideally placed to expose differences in firm-specific implementation on the ground. For example, from next year onwards, the Groupe de Contact will turn its attention from developing the architecture to placing more emphasis on sharing practical experiences in implementing Pillar 2, which should highlight differences in approach.

The FSA's work in EU and global committees

14. We have been fully engaged in the work undertaken by CEBS. The CEBS Expert Group on the CRD, which is undertaking the bulk of CEBS' work on the CRD, is chaired by Clive Briault, and we are represented on all CRD-related workstreams.
15. We underline the statement in CEBS consultation paper on its role and tasks (CP08) of July 2005 that CEBS work is having a positive impact. For example, as a result of the Pillar 2 consultation, all institutions and supervisors in the EU are now working from a common starting point. Projects such as the 'Guidelines on ICAAP for Smaller Institutions' (currently discussed at a work-stream of the Groupe de Contact) have the potential to be a useful tool for firms and supervisors. Also, many EU regulators have stated that they will use drafting from CEBS consultation papers for their implementation. We will take account of CEBS materials in our implementation.
16. The Accord Implementation Group (AIG), a work-stream of the Basel Committee on Banking Supervision, promotes consistency through supervisors exchanging information on implementation approaches. The AIG regularly exchanges opinions on cross-border implementation, national discretions and Pillar 2 and conducts work – through its sub-groups – on validation, operational risk and LGD. Its outputs include the principles on

1 'MaRisk' – Minimum requirements for risk management, http://www.bafin.de/marisk/marisk_entwurf.pdf, only available in German.

validation² and – most recently – a newsletter setting out the views of the AIG’s validation sub-group on the validation of low-default portfolios.³ Currently, the AIG is working on a paper about information-sharing between home and host supervisors under Basel 2 which is scheduled to be published by the Basel Committee later in 2005.

17. We have been fully engaged in the AIG’s work. We are using the discussions in the AIG to understand as much as possible about the approaches adopted by other regulators and to ensure that national implementation is consistent and equivalent across member countries.
18. Our work in supervisory colleges, especially with our colleagues from non-EEA countries at the G-10 level, represents the practical side of this. These colleges are an important opportunity to gather information about other supervisors’ approaches and expectations. This is necessary to identify potential obstacles to promoting a co-ordinated approach to firm-specific implementation. Where we are host supervisors, we propose a co-ordination strategy, taking into account the Basel Committee’s ‘High-level principles for the cross-border implementation of the new accord’. These colleges have worked well to achieve practical solutions for the challenges of cross-border supervision.

2 See the Basel Newsletter of January 2005, http://www.bis.org/publ/bcbs_nl4.htm. These principles were endorsed by the CEBS’ CP on Validation (CEBS CP10).

3 Basel Newsletter of January 2005, http://www.bis.org/publ/bcbs_nl6.pdf.