

Pillar 2 progress report

Introduction

1. This paper describes the Pillar 2 framework created by the Capital Requirements Directive ('CRD') and explains how the work of the Committee of Banking Supervisors ('CEBS') will be factored into the FSA's approach.
2. It goes on to outline the FSA's approach to supervisory review under Pillar 2 and sets out some of the key Pillar 2 milestones, including how firms are likely to be impacted, what and when FSA is likely to communicate to firms and what will be expected in response.

Background

3. The core Pillar 2 (Supervisory Review Process) provisions of the CRD lie in Articles 123,124 and Annex XI.
4. The Supervisory Review Process prescribed in the CRD is intended to achieve two important goals. First, to ensure that firms hold internal capital which is consistent with their risk profile and strategy (Article 123). Second, for supervisors to review firms' processes and strategies and, if weaknesses or deficiencies are identified, to determine appropriate "prudential measures" (Article 124). Whilst appearing separate, the two processes described in Articles 123 and 124 will be closely intertwined, and will form the basis of the dialogue between firm and supervisor.
5. CEBS refers to the two elements of the Directive as the 'Internal Capital Adequacy Assessment Process (ICAAP)' (Article 123), and the 'Supervisory Review and Evaluation Process ('SREP')'(Article 124), these being the key elements of the overall 'Supervisory Review Process'. To bring consistency to terminology already adopted in the Prudential Sourcebook, in FSA parlance the ICAAP will be known as the 'ICAP (Individual Capital Assessment Process)'; the SREP becomes the 'SRP (Supervisory Review Process)' and the overarching framework will be referred to as the 'ICAS (Individual Capital Adequacy Standards)'.
6. The CRD states that Articles 123 and 124 shall apply from 31 December 2006.

Characteristics of the ICAP and the SRP

7. In May 2004 CEBS issued a consultation paper defining, by way of High Level Principles 'HLPs', the Supervisory Review Process and characteristics of both the ICAP and the SRP. FSA's January 2005 Consultation Paper will outline its approach to the ICAS framework drawing on the CEBS High Level Principles. FSA will explain how to approach the development of ICAP in a way which is proportional for firms having regard to the complexity of their business. The aim will be to elicit from firms how prescriptive they would like the FSA to be in respect of a process which is the firms own.

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.

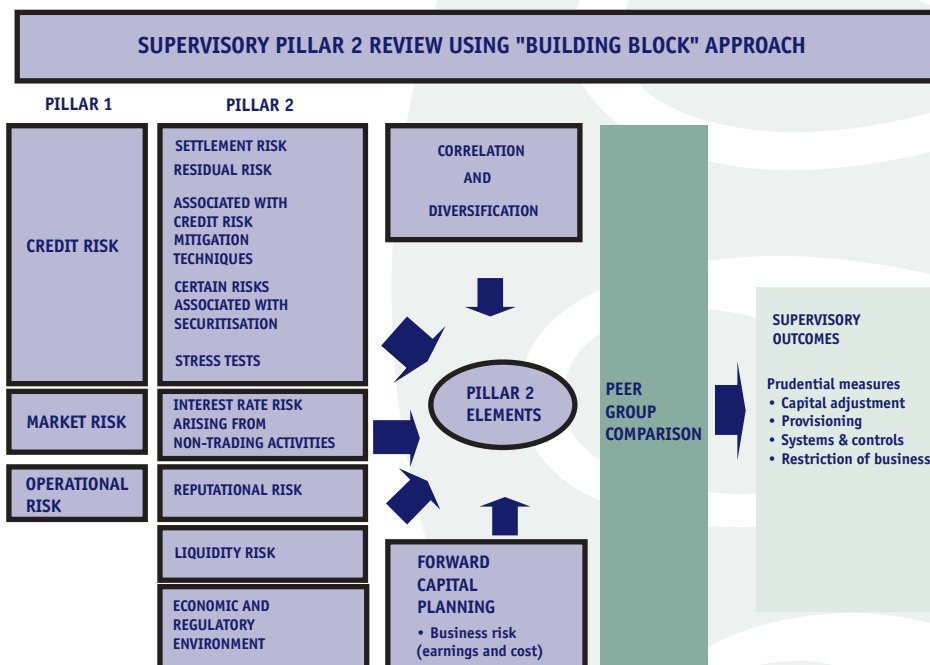
The interaction between ICAP and SRP

Relating Pillar 1 & Pillar 2

8. FSA sees the main challenge as how to reconcile the supervisory perspective of regulatory capital with the firms' own perspective as seen through the ICAP which will be prepared in terms of internal/economic capital, and which may include assumptions not recognised by Pillar 1, e.g. diversification benefits.
9. This will necessarily require supervisors to apply judgment when making their evaluation, which will supplement the more traditional quantitative approach. Pillar 1 will continue to provide supervisors with a frame of reference for standard measurement, whilst the ICAP will help to inform firms and supervisors about risks for which no standard measurement methodology has been defined.

The Pillar 2 Building Blocks

10. Given these challenges, FSA believes that there must be a structured dialogue between firms and supervisors to understand whether the capital held covers all material risks. These will include Pillar 1 risks, risks not fully captured under Pillar 1, explicit Pillar 2 risks and risk factors external to the institution.



Risks not adequately covered by Pillar 1

11. For firms applying for advanced model approaches, the approval processes will be used to identify relevant aspects of the firms' approaches which cannot be addressed in Pillar 1. Accordingly, a significant proportion of the supervisor's own Pillar 2 assessment could be informed by the detailed work to be performed as part of the approvals process.
12. For firms adopting the standardised approaches under Pillar 1, FSA will develop a template which identifies those elements unlikely to be adequately catered for by the standard models, and so requiring review under Pillar 2.
13. More generally in relation to Pillar 2, the FSA would be happy to comment upon or review any guidance which trade associations may choose to issue to its members.

Explicit Pillar 2 Risks

14. It will be for the firm in the first place to justify its process for identifying and measuring these risks and how much capital, if any, it allocates against them. FSA aims to develop key elements to be covered in each risk category to ensure an appropriate degree of comparability in the dialogue with firms. This will generate convergence of individual firm outcomes for benchmarking/peer group purposes.

Other non-specific Pillar 2 risks

15. In addition, the dialogue will need to cover other Pillar 2 risks which institutions themselves identify as key considerations. This by its very nature will be a 'bespoke' area which does not lend itself to a template approach.

Nature of the Dialogue

16. FSA will determine when the dialogue should start and how intensive it will be. For large, sophisticated firms the dialogue will be more bespoke reflecting their complexity. For smaller firms, where FSA believes there is no requirement for a detailed dialogue, it may provide standardised guidance on the Pillar 2 components. FSA will ensure that this Pillar 2 work is dovetailed with its ARROW assessment.

Prudential Measures

17. If, on the basis of the SRP, the supervisor considers that the ICAP does not adequately reflect the overall risk profile, then consideration would be given not only to increasing the capital requirement when delivering a firm's Individual Capital Guidance but to other prudential measures where it is clear that capital may not be the only or most appropriate mitigant.

Pillar 2 key timescales

January 2005: Strengthening Capital Standards FSA Consultation Paper

- First, high-level, description of the ICAS framework.

March 2005: CEBS Consultation Paper: Interaction between ICAAP and SREP

- CEBS paper defining in more detail the interaction between the two processes including the nature of the dialogue between the firm and the supervisor. Since FSA will reflect the outputs from CEBS in the design of its Pillar 2 framework, it is important that firms and trade associations provide feedback to CEBS.

April 2005: completion of Phase 1 of FSA's Pillar 2 Project

- By end-April, FSA intends to have completed both the development of the main elements of its approach to Pillar 2 and its strategy for implementing Pillar 2. FSA will not consult formally on this but will discuss its approach with trade associations and industry in existing relevant standing groups.

July-December 2005: first Application Window for Pillar 1 waiver approval for FIRB and Retail

- At this stage, FSA is clear that the review work undertaken as part of the model approvals process will identify material risks which cannot be addressed in Pillar 1 and which therefore need to be reviewed as part of a Pillar 2 assessment. FSA needs to define for firms the impact that this is likely to have on a model application and/or level of capital to be held by a firm. It is intended to give firms clarity on this by end April 2005.

September 2005: FSA Consultation Paper

- A more detailed description of the ICAS framework, including an approach to the policy issues raised in the January CP, for example reconciling regulatory capital to internal/economic capital and approaches to diversification benefits.