

Use of non-EEA regulators' requirements in group capital calculations

1. In CP05/3, we said that we planned to allow firms to include, as part of their group capital calculations, requirements calculated under the rules of non-EEA regulators if those rules could be regarded as 'equivalent' to those in the CRD. Our intention is that, where possible, firms should not have to maintain two sets of capital calculations for the same business.
2. In this paper, we explain how our thinking on this subject has developed. We also summarise the options that we think are available within the boundaries of the CRD to help deal with the implications for firms of the US regulators' decision to delay implementation of Basel 2 until 2009.

Background

3. Under our implementation of the CRD, firms will generally be able to calculate each component of their group capital requirements by:
 - consolidation – applying our rules to the exposures and positions of the group as a whole; or
 - aggregation – summing the individual requirements of the entities in the group; or
 - a combination of these two methods.

Some restrictions will apply, mostly dictated by the Directive.

4. The CRD requires that a group's capital resources be at least equal to its requirements, calculated in each case on the basis of the group's 'consolidated financial situation'. So, where aggregation is used, a local requirement calculated under the rules of a non-EEA regulator can only be included if it is at least the amount that would result from applying the provisions of the CRD. We use the term 'CRD-equivalent' to mean a requirement that meets this test¹. (Requirements calculated under the rules of another EEA regulator are CRD-equivalent by definition.)

1 It should be noted that the concept of 'equivalence' under the Financial Groups Directive (FGD) is not the same as CRD-equivalence as defined here. In the FGD context, we are required to determine whether or not a group is subject to consolidated supervision that is equivalent to the principles set out in European directives. So FGD equivalence decisions are not indicative of the likely outcome of our CRD-equivalence assessments.

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.

What does CRD-equivalence mean in practice?

5. We have identified two distinct aspects of CRD-equivalence:
 - whether the *content* of each non-EEA regulator's rules is such that, *in principle*, they are likely to achieve a CRD-equivalent result; and
 - whether, in each particular case, the outcome *in practice* is CRD-equivalent.

In general terms, we will allow a local requirement to be included in the group calculation by aggregation if it meets both criteria.

Standardised² approaches

6. Under our approach to CRD implementation, a firm will be able to aggregate into the calculation of its group capital requirements a non-EEA group member's local standardised requirements if:
 - the local rules for the relevant risk component are CRD-equivalent in principle, as listed in our Handbook; and
 - the firm has no reason to believe that the outcome of applying those rules to the relevant group member is not CRD-equivalent.
7. We have begun our work to assess non-EEA regulators. Inevitably, our assessments at this stage are based on incomplete information and so we will need to refine and revise them over time. We will report our progress and publish a list of the relevant non-EEA regulatory regimes in our February CP.
8. A firm that wants to include in its group capital calculation the standardised requirements of a non-EEA regulator that we have not assessed as CRD-equivalent will be able to apply for a waiver. In doing so, the firm will need to demonstrate that the result of applying the relevant regulator's rules is CRD-equivalent, as well as meeting the usual waiver conditions.

Advanced approaches

9. A firm will need to obtain a rule waiver from us if it wishes to include in group capital requirements any amounts resulting from the use of the advanced approaches. As part of its waiver application, a firm will need to provide a self-assessment of their compliance with the relevant requirements in our Handbook. We will expect firms' self-assessments to highlight clearly any gaps against FSA standards and to provide a plan for remedying them where appropriate. In particular, UK firms that have used a non-EEA home regulator's standards and UK groups that have used a non-EEA host regulator's standards in developing their models should explain the differences between those standards and our requirements. This will be the starting point for a discussion about whether or not we can allow those differences under our CRD implementation and, if not, what needs to be done to deal with, or compensate for, them.

Options for dealing with the US delay in Basel 2 implementation

10. On 30 September, the US banking regulators announced a one year delay – to 1 January 2009 – in their implementation of the advanced approaches under Basel 2. This may have consequences for:
 - UK operations of US banking groups; and
 - UK groups that have banking operations in the US.

2 Throughout this paper, we use the term 'standardised approaches' to mean those approaches that do not require regulatory approval.

11. We have considered the options that we can make available to such firms and groups within the constraints of the CRD. We have sought to be as flexible as possible whilst still complying with our obligation to implement the Directive properly.
12. The transitional provision in the Directive that allows firms to continue to use Basel 1 type credit risk capital requirements and a scaled-down operational risk charge applies only in 2007. So, from 1 January 2008, all UK firms and groups must comply with the new capital requirements in the CRD, as implemented in our Handbook.
13. We do not regard the delay in US implementation as a barrier to firms seeking waivers to use advanced approaches in the UK from 2008. So a UK group can include advanced approaches for its US operations in its waiver application. And a UK firm that is part of US banking group can apply to use advanced approaches in the UK, even though its home regulator will not have approved those approaches. We will deal with these applications in the normal way. In particular, we will look to collaborate with the US regulators in relation to particular waiver applications and will aim not to duplicate their work. But if the delay means that the US regulators' review work is less advanced than it would otherwise have been – so that we are able to place less reliance on it and need to do more work ourselves – we may look to charge additional waiver application fees so as to recover our additional costs. We may also reserve the right to review advanced approach waivers once the US regulators have completed their approval process.
14. UK firms and groups that do not wish to use advanced approaches from 1 January 2008 will have to implement the standardised approaches, as set out in our Handbook. And firms and groups that will be using advanced approaches on a partial basis – either during the roll-out period or under a permanent partial exemption – will also need to incorporate standardised requirements as set out in our Handbook. As explained in paragraph 6 above, a UK group will be able to include the local standardised requirements of a group member that is subject to CRD-equivalent rules.
15. Basel 1 is not CRD-equivalent for credit risk, as it will not always give a result that is at least the amount required to cover credit risk under the Directive. And it contains no explicit operational risk requirement. So we cannot allow a UK group to include the requirements of a US banking subsidiary as calculated under the existing US rules in the period between 1 January 2008 and US Basel 2 implementation. But we will include provisions in the Handbook that will deem a scaled-up requirement (= 1.25 x US Basel 1 credit risk requirement) to be CRD-equivalent for credit risk purposes if the US banking subsidiary in question is in the 'well capitalized' category. This reflects the actual capital that a well capitalized bank needs to support its credit risk requirements, given that such a bank must have an overall capital ratio of 10% rather than the Basel minimum of 8%. An operational risk requirement – calculated under our rules – will also be needed.
16. The option described above is designed to enable us to comply with our obligation to implement the CRD in full from 1 January 2008, whilst offering UK groups a proportionate approach that does not require them to develop new systems that will only be needed for a short period. This option is easy to apply, but we recognise that it may well deliver higher overall capital requirements than would result from applying our standardised rules. Each group will need to assess the costs and benefits for it of taking up the option.
17. As a further option, we will be prepared to consider waiver applications from UK groups that wish to use a different method to calculate the capital requirements for their US banking business. We have no fixed views about how such a method might be constructed. But a group applying for a waiver of this sort would need to demonstrate that its proposed method is CRD-equivalent, as well as meeting the usual waiver conditions.