

Pillar 2: Project Update

1. This note gives an update on preparations for implementation of Pillar 2 requirements under the CRD, including key developments since the last meeting of the Advisory Group held on 24 March.

Pillar 2 project

2. The project remains on course to deliver by end-Q3 2006:
 - an ICAS (Banking and Investment Firms) Procedures Manual for supervisors; and
 - guidance for firms on the ICAS Framework (Banking and Investment Firms).

Pillar 2 Policy Development

3. In accordance with the project plan, the last few months have seen progress on a number of key areas of Pillar 2 policy:
 - **Investment Firms:** we have been working pragmatically to define the FSA's risk appetite to inform decisions on the intensity of application of Pillar 2 to investment firms;
 - **Calibration:** we have considered whether there is a case for prescribing a confidence level for firms' Pillar 2 models. On the basis of CP05/03 feedback received from trade bodies and firms, and given the general objective not to be super-equivalent to the CRD, we are minded not to set a confidence level for the calibration of firms' Pillar 2 models, although the arguments for and against will be kept under consideration;
 - **Diversification Benefits:** we have examined the treatment of diversification benefits and shared some of our current thinking with the new Standing Group;
 - **Transitioning banks from Individual Capital Ratios ('ICR') to Individual Capital Guidance ('ICG'):** we have been looking at a process for the transitioning of firms' ICRs into ICGs.
4. As we work to close out on those issues, our attention is now turning to interest rate risk in the banking book, concentration risk and stress testing within 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.

Planned work on practical implementation:

- **Planning for ICAAP Reviews:** the output from this will be a timetable for the ICAAP reviews, taking into account factors such as ARROW cycles and model recognition schedules;
- **Relationship between Pillar 2 and the Pillar 1 models approval process:** to identify issues arising from the models approval process which may have to be taken into account in Pillar 2.

Pillar 2 Standing Group

5. An external Pillar 2 Standing Group has been established for the purpose of sharing and exchanging views with industry on FSA's thinking. It met in March, April and June, with the next meeting scheduled for mid-July. Minutes are on the website.
6. Issues which the Standing Group has discussed include:
 - **CEBS** – the Group has been kept informed about the progress on draft papers on interest rate in the banking book, the home/host co-operative framework and the updated CP on Pillar 2. The Group was also updated on developments such as the establishment of a new workstream on stress testing in Pillar 2 which, among other things, will map the interaction with the seven Pillar 1 stress tests mentioned in the CRD and the five stress tests mentioned in the Trading Book Review. This work will be fully supported by the FSA and in turn the FSA will draw on the results of this work to inform its own approach;
 - **Pro-cyclicality** – an update was given on work in the Credit Risk Expert Group;
 - **Pillar 2 Cost Benefit Analysis** – a revised Pillar 2 Quantitative Impact/Cost Benefit Analysis questionnaire was re-submitted to the Group for comment;
 - **Calibration and diversification** – we shared our thinking;
 - **Update on Firm/Industry Responses to CP05/03** – the Group was given an oral summary of the key Pillar 2 messages that have emerged from firm/industry responses to the CP05/03.
 - **Update on Pre-pilots/ SREP Manual** – representatives of the Group are participating in the pre-pilot exercise and at least one meeting has been held with each firm. The next step is to collect quantitative data, however tentative/provisional, relating to the firms' ICAAPs. Initial work has begun on sketching out the Procedures Manual for supervisors, drawing on the results of the pre-pilot work so far. Our intention is to discuss the first draft with the pre-pilot firms in conjunction with the outputs from their ICAAPs. This will enable us to understand whether we are developing the Manual in the right direction.

Pillar 2 - Technical Training

7. We have successfully implemented the second phase of Pillar 2 training for approximately forty staff (specialists and superusers) involved in the design and implementation of the Pillar 2 framework.