Policy Statement

06/6

Financial Services Authority

Strengthening Capital Standards 2

Feedback on CP06/3

July 2006

FSA®

Contents

This Policy Statement reports on the main issues arising from Consultation Paper 06/3 (*Strengthening Capital Standards 2)* and publishes final rules.

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1 Overview

Introduction

1.1 In this Policy Statement (PS), we respond to comments received on Consultation Paper (CP) 06/3 'Strengthening Capital Standards 2'. We published CP06/3 in February 2006 along with a complete set of draft Handbook text for implementing the Capital Requirements Directive (CRD) in the UK.

1.2 We received 37 responses to CP06/3 including a joint-industry submission from the British Bankers' Association (BBA), the European Securitisation Forum (ESF), the International Swaps and Derivatives Association (ISDA) and the London Investment Banking Association (LIBA). We are grateful to all respondents for the time they devoted to prepare their detailed comments. These are being taken into account as we revise the rules and guidance for the GENPRU and BIPRU modules of the FSA Handbook in time for the planned formal rule-making by the FSA Board in October.

1.3 This PS follows the same chapter sequence as CP06/3. Each chapter contains a summary of the comments received to the questions posed in that CP and our responses to them. We also discuss other substantive issues raised by the industry and set out what changes we plan to make to the draft Handbook text included in CP06/3.

1.4 In a box at the end of this chapter we highlight some key points for smaller firms, investment firms and consumers.

1.5 This Overview covers the main feedback messages, including points made about:

- the clarity and accessibility of copy-out rules in GENPRU and BIPRU;
- key policy decisions and updates;
- the status of CEBS material;
- individual guidance;
- international implementation issues;

1 Committee of European Banking Supervisors.

- outstanding issues;
- practical implementation for firms; and
- other CRD-related consultation papers.

Clarity and accessibility of copy-out rules in GENPRU and BIPRU

Copy-out approach

1.6 We agreed with the industry several years ago that it made sense to use a predominantly copy-out approach to transpose the CRD into our Handbook. This was with the aim of minimising any unintended superequivalence and providing flexibility of interpretation for firms. The draft GENPRU and BIPRU text consulted on in CP06/3 is a product of the detailed and constructive discussions with the industry, which have covered a vast amount of ground since the Basel 2 and CRD texts were published in mid-2004.

1.7 We acknowledge the industry's concern that the relevant Handbook text should be as clear and helpful as possible. While we remain committed to the copy-out approach, we are equally determined to ensure we achieve clear and practical prudential regulation through the effective implementation of what is undoubtedly a complex directive. We have therefore developed four different ways of addressing the industry's concerns, which are summarised below.

Improving the clarity of GENPRU and BIPRU

1.8 The main focus of the revisions will be on improving and adding guidance – in the form of plainer English narrative, navigational tables and worked examples in a few key areas – in the GENPRU and BIPRU text where comments from the industry have persuaded us that clarification of the copy-out rules is important. There will not be time to provide the industry Standing Groups with copies of all the revised chapters of Handbook text before the rules are made in October. But where that is particularly important because of the nature and number of changes made, we will endeavour to do so. This PS states in some detail the changes we are proposing to make to each chapter of GENPRU or BIPRU and we are confident this will give firms a clear indication of what they can expect to find in the final version of the rules.

1.9 As an example of the type of changes we are making, we include a revised version of BIPRU 3 (standardised approach to credit risk) in this PS (at Annex 3). We chose BIPRU 3 as the most appropriate copy-out chapter to revise, because we expect most firms will adopt the standardised approach for their credit risk exposures, at least in the first instance.

Accessing the Handbook – personal handbooks

1.10 We have launched personal handbooks which will enable firms to identify the CRD rules and guidance that apply to them. Personal handbooks allow firms to build their own handbook by answering just 10 questions about their business. We intend to make CRD available in personal handbooks as soon as possible after the final rules are published, but as the bulk of the work cannot be done until the Handbook text is fully revised, this may well be towards the end of 2006. We plan to provide more detail on what is involved in a Handbook Newsletter shortly.

Transitional provisions

1.11 We acknowledge the comments made on the industry's difficulty in understanding the transitional provisions (BIPRU TP), arguably the most opaque section of the CRD. There is good reason to make an exception to the copy-out approach for these provisions and we provide in this PS a set of revised TP chapters, which take account of the specific comments made by firms. The revised draft rules can be found at Annex 2.

2007 transitionals

1.12 We have put particular effort into the rules which will apply during 2007, when all firms must comply with certain elements of the new CRD regime, even if they opt to delay adopting the full set of rules until 1 January 2008. Our solution, agreed with trade associations, is to indicate for each category of existing IPRU (interim prudential sourcebook) firm – banks, building societies, investment management firms, UCITS investment firms, securities and futures firms and personal investment firms – which rules will continue to apply during 2007 alongside the new CRD elements. And we will show how firms can deal with any awkward combinations of the rules during this one transitional year.

1.13 We have completed this work for each of the four categories of IPRU (Inv) firm, for which the interaction of the new and existing rules is most complex, and for building societies (IPRU (BSoc)). We plan to publish a similar chapter for banks shortly. For the time being, banks that want to take advantage of the 2007 transitionals should base their planning on the statement of GENPRU/BIPRU rules applying to all firms from January 2007, as set out in the revised chapter of TP3, and the IPRU (Bank) rules on all other areas, including credit risk, large exposures and liquidity.

1.14 Firms should note there is one area relating to market risk – interest rate specific risk including credit derivatives treatment – which will now be subject to the transitional provisions during 2007.

Capital floors

1.15 We have reviewed the transitional rules on capital floors in response to industry comments. All firms which make use of the internal ratings based (IRB) approaches for credit risk and/or the advanced measurement approaches (AMA) for operational risk will find clarification that they need to undertake two parallel capital calculations during the first three years of operation of the new requirements. An example of how they work is provided in TP2, but essentially the position is as follows:

- First, firms must calculate the GENPRU capital resources on the basis of the new BIPRU rules.
- Second, to calculate the floor firms must apply the IPRU rules to current exposures, with the exception of market risk business where the new BIPRU rules are applicable.

Firms with a CAD1 permission or value-at-risk (VaR) model permission should make use of these in both calculations. Any firm which obtains such a permission after 1 January 2007 can also apply it to the IPRU calculation from that point and take the benefit of any capital reduction achieved.

Explanatory notes

1.16 To enhance understanding of the new prudential framework being introduced by the CRD, we have decided to pilot the idea of explanatory notes to help firms orientate themselves as they approach the different sections of Handbook text. With this PS, we include a draft explanatory note on the standardised approach to credit risk. This can be found in Annex 3 alongside the revised text of BIPRU 3.

1.17 If this proves helpful to the industry, we propose working with trade bodies to produce similar explanatory notes to sit outside the Handbook – possibly in the form of a regulatory guide – on at least the CRD rules and guidance which are more likely to apply to smaller firms.

Status of material produced by the CEBS

1.18 We are aware of firms' concerns that we will require them to comply with CEBS guidelines. Our position remains that the CEBS guidelines do not by their very nature lend themselves to 'copy out' into our Handbook. Where we consider material in the CEBS guidelines to be particularly appropriate for inclusion in our Handbook, we will restate it in the form of guidance. Otherwise, and to reassure firms further, we have removed from the GENPRU and BIPRU text all references to CEBS guidelines. This is except for external credit assessment institutions (ECAIs), where the requirements are placed on us and not the industry. However, the CEBS guidelines continue to provide useful background for firms as they develop their compliance with the new Handbook requirements.

1.19 In addition to the CEBS guidelines, there are a number of papers produced by the Accord Implementation Group (AIG) and also by FSA staff in response to discussions in the various expert groups set up by the industry to which firms may wish to refer as they prepare for implementation. We have therefore decided to produce a list of auxiliary material, included in this PS as Annex 5. We make no claims for its completeness, but have produced it in response to suggestions from trade associations.

Key policy decisions and updates

Senior management understanding

1.20 CRD requires the board or a 'designated committee' to approve all material aspects of IRB rating and estimation processes. We consulted in CP06/3 on a BIPRU Glossary definition of 'designated committee' such that it should include at least one board member. Our intention is also to apply the definition to AMA, which we see as necessary to ensure sufficient senior input into the AMA and consistency with our approach to IRB governance.

1.21 We have considered how best to strike an appropriate balance between the IRB governance requirements in the CRD and industry concerns about proportionality and practicality. We have also reviewed the industry's comments on AMA.

1.22 We can now confirm that we consider the designated committee definition to be appropriate. However, we will clarify that the designated committee will be required to approve only the 'material' IRB rating systems and AMA elements.

1.23 Groups with IRB and AMA models should note the clarification of the requirements for firm and group-level approval (see Chapter 19).

Economic cycle stress tests

1.24 Over the last year, we have had a great deal of constructive dialogue with the industry on this subject. The most important development was the proposal not to impose regulatory capital add-ons automatically in response to the results of economic cycle stress testing. Instead we will expect all firms to produce a credible capital management plan which explains how they will manage their business through the cycle. We have reviewed the industry's comments and held a further meeting with the relevant expert group. Our considered view is that the description 'such as might be experienced once in 25 years' is the most suitable way of indicating the severity of the recession we wish to see addressed (see Chapter 7).

Risk-weighting of third-country mortgages

1.25 We have reconsidered our stance on the risk-weighting of mortgages on residential property in non-EEA[2] states in response to industry concerns. Where the property is in a country which we have deemed CRD-equivalent, we have decided that firms can apply the local risk weighting. Where the property is not in a CRD-equivalent country, we have decided to allow firms to continue to apply the current risk weighting of 50%, rather than 100% as proposed in CP06/3, provided the CRD requirements are met (see Chapter 5).

New credit derivative add-ons

1.26 We have discussed with relevant firms their concerns about the new add-on percentages for firms using the mark-to-market (MTM) method to calculate counterparty risk exposures which will come into effect from 1 January 2007. Since these add-ons are not subject to the transitional provision which allows firms to remain on current rules until 1 January 2008, affected firms will face a significant increase in capital requirements until the internal models method (IMM) becomes available on 1 January 2008. This also has implications for large exposures. Although we are unable to waive or delay the new requirements, we are sympathetic to the problems they cause. We have therefore decided that firms may apply for individual guidance relaxing the restriction on the netting of credit derivatives for counterparty risk purposes during the transitional year 2007 and understand that this will have the counter-balancing effect of reducing capital requirements for such business (see Chapter 9).

Removal of limits on the inclusion of interim trading profits in tier 3

1.27 In response to industry comments, we are removing the limits on the inclusion of interim trading book profits in tier 3 capital. We agree that requiring them to be included within the 200% and 250% limits on tier 3 would be superequivalent. We also propose to make clear in the Handbook text that a firm can use both tier 2 and tier 3 capital up to a maximum combined limit of 300% or 350% of tier 1, subject to certain requirements (see Chapter 3).

Waiver approval process

1.28 The joint-industry response asked us to adopt a pragmatic and flexible approach to our process of assessing waivers. We consider we have demonstrated this in the approach taken to applications submitted during the consultation period. And as stated in CP06/3, we will continue to deem valid the preparatory work undertaken by firms in good faith before the CRD was agreed and our Handbook text is finalised, subject to agreement with such firms on an appropriate timetable for making any necessary changes. We will continue with this approach as far as possible, including placing reliance where we can on review work done before a formal application. However, firms must still expect rigorous challenge on their application from FSA staff. We will communicate to firms at an early stage any significant shortcomings in an application (see Chapter 18).

2 European Economic Area.

1.29 We expect to receive the bulk of waiver applications later in 2006. This peak of work will restrict our capacity for flexibility on review visit dates within our published waiver application timelines (diagram 18.1 in CP06/3). This may mean that for applications that have significant shortcomings we may not be able to take our formal decision by June 2007.

Individual guidance

1.30 We are aware from industry comments that many firms are uncertain and concerned about the status of individual guidance after 1 January 2007. Some of the confusion relates to the different kinds of individual guidance, so we have summarised the different categories below. The details of our approach can be found in the CRD/Basel 2 practical information pages on our website.

Existing individual guidance in the interim prudential sourcebooks

1.31 As we explained in FS05/1[3], IPRU individual guidance that is not explicitly covered by a transitional rule will not carry forward into the new regime unless:

- it is an interpretation of a provision that is substantially unchanged; and
- the particular circumstances relating to the original request for individual guidance still apply.

In our view, all (or most) of the rules in the areas in the table below have changed substantially or are entirely new. We therefore do not expect that existing guidance given in respect of these areas will carry forward into the new regime.

GENPRU	Adequacy of financial resources (1.2)
	Valuation (1.3)
	Calculation of capital resources requirements (2.1)

BIPRU	Definition of the trading book (1.2)
	Advanced approaches, other than for market risk (1.3) (4) (6, relevant parts) (7, relevant parts)
	Adequacy of financial resources (2.2)
	Solo consolidation (2.1)
	Credit risk mitigation (5)
	Operational risk (6)
	Group risk (8)
	Securitisation (9)
	Disclosure (11)

3 Our Feedback Statement on CP05/3, our first CP on CRD implementation.

In other areas, firms that wish to continue to rely on interpretive IPRU individual guidance should check that it meets the criteria at the beginning of this section. In deciding if a particular provision is substantially unchanged, firms should consider the surrounding context of both the IPRU provision and its 'counterpart' in the new regime. So, for example, any IPRU individual guidance that is inconsistent with general guidance in GENPRU or BIPRU will cease to be effective.

IPRU individual guidance carried forward by transitional rules

1.32 In some specific areas, we will carry forward the effect of some types of individual guidance by using transitional rules. The main areas are:

- the definition and composition of capital – the transitional rules were published in CP06/10;
- the concentration risk regime for cross-border intra-group exposures – see BIPRU TP10 and TP11; and
- banks' individual capital ratios and building societies' threshold ratios – transitional rules were included in CP06/10 to preserve these throughout 2007 and until we give them individual capital guidance under the new regime.

New individual guidance on GENPRU and BIPRU rules

1.33 Firms should consider carefully any request made to us for new individual guidance. We will only give individual guidance if there is uncertainty after a firm has considered the new CRD rules and guidance. Our aim is to target individual guidance at a relatively small number of significant areas. In all cases, we will expect firms to explain why any relevant GENPRU/BIPRU general guidance is not sufficient for their circumstances.

1.34 Firms may request individual guidance using their normal FSA contacts, as set out in the supervision (SUP) manual of the Handbook. Before applying for individual guidance, firms should bear in mind the comments we have already made, including those in FS05/1 that we will be unable to make issuing new individual guidance a priority during the initial period of the new regime. However, to allay industry concerns that this may have significant implications for complex new transactions they may wish to undertake early in 2007, we can confirm we will seek to accommodate any requests for individual guidance where there is a clearly stated need. Beyond that, we will look to trade associations to gather together the main queries and concerns from firms in the early months of the new regime and will discuss with the trade associations how best to respond.

International implementation issues

Home-host relationships

1.35 We acknowledge that UK-based firms which operate outside the UK, whether in the EEA or more globally, are concerned about the way in which home-host relationships will operate in practice. This is particularly the case for the application of Pillar 2 across international groups and for firms applying for an advanced approach under Pillar 1 in more than one jurisdiction. For some time now, we have been working closely with our counterparts in other countries and will take an approach consistent with the CEBS guidelines for home-host relationships within the EEA and in line with AIG principles in non-EEA jurisdictions. We are committed to doing what we can – within the constraints of the directive – to reach practical and pragmatic ways forward with other regulators.

1.36 Over the last year we have discussed home-host issues with overseas regulators and internationally-active firms in a series of 'regulatory colleges'. These meetings have demonstrated a willingness to work constructively together and minimise duplication of effort. We have been involved both as the lead home-state regulator for the large UK-based groups, and have also participated in other colleges organised by groups headquartered outside the UK. These 'set piece' meetings are now being usefully complemented by more frequent day-to-day contact to discuss and agree matters of detail and practical cooperation.

1.37 We are seeking to accelerate discussion of the specific work which will be required by other regulators in relation to model approval. In respect of groups for which we are the home regulator, we are in the process of agreeing with the host regulators what work they will undertake. Where we are the host regulator, we have begun to explain to the home regulator our view of the main issues arising in relation to the UK subsidiary. During the transitional period, we will seek to be as pragmatic as possible, for example on consolidation methodology and in relation to the US gap year. And where we are the host regulator, we want to follow a credible but flexible approach on Pillar 2.

1.38 As regulators we must be as clear as we can about our position on home-host matters, especially where different countries are staggering their implementation plans. But the business decisions themselves – for example on implementation-related systems – are for individual firms alone. If home-host issues arise that are specific to a particular firm's circumstances, it should approach its usual supervisory contact who will seek to clarify the position.

CRD equivalence

1.39 We have now completed our initial assessment of Singapore and have deemed CRD-equivalent the requirements of the Monetary Authority of Singapore (MAS) for the standardised approaches to credit risk and operational risk. In line with the approach stated in CP06/3, we will also carry forward our assessment of the MAS's equivalence for market risk until we can review the changes brought in by the Trading Book Review (TBR) for market risk CRD equivalence.

1.40 Since publishing CP06/3, we have made good progress in undertaking our initial, high-level reviews of the implementation of Basel 2 in Jersey, Guernsey and the Isle of Man. We are also close to reviewing the equivalence of regulatory requirements in a number of other non-EEA countries. We will make available the results of this work by the end of the summer and add it to the list in BIPRU 8 when the Handbook text is finalised. As stated in CP06/3[4] these assessments are based on incomplete information and we will need to review them over time.

CRD implementation in Gibraltar

1.41 We are in discussion with the Gibraltar Financial Services Commission about its implementation of the CRD. We will make known the outcome of this discussion in due course.

Outstanding issues

Loss given default (LGD)

1.42 Following the completion of the fifth Quantitative Impact Study (QIS5) exercise, we have been undertaking further analysis, notably in relation to downturn LGDs, in parallel with work under way in the Basel Committee. In the context of LGD modelling, the Retail Mortgage portfolio is one for which the concept of 'downturn' assumes special relevance and this is one area where we will look for firms to clearly demonstrate the appropriateness of the methodologies used.

1.43 We are at present working with the industry to gain a deeper understanding of the different methodologies used by firms. This includes a hypothetical portfolio exercise, in which a selection of firms has been asked to provide results for their LGD estimates for a pre-defined portfolio of mortgage exposures. This exercise will help improve our current understanding of the Retail Mortgage LGD models and support our decision-making process on waiver applications. Firms should be aware that we will also expect them to apply an appropriate level of conservatism to compensate for any limitations in their models.

Capital

1.44 We are still considering our policy options in relation to two issues:

- the use of subordinated currency swaps to hedge subordinated debt in a foreign currency for regulatory capital purposes; and
- the revaluation of fixed rate capital instruments at par rather than fair value for regulatory capital purposes.

We will communicate our conclusions in the relevant Handbook Notice when we make the final rules.

4 Paragraph 14.8 of Chapter 14.

Covered bonds

1.45 Chapter 20 of this PS summarises the responses received to the questions we asked about covered bonds in CP06/3. Since its publication in February, the responsibility for implementing an EU-compliant covered bond regime has passed to the Treasury[5]. This was necessary as the Treasury has the wider rule-making powers required to implement the regime.

Mapping accounting changes into the new Handbook structure

1.46 In PS05/5 and Handbook Notice 55 (May 2006), we set out changes to the IPRU for banks, building societies, investment firms, insurers and friendly societies, the SUP and the integrated prudential sourcebook (PRU) to take account of changes in accounting practice following widespread adoption of International Financial Reporting Standards (IFRS) in the UK from 1 January 2005. Some, but not all, of those changes are reflected in the GENPRU and BIPRU text in CP06/3. However, as part of the process of mapping existing text into the new framework, the 'near final' Handbook text will include all amendments made under PS05/5 and Handbook Notice 55 into the GENPRU and BIPRU text, as well as into the new INSPRU, MIPRU and UPRU[7] sourcebooks, as applicable.

Practical implementation issues for firms

1.47 In tandem with our efforts to date on developing the policy proposals through the consultation process, we have considerably increased the emphasis on preparing for practical implementation. Firms must be ready for increased scrutiny from their relationship manager or normal supervisory contact on their preparations for the introduction of the new capital requirements regime.

1.48 We continue to add material to the 'practical information for firms' pages in the CRD/Basel 2 section of the FSA website. Those pages include materials relevant to all firms, including specific pages for firms applying for advanced approaches, and for investment firms. This information will be augmented by feedback to firms on our initial experience of reviewing firms' applications. We expect to comment on the suitability of the content of the applications generally, both in terms of coverage and ease of use, the importance of providing a credible self-assessment, progress in producing good quality validations, on the use test and on stress testing.

1.49 Firms are reminded that our website contains information on the various waivers within the BIPRU text other than those relating to the advanced approaches. We call these 'embedded' waivers. Firms that do not want to follow the standard treatment will need to have waivers in place from 1 January 2007 or 2008, depending on which

5 A written Ministerial Statement appeared in Hansard on Thursday, 29 June. This can be found at http://www.publications.parliament.uk/pa/cm/cmhansrd.htm.

6 Implications of a changing accounting framework, published in April 2005.

7 For an explanation of these sourcebooks see the bottom section of the table in paragraph 1.50.

waivers they need and whether they move fully onto the new CRD requirements from 1 January 2007. We have summarised all the embedded waivers contained within BIPRU on our website, and asked firms to let their normal supervisory contact know as soon as possible if they are likely to apply for any. We are dealing with requests as early as we can, using 'in principle' decisions until the final rules come into force.

Other consultation papers of relevance for CRD implementation

1.50 During May, we published three CPs that touch on specific aspects of CRD implementation. These are all of relevance to firms impacted by the directive. The table below provides a summary for each one.

CP06/9 **Organisational systems and controls**	Our proposals for implementing the general organisational and systems and controls requirements in the Markets in Financial Instruments Directive (MiFID) and CRD. All CRD firms will need to comply with these requirements from 1 January 2007. Following the consultation, the 'near final' Handbook text will be made in October at the same time as the BIPRU and GENPRU text. The CP also contains draft perimeter guidance on the scope of MiFID and the recast Capital Adequacy Directive to investment firms.
CP06/10 **Restructuring the Handbook**	Our proposals for completing the new prudential structure introduced by CP06/3 (GENPRU and BIPRU) by repealing – except for their liquidity provisions – IPRU (Bank) and IPRU (BSoc). From 1 January 2008, these are the only IPRU provisions which will remain for credit institutions, although transitional rules will apply in a small number of areas. Investment firms which fall within the scope of the CRD will have no IPRU requirements from that date. The CP consults on several transitional rules, including the definition of capital and capital ratios for banks and building societies in the initial phase of the new regime. The CP also proposes creating – from existing material – new prudential sourcebooks for: • insurers and Lloyd's firms (INSPRU); • mortgage firms and insurance intermediaries (MIPRU); and • UCITS firms (UPRU).
CP06/11 **Integrated regulatory reporting**	Our proposals for revised reporting requirements to monitor the capital adequacy of firms accepting deposits and issuing electronic money and of those investment firms affected by the CRD. These include the transitional arrangements for 2007. The Handbook text covering these requirements will also be made in October.

Smaller Firms and Investment Firms

Implementation bulletins

We have begun to produce short implementation bulletins on practical issues for smaller firms and investment firms. They cover the main issues we expect these firms to face and point to where they can find more information on particular topics. We will continue to issue these bulletins at quarterly intervals, with tailored versions for deposit-takers and investment firms.

Standardised approach to credit risk

We expect nearly all smaller firms to use the standardised approach to credit risk. But they need to decide whether to use it and comply with CRD requirements more generally from 1 January 2007 or 1 January 2008. The publication in this PS of the revised rules in BIPRU 3 and an explanatory note on the standardised credit risk requirements should help firms to make this decision (see Chapter 5 and Annexes 3 and 4).

Categorisation of investment firms

We will write to investment firms we think will be subject to the CRD to provide our assessment of their categorisation. This will be based on the scope of permission as recorded on our Register. Firms will be asked to review the information and analysis and confirm that they agree with our assessment. If firms do not agree, they will need to advise us of any proposed action they wish to take, for example by applying for a variation of permission.

Use of mid-market valuations

We have been asked by APCIMS[8] whether smaller firms can to continue using mid-market valuations in calculating their capital requirements for counterparty risk. Given the costs of systems changes to move to bid or offer valuation, we are considering whether we can allow firms whose trading is limited to matched principle broking to continue to use mid-market valuations for a transitional period of at least one year until 2008 (see Chapter 9).

Simplified Standardised approach to credit risk

In response to an industry request, we have decided to extend the availability of the simplified version of the standardised approach to all investment firms with only limited exposure to credit risk (see Chapter 5).

CONSUMERS

As stated in CP06/3, the objectives of the CRD and our implementation work are primarily prudential in nature. Assuming these can be met, this will help us meet our statutory objectives relating to consumer protection and market confidence. We did not receive any comments about CP06/3 from consumers or consumer bodies and no issues of special relevance for consumers have arisen since we published.

8 Association of Private Client Investment Managers and Stockbrokers.

2 CRD scope for investment firms

Introduction

2.1 Chapter 2 of CP06/3 examined the issues of scope for the wide range and number of investment firms that will become subject to the CRD through the recast Capital Adequacy Directive (CAD). The chapter outlined to investment firms whether and how the CRD would apply to their activities and whether the requirements would apply during 2007 or from 1 January 2008. In particular, we examined the interaction between the CRD and the Markets in Financial Instruments Directive (MiFID).

2.2 Since publishing CP06/3, we have produced draft Perimeter Guidance (PERG) in CP06/9 which describes more fully the impact of the recast CAD on investment firms, including how their permissions might change. The rest of this chapter provides responses to individual questions posed in CP06/3.

Response to individual questions

Exempt CAD firms

Q1: Do you have any comments on the proposed policy for recast CAD Article 7 and firms at this stage? Please also indicate if you are affected by this change.

2.3 We received substantive responses on our policy approach from two trade associations. One welcomed the flexibility for firms to determine how they meet their capital requirement by using professional indemnity insurance (PII), capital or a combination of the two. It suggested the rules should be clearly signposted and clear to firms on how to calculate their capital requirements. The second respondent requested clarification on what requirements would apply to a firm within the scope of recast CAD Article 7 or 8.

2.4 **Our response:** As previously indicated, we intend to consult fully on our proposals as part of the MiFID CP, which will also be published in July 2006. MiFID amends the CAD so that it requires all firms within the scope of recast CAD Article 7 (exempt CAD firms) to hold a minimum level of PII (or a comparable guarantee) or initial capital of €50,000. It also allows a trade-off between capital and PII, provided that the combination gives coverage equivalent to either of these requirements. Recast CAD Article 8 requires those exempt CAD firms that are also within the scope of the Insurance Mediation Directive (IMD) to hold 50% of MiFID's requirements in addition to the IMD requirements.

UCITS investment firms

Q2: Do you have any comments on our proposed policy for UCITS investment firms at this stage? Please also indicate if you are affected by this change.

2.5 We received responses from a trade association and two regulated firms. In summary, they argued our proposal to apply the requirements of the CRD to the whole of the business activities of UCITS investment firms, including their UCITS scheme management activities, was inappropriate.

2.6 **Our response:** We issued further, more detailed proposals, together with an associated cost-benefit analysis and compatibility statement, in CP06/10[1] which expanded significantly on our policy proposals. The MiFID Transposition Group has also recently given its view on applying the CRD in this regard. We confirm we will review our proposals in the light of the feedback already received to CP06/3, the clarification received from the MiFID Transposition Group and, any responses we receive to CP06/10.

Further exemption from the ORCR for certain types of investment firm

Q3: Do you agree with our proposal to implement this national discretion using the waiver process, exempting until December 2011, on a case-by-case basis, investment firms from the full operational risk capital requirement, provided that they meet the criteria?

2.7 Respondents agreed with our proposal to implement the national discretion using a waiver process. They also agreed with the period of the exemption and the policy of applying it on a case-by-case basis.

2.8 **Our response:** We will implement the national discretion as described and do not propose any changes.

Q4: Do you agree with our interpretation of relevant employees and incremental increases?

2.9 While no respondents disagreed with our interpretation of incremental increases, some raised concerns about the definition of 'relevant employees'. One trade association suggested that the definition should only relate to staff directly involved in placing the firm at risk through own-account dealing.

1 CP06/10 – 'Strengthening Capital Standards – Restructuring the Handbook' – issued in May 2006.

2.10 **Our response:** After extensive consideration, we are not clarifying further the definition of 'relevant employees' provided in the BIPRU rules. We think the list of employees set out in CP06/3 is appropriate given the CRD definition of operational risk and the potential for operational risk errors to occur throughout the chain between sale and completion. These could be attributable to any staff member involved in this chain. We have also taken into account our statutory objectives relating to market confidence and consumer protection.

Commodity and other non-ISD firms

Q5: If you are likely to wish to use the CAD Article 45d transitional provision, what percentage of your total business relates to the MiFID financial instruments listed in CAD Article 45d?

Q6: For firms that simply act as arrangers and whose permissions do not allow positions to be taken as principal, until such time as the Commission completes its review, would you prefer us to apply a principles-based regime for capital with no detailed rules or guidance on appropriate levels of capital?

Q7: For energy market participants benefiting from the exemptions, until the Commission completes its review, would you prefer us to apply a principles-based regime for capital, with no detailed rules or guidance on appropriate levels of capital?

Q8: Would our proposals have any significant impact on your organisational/group structure?

2.11 We received no responses to Questions 5, 6 and 8 and only one response to Question 7, in which the respondent asked us to move to a principles-based approach.

2.12 **Our response:** Since only one firm requested the removal of prudential rules and guidance for commodity arranger firms, we propose continuing with the existing regime until the European Commission's review is completed and implemented. In the interim energy market participants have the option to apply for a capital waiver.

2.13 We were asked for an overview of the regulatory regimes applicable to specialist commodity derivative firms post implementation of MiFID and CRD. This is provided in the table below:

Regulatory regimes applicable to specialist commodity firms

	Firm outside MiFID scope but within FSA perimeter	**MIFID firm exempted from capital requirements of CRD by recast CAD Art 48[2]**	**MIFID firm which does not benefit from exemptions under CAD**
Handbook classification	*Securities and futures firm* (which is not a *MiFID[3] investment firm*)	*Securities and futures firm* (which is an *exempt BIPRU commodities firm*)	*BIPRU investment firm*
Prudential regime	No change in capital regime i.e. continues to apply *IPRU (INV) Chapter 3*, *OMPS* and *EMPS* regimes	No interim change in capital regime, i.e. continues to apply *IPRU (INV) Chapter 3, OMPS* and *EMPS* regimes. But must apply non capital-requirements of *SYSC, GENPRU* and *BIPRU*; a summary of which can be found in *BIPRU TP15* (Commodities firms transitionals: Exemption from capital requirements).	Apply *GENPRU* and *BIPRU*
COB regime	Consultation on COB regime for non-scope firms intended in First Quarter/Second Quarter 2007	New MiFID-based COB regime will apply from 1 Nov 2007. We will consult on the implementation of MiFID COB provisions in our October 'Reforming COB regulation' CP	New MiFID-based COB regime will apply from 1 Nov 2007. We will consult on the implementation of MiFID COB provisions in our October 'Reforming COB regulation' CP

2 In the final version of recast CAD, Article 45d has become Article 48.

3 Further amendments consequential to implementation of MiFID will be consulted on later.

3 Capital definition and solo consolidation

Introduction

3.1 We consulted on rules for the definition of capital which are set out in GENPRU 2.2. Following feedback, we plan to make some changes to the Handbook text. The most significant change relates to limits on tier 3 capital.

3.2 BIPRU 2.1 sets out our draft rules on solo consolidation. There have been no major changes in policy as a result of industry feedback or the European transposition and jurists-linguists processes. However, we have made one drafting amendment of note in BIPRU 2.1.12(3) where the word 'or' has been removed. The test is now that the parent firm must have more than 75% of the voting rights and have the right to appoint or remove a majority of the governing body of the subsidiary. This change was required to deliver our original policy intention. We set out below our responses to the main issues raised by industry about the definition of capital and solo consolidation.

Response to individual questions

Changes in capital definition policy since CP05/3 and FS05/1

> Q9: Taken as a whole, and in view of the impending Own Funds Review (OFR), do our proposed rules on capital represent the most appropriate interim solution that adequately protects consumers while not imposing unnecessary cost burdens on firms?

3.3 Respondents broadly supported the proposed rules and agreed that the objective of protecting consumers through the mitigation of risk of firm failures has been achieved. However, respondents mentioned some specific areas of concern.

3.4 Some respondents suggested that limiting the inclusion of interim trading book profits, by including them within the 200% and 250% limits on tier 3, was superequivalent to the CRD. Concern was also expressed that GENPRU 2.2.47R and 2.2.48R appeared to restrict the total amount of tier 2 and tier 3 subordinated debt capital to 200% or 250% of tier 1 capital after deductions.

3.5 **Our response:** We agree that including interim profits within the 200% and 250% limits on tier 3 would be superequivalent to the CRD and confirm that this was not the intention when drafting the rules. This superequivalence will be removed and the limits will only apply to the subordinated debt component of tier 3.

In response to the second point, we will redraft the Handbook text, subject to further legal analysis of the CRD. We propose to make clear that a firm can use both tier 2 capital, up to a maximum of 100% of tier 1, and tier 3 subordinated debt, up to a maximum of 200% or 250% of tier 1, to meet the requirements set out in GENPRU 2.2.46R. These limits, however, are subject to the CRD requirement that the tier 1 must be available to meet the requirements in GENPRU 2.2.46R and is not also being used to meet the requirements listed in GENPRU 2.2.44R.

3.6 A number of respondents put forward policy suggestions to assist firms in the hedging of their total regulatory capital against exchange rate and interest rate movements. These proposals included permitting subordinated swaps to count towards regulatory capital and revaluing fixed rate capital instruments from fair value to par value for regulatory capital purposes.

3.7 **Our response:** We are actively considering the policy options in this area and plan to communicate our conclusions in the relevant Handbook Notice when we make the final rules.

3.8 We were asked again whether firms could benefit from the collateralisation of illiquid assets, through reduced illiquid assets deductions.

3.9 **Our response:** Further to our comments in FS05/1[1] and CP06/3[2], we are unable to allow such a treatment as the CRD does not allow the use of collateral to reduce the amount of illiquid assets that must be deducted.

3.10 Some respondents objected to the rules which do not permit tier 3 capital to be used to meet operational, counterparty and settlement risk requirements.

3.11 **Our response:** In our view the CRD does not permit the use of tier 3 to meet these requirements[3].

3.12 We were asked to clarify how our draft rules on partnership capital apply to Limited Liability Partnerships (LLPs).

3.13 **Our response:** We will clarify in our rules that GENPRU 2.2.70R and GENPRU 2.2.71R apply to LLPs. We are consulting separately in our July Quarterly CP on amendments to our IPRU (Inv) and UPRU rules to allow non-BIPRU firms to include LLP members' capital within their capital resources.

3.14 We received further calls to remove the policy on the deduction of connected lending of a capital nature, with the argument that the burden imposed is insufficiently related to the objective.

1 See FS05/1 3.31 for further details.

2 See CP06/3 3.8 for further details.

3 See FS05/1 3.26 for further details.

3.15 **Our response:** Although this policy remains superequivalent, the rules have been modified since CP05/3 to take on board the main industry concerns (risk mitigants, such as collateral, and ability to terminate the lending without penalty, are now taken into account). The policy will be looked at again as part of the project on the interaction between solo and group capital regimes mentioned in paragraph 1.55 of CP06/3. Further details on the project can be found on our website[4].

3.16 The joint-industry response argued that mortgage servicing rights should not be deducted as an intangible asset.

3.17 **Our response:** The CRD requires that all intangible assets should be deducted from tier 1 capital.

3.18 We were asked whether existing legal opinions on tier 2 instruments would be grandfathered.

3.19 **Our response:** We are currently consulting on the transitional provisions to GENPRU 2.2 in CP06/10. These include a transitional rule in respect of legal opinions for capital instruments issued before 31 December 2006 which would allow grandfathering.

3.20 With respect to free deliveries, we were asked to consider allowing firms to choose between a deduction from capital and a 1250% risk weight.

3.21 **Our response:** The CRD does not allow the option of a 1250% risk weight for free deliveries which must be deducted from capital.

3.22 We received feedback on the guidance we had given in respect of the external verification of interim profits.

3.23 **Our response:** We will amend the guidance to refer to the professional auditing guidance in this area, rather than providing our own guidance on what verification entails.

3.24 Respondents asked whether the rules in GENPRU 2.2 represent a change in the requirements of IPRU (Bank) for the treatment of acquired insurance subsidiaries[5].

3.25 **Our response:** We will examine the appropriate treatment of goodwill and post-acquisition increases in embedded value for BIPRU firms that have acquired insurance subsidiaries. We plan to communicate our conclusions in the relevant Handbook Notice when we make the final rules.

3.26 In response to our proposed policy on remedies in the event of default on subordinated debt[6], we have been advised that this policy may limit firms' ability to make public issues of subordinated debt in the United States. This is because under the Trust Indenture Act it is not possible to restrict remedies to the extent required under our rules.

3.27 **Our response:** We will consider this issue with the industry more fully and communicate our conclusions in the relevant Handbook Notice when we make the final rules. It is essential, however, that any additional remedies do not compromise the subordination of any amounts due to investors or lead to the acceleration of payments.

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4 http://www.fsa.gov.uk/Pages/about/what/international/basel/cap_requirements.shtml.

5 IPRU (Bank) Chapter CA 10.2.

6 See CP06/3 3.4 for further details.

Solo Consolidation

Q10: Considering our copy-out approach to solo consolidation conditions; and the criteria we will use to assess compliance with these conditions; are firms clear what we will expect from them when they apply for a solo consolidation waiver?

3.28 Most respondents found the requirements for solo consolidation reasonably clear. A few were concerned that the rules were too complex for a relatively simple group structure.

3.29 Some respondents felt that further clarity was needed in relation to the wording in BIPRU 2.1.14(3)G to make clear that liabilities only need to be repaid when due.

3.30 The joint-industry response raised concerns over the possible publication of commercially sensitive information during the process of applying for a waiver for solo consolidation. Clarification was also sought over the timing and information required for the notification process for existing solo consolidated entities.

3.31 **Our response:** We do not think that further clarity is needed in BIPRU 2.1.14(3) G as the rule in 2.1.13R is clear in its requirements.

Section 148 of the Financial Services and Markets Act 2000 (FSMA) requires us to publish each waiver unless we believe publication would prejudice, to an unreasonable degree, the commercial interests of the authorised person concerned or any other member of his immediate group. It is this condition we will take into account when deciding whether a waiver should be published. Early applications for waivers are encouraged.

Notifications to continue existing solo consolidation treatments should be submitted as early as possible and should include all information necessary to demonstrate how the new conditions for solo consolidation are met.

GENPRU 2.2 changes

Reference	Comments	Response
GENPRU 2.2.47R-2.2.48R	See 3.4 above for details.	See 3.5 above for details.
GENPRU 2.2.74G	See 3.22 above for details.	See 3.23 above for details.
GENPRU 2.2.70R-2.2.72G	See 3.12 above for details.	See 3.13 above for details.
GENPRU 2.2.14R	We have been asked for guidance on the eligibility of share premium as core tier 1 capital.	We will amend the Handbook text to clarify the policy.
GENPRU 2.2.225R-2.2.226G	We were asked to clarify the guidance on the treatment of capital instruments with convertible, exchange or stock settlement features.	We will amend the Handbook text on the treatment of capital instruments with convertible, exchange or stock settlement features.
GENPRU 2.1.9R, 2.1.48R	We were asked to move the guidance closer to the rule.	We will amend the Handbook text.

Reference	Comments	Response
GENPRU 2.1.16R & GENPRU 2.1.29R	Cross-references incorrectly suggest that these tables belong to 'BIPRU' not 'GENPRU'.	We will amend the Handbook text.
GENPRU 2.1.29R, CP Table 2.1	Respondents said that they found the explanation in Table 2.1 in the CP of how firm categories in 2.1.16 fit with the investment firm categories listed in this table helpful, and asked if it could be added as guidance.	We will consider adding table 2.1 in the CP as guidance in the Handbook text.
GENPRU 2.2.3R	Respondents said that the signposting in the contents guide was very helpful and suggested that these guides are presented in the form of a table.	We will amend the Handbook text.
GENPRU 2.2.8G	Remove 'for a BIPRU investment firm only' in respect of trading book profits.	We will amend the Handbook text.
GENPRU 2.2.14R Stage (M)	Third item: Replace 'which are not' with 'excluding any amount which is already deducted as …'	We will amend the Handbook text.
GENPRU 2.2.36R-2.2.37R, Annexes 4R - 6R	The Handbook text refers investment firms to Annexes for the relevant tables on capital resources. Respondents said that they would prefer the annexes to be integrated into the main text.	We will consider how to amend the Handbook text in response to the feedback.
GENPRU 2 Annexes 4R – 6R	We were asked to clarify in the tables at GENPRU 2 Annex 4 that investment firms need only deduct material interim net losses as set out in GENPRU 2.2.63R.	We will amend the Handbook text.
GENPRU 2.2.63R	Add guidance to make clear that the whole amount of a material interim net loss should be deducted, and not just the amount over 10%.	We will amend the Handbook text to clarify the policy.
GENPRU 2.2.63R-2.2.69R	Add guidance to say that other reserves excludes revaluation reserves in GENPRU 2.2.152R.	We will amend the Handbook text.
GENPRU 2.2.166R(1)(a)	After 'stage V' insert 'excluding deductions for qualifying holdings'.	We will amend the Handbook text.
GENPRU 2.2.172R	Reword: 'For the purposes of 2.2.171R a holding is either an ….'	We will amend the Handbook text.
GENPRU 2.2.174G	Move paragraph to immediately follow 2.2.169R.	We will amend the Handbook text.
GENPRU 2.2.185R(1)	We received feedback that it was wrong in principle to base the rule on whether the borrower regards the funding as being of a capital nature.	We will amend the Handbook text.
GENPRU 2.2.202R	We received feedback that this paragraph was difficult to follow because of the extensive cross referencing.	We will consider how to amend the Handbook text in response to the feedback.
GENPRU 2.2.202R(2)	Second reference to 'tier three' should be 'tier two'.	We will amend the Handbook text.

Reference	Comments	Response
GENPRU 2.2.82G	Guidance is circular and inconsistent	We will delete this guidance.
GENPRU Annex 6R	Replace 'solo consolidation waiver' by 'CAD waiver'	We will amend the Handbook text.
GENPRU 2.2.43R	Respondents asked how innovative Tier 1 instruments could be used as a regulatory capital resource. GENPRU 2.1.9 and 2.2.43 appear to prohibit the use of innovative Tier 1 within capital resources and for the purpose of meeting regulatory capital requirements.	We will consider how to amend the Handbook text in response to the feedback.
GENPRU 2.2.102R(3)	The reference in the first line should be to (2) rather than (3).	We will amend the Handbook text.
Possible new Handbook text	See 3.6 above for details.	See 3.7 above for details.
GENPRU 2.2.126R & 2.2.175R	See 3.24 above for details.	See 3.25 above for details.
GENPRU 2.2.130R(4)-(5)	See 3.26 above for details.	See 3.27 above for details.

4 Pillar 2: individual capital adequacy

Introduction

4.1 In CP05/3, we consulted on our approach to the new individual capital adequacy standards. In CP06/3, we provided further information on our approach to the supervisory review and evaluation process (SREP). We also sought to provide more information on stress testing and scenario analysis, diversification and concentration effects, and pension obligation risk within the internal capital adequacy assessment process (ICAAP). The Handbook text for Pillar 2 can be found in GENPRU 1.2, BIPRU 2.2 and BIPRU 2.3.

4.2 The responses were generally supportive of the overall approaches we propose for the ICAAP and SREP. In addition to the comments under the specific questions, we also received a number of minor drafting suggestions on the proposed Handbook text. We will consider these comments as we finalise the text.

4.3 Some areas of our SREP are still being developed – for example, how we will approach concentration risk, stress testing and the adjustment factor for qualitative risks. The SREP will continue to be refined after the CRD is implemented, possibly for several years. We will, as a matter of good practice, discuss important developments through the Pillar 2 Standing Group. However, the exercise of supervisory judgement on a case-by-case basis and the structured framework within which such judgements are made are not subject to formal consultation.

Insurers and Pillar 2

4.4 We are pleased that a number of insurers responded to our proposed consolidation of Pillar 2 rules across sectors. While supportive of such harmonisation, the main comment received was that the rules introduced in GENPRU 1.2.30R and 1.2.42R – concerning a firm's assessment of whether it could continue to meet minimum Pillar 1 capital requirements through a recession or an insurance cycle – amounted to a higher standard than currently exists under PRU.

4.5 This is not our intention. But we think forward-looking capital planning considerations are important parts of a Pillar 2 assessment and insurers should be able to explain how they intend to manage their capital requirements taking into account new business plans

and wider considerations. This is already referred to in PRU 2.3.37G(6) and PRU 2.3.44G, but we are giving greater prominence to it as part of restructuring the Handbook. Insurers should note that the new rules relate to the information we expect to review as part of our assessment rather than the amount of capital we would consider adequate. Under the existing individual capital adequacy standards (ICAS) Pillar 2 regime, if we were to have concerns that an insurer had inadequate means to ensure that future Pillar 1 requirements would be met – taking into account the ability to raise capital or reduce risks in the future – we would consider imposing remedial requirements. There is therefore no change in our policy, but we think the restructured rules will be clearer.

4.6 There are a number of other areas where further insurance-specific interpretation of the GENPRU rules has been requested. We will continue to revise our Pillar 2 rules and guidance in INSPRU as the ICAS regime develops and will consider dealing with such requests as part of those future consultations and through the Insurance Standing Group and Expert Group.

Response to individual questions

Supervisory review and evaluation process

Q11: Do you consider our approach to the SREP reasonable?

4.7 Respondents felt the proposed approach to the SREP was reasonable, provided it was undertaken in a pragmatic and proportionate manner.

4.8 A concern was expressed about applying the Pillar 2 process within internationally active groups, in particular a lack of clarity about the requirements for ICAAPs at different levels in such groups, and a lack of guidance about our expectations where we are host supervisor.

4.9 **Our response:** We recognise there are major challenges facing the industry in implementing the CRD and Basel framework on a cross-border basis.

Although the ICAAP is the firm's responsibility and we do not intend prescribing its operational form, we appreciate that many firms will not know how extensive or elaborate these processes need to be to meet supervisory objectives under the SREP. In addition, we recognise that a firm for which we are host supervisor may be managed along global lines rather than by legal entity or geographic units, and may use centralised risk-management processes not specific to the UK.

We are committed to finding pragmatic solutions to the challenges posed by these issues through discussions with firms and other supervisors. In developing these solutions we will take a proportionate approach to the ICAAP and our SREP, reflecting the scale and nature of the firm's activities in the UK. Where we are the host supervisor we will seek to rely on the ICAAP implemented at a group level by the parent firm where possible, although this will depend on the nature and scale of the firm's operations as well as the extent to which the group ICAAP adequately addresses the risks in the UK operations. We have no desire to duplicate work undertaken by other supervisors and therefore, as far as possible, we will seek to work closely with home country supervisory authorities to avoid this.

As noted in the joint-industry response, we have recently entered into discussions with firms to identify, at a more detailed level, firms' concerns on home-host arrangements. As these discussions progress we intend to expose our thoughts on the way forward to the Pillar 2 Standing Group, and in due course to provide illustrations on our web pages. We are also providing on the same web pages a more detailed statement of our approach to Pillar 2 home-host issues, where we are a host supervisor. These can be found in the 'practical information for firms' section of our Basel 2/CRD web pages under Pillar 2[1].

We do not need to make any changes to the Handbook to reflect our approach to home-host issues.

Internal capital adequacy assessment process

Q12: Do you have any comments on the proposed rules and guidance for firms' ICAAPs?

4.10 Generally, respondents thought the approach and guidance were helpful and reasonable. But they did raise a number of specific points.

4.11 Some thought the list of risks in GENPRU 1.2.30R(2) was too prescriptive and investment firms in particular felt the list would require them to implement systems, processes and strategies to assess risks that were not relevant to their business.

4.12 There was a request for further guidance on applying the ICAAP when an investment firm has been granted an *investment firm consolidation waiver*.

4.13 Respondents asked for cross references to CEBS guidelines to be removed or, in the interests of providing clarity to firms on the ICAAP provisions, for the relevant CEBS guidelines to be included in the Handbook.

4.14 Respondents noted that the concept of internal capital had been introduced without definition and thought that the requirement to assess the quality of capital had not been sufficiently justified. They added that, to require the process of allocating capital to different parts of the group to include an assessment of the quality of that capital was superequivalent to the CRD.

4.15 Firms remain uncertain and worried about how we will use stress testing under Pillar 2 to ensure prudential soundness during a recession. Uncertainty seems to focus on the depth of recession we are interested in and the extent to which we will require capital to be held now, in relatively benign circumstances, rather than relying on firms being able to raise capital in the future if needed. While seeking clarity on this, firms do not want rigid or complex rules and urged some further consolidation of our Handbook guidance on stress testing.

4.16. **Our response:**

List of risks

The list of risks in GENPRU 1.2.30R is intended to indicate a minimum standard of analysis and granularity in a firm's assessment, and also to draw firms' attention to specific risks which are generally thought not to be adequately captured under Pillar 1. However, we do not intend this list to oblige firms to implement systems, processes and strategies or conduct stress or scenario analyses for risks which are demonstrably not relevant to them. The ICAAP is the firm's responsibility and it is for the firm to identify the risks to which it is subject and to be satisfied it is not exposed to other risks. In addition the systems, processes and strategies that the firm implements should be proportionate to the nature and scale of the risks. So in the case of investment firms, if a particular risk is demonstrably negligible, the firm need not implement systems, processes and strategies to deal with that risk. We propose amending the text of GENPRU 1.2.30R to clarify that a firm need only implement systems, processes and strategies to assess those risks that are relevant given the nature and scale of the firm's business.

Investment firm consolidation waivers

In the case of a group with an *investment firm consolidation waiver*, the proposed Handbook rules do not prevent individual firms within such a group from relying on group-wide processes which make a capital assessment for the individual entities in that group. We do not propose adding further guidance to the Handbook as to do so could add too much prescription when a number of possibilities exist. In addition, the situation is similar to other circumstances – for example UK firms that are members of an overseas group seeking to rely on centralised processes – and to distinguish guidance applicable to different circumstances may introduce too much complexity into the Handbook.

Cross-references to CEBS material

We will remove from the Handbook cross-references that firms should treat CEBS guidelines on Pillar 2 matters as if they were FSA guidance. The Handbook will include all guidance that firms need to read to comply with our rules. For example, we will remove the general reference to CEBS from BIPRU 2.2.7G and replace cross references to CEBS guidelines on interest rate risk in the non-trading book at BIPRU 2.3.8G with direct guidance.

Quality of capital

The capital-quality requirement and the term 'internal capital' are derived from Article 123 of the CRD, which requires firms to '…assess and maintain on an ongoing basis the amounts, types and distribution of internal capital…'. We do not, therefore, propose to amend the Handbook, except for the proposed rules requiring the allocation of capital to individual entities or different parts of the group. For these rules we will clarify that the process by which the group allocates capital to individual entities or different parts of the group does not require firms, in addition, to assess the quality of capital that has been allocated. Moreover, the allocation rules, of themselves, do not require the

individual firms to have their own capital processes or produce a separate submission to that of their group explaining how capital has been allocated. We will require an assessment of the quality of capital of the group as a whole.

Stress testing for a recession

Firms remain uncertain and worried about the level of stress testing we will expect firms to carry out under Pillar 2 to demonstrate their prudential soundness during adverse economic circumstances. In particular, firms have sought views on the depth of recession we consider should be modelled, and on the extent to which we would require capital to be held up front, as a contingency for potential future shocks, rather than rely on firms being able to raise capital in the future if needed. While seeking clarity on this, firms do not want rigid or complex rules and urged some further consolidation of our Handbook guidance on stress testing. We will take to the Pillar 2 Standing Group any proposals for further guidance, and consequent changes to the material around stress testing in our Handbook, as we draw conclusions from the Pillar 2 pilot studies currently under way.

In keeping our Pillar 2 Handbook provisions flexible and principles based, the following are key considerations:

- First we expect all firms to assess how they will meet their future *capital resources requirement* throughout a period of economic stress. We do not envisage specifying standard stress environments, since different business models will be affected by different economic events and it will be important for firms to choose the combination of such events that are most relevant to their circumstances.
- Second, the assessment should be linked to a normal planning horizon of three to five years, and should take into account both changes in strategy and other management actions which a firm could and would take in response to adverse circumstances, as well as the projected impact of future retained profits and losses, dividends payable and capital which might be raised.
- Third, the stress and scenario analyses undertaken should be proportionate to the risks inherent in, and scale of, the firm. We will expect more sophisticated analysis from the larger and more complex firms than from smaller firms with simple business models adopting a standardised approach.

How stress testing is approached in practice is therefore likely to vary between firms. For example, firms that must already perform an IRB economic cycle stress test of credit risk as described in Chapter 7 will need to consider whether, for the sake of consistency, they should apply a similar degree of severity in stressing the other risks identified in the rest of their capital assessment. On the other hand, we do not require firms on standardised approaches to credit risk to perform a Pillar 1 stress test because their Pillar 1 capital charge is based on a formulaic approach. They too will need to consider the appropriateness of performing a Pillar 2 stress test of a similar order of severity to that used for the IRB stress test – i.e. 'such as might be experienced once in 25 years'.

As part of our supervisory assessment (SREP) process we will consider the credibility of a firm's projections and approaches. In particular, we will consider whether the Pillar 1 *capital resource requirement* calculations capture all the risks a firm faces (for example concentration risk both now and during the recession) and the extent to which a firm's senior management are committed to taking the actions and changes in strategy suggested – in particular where appropriate, in the face of investor expectations, rating effects, and competitive pressures. Only after taking all this into account will we come to a view as to whether a firm needs to hold additional capital now.

GENPRU 1.2 & BIPRU 2.2 changes

Reference	Comments	Response
GENPRU 1.2.30	The list of risks requires processes be implemented for non relevant risks.	We shall clarify that firms need only implement processes for those risks that are relevant to them (refer above for more detail).
GENPRU 1.2.52	The requirement to assess the quality of capital allocated to individual entities is superequivalent.	We shall clarify that firms within a group do not need to assess the quality of capital allocated to them (refer above for more detail).
BIPRU 2.2.7 (cross reference to CEBS)	References to CEBS should be removed, and relevant guidance should be included in full in the Handbook.	We shall delete references to CEBS and the Handbook will include all guidance that firms need to comply with our rules (refer above for more detail).
BIPRU 2.2.17	It is not clear what tier of capital is being referred to.	We shall clarify the different tiers of capital that are being referred to for the purpose of giving ICG.

5 Standardised approach to credit risk

Introduction

5.1 CP06/3 set out our revised proposals for the standardised approach to credit risk and presented the draft Handbook text, BIPRU 3, for implementing these proposals. Respondents generally welcomed our proposals, which they considered to be pragmatic and flexible. This reflected the constructive dialogue which had taken place between industry and the FSA during 2005 – and in particular the significant efforts of the standardised approach expert group. The revised text of BIPRU 3 can be found in Annex 4. References may have changed in the revised draft. An explanatory note on the standardised credit risk requirements is attached as Annex 3.

5.2 Respondents made a range of comments, both about the substance of some of our proposals and for improving the clarity of the BIPRU text. These are set out below together with our responses.

General issues

5.3 Respondents commented that while the standardised approach represents the simpler approach to credit risk, in a number of respects it remains complex – the treatment of residential mortgages was cited as one example of this. Respondents suggested that further efforts be made to clarify the text such as through worked examples.

5.4 **Our response:** We agree that some aspects of the standardised approach are complex. To a certain extent this reflects the requirements of the CRD. It also reflects the availability of preferential treatments in different circumstances. Yet we agree with respondents that there are a number of aspects where greater clarity could be achieved. Accordingly, we have reviewed BIPRU 3 in light of the comments received and have sought to improve the clarity of the text within the constraints of a copy-out approach. We have also included a number of worked examples where we think these may be helpful.

5.5 The joint-industry response highlighted that the industry has a number of concerns regarding 'CRD equivalence'. Concerns were expressed about potential competitive effects. We were urged to take into account the impact that any decisions on equivalence could have on firms' portfolios and to act in a transparent manner.

5.6 **Our response:** The outcome of our initial reviews of equivalence in various non-EEA countries are set out in BIPRU 8. Details of other equivalence reviews currently underway are set out in the Overview and Chapter 14 on groups issues.

We have taken into account the industry's concerns on the proposed treatment of residential mortgages in non-EEA jurisdictions, where we consider that a more flexible approach can be made available (see paragraphs 5.12-5.15 below).

Response to individual questions

Exposures to public sector entities

> Q13: Do you agree with our proposed approach to the treatment of regional governments, local authorities and PSEs?

5.7 Respondents welcomed our proposal to exercise the discretion allowed in the CRD which permits public sector entities (PSEs) to be treated as institutions. However, the industry would prefer us to produce and maintain a list of PSEs rather than provide only a definition aimed at identifying bodies that carry out activities on behalf of the government. Some respondents were disappointed that we had removed a list of examples of PSEs from the Handbook text.

5.8 The joint-industry response noted that our proposed definition was practical and should capture most entities that industry considers should be PSEs. However, it suggested we remove 'non commercial' from the definition as 'explicit guarantee arrangements' will override most commercial aspects.

5.9 Respondents also noted there is some divergence between the Office for National Statistics (ONS) and our classifications of PSEs which could add to systems complexity and costs.

5.10 The joint-industry response was concerned that a decision to treat regional and local government as institutions may mean their debt securities would no longer be regarded as eligible collateral and they could not be considered eligible unfunded credit protection providers.

5.11 **Our response:** We welcome the generally supportive comments of the industry for our proposal to exercise the discretion to treat PSEs as institutions.

We do not think it would be practical to include a fully considered and appropriately comprehensive list of PSEs in the BIPRU text at this stage. However, we are happy to work further with the industry in the future on this.

In relation to respondents' comments concerning the definition of 'public sector entity' in the Glossary, we note that paragraph (c) represents 'copy out' of the CRD. Accordingly we do not propose to amend it.

In determining whether an entity qualifies as a PSE for capital requirements purposes, our considerations will not necessarily be the same as those of the ONS. Accordingly, some differences may be expected.

It is not our intention to prevent the debt issued by PSEs being considered eligible collateral. We intend to ensure that any amendments to the Handbook text in this area are also reflected in guidance in BIPRU 5.4 (financial collateral) to ensure this is clear. However, we take this opportunity to confirm that the requirements of BIPRU 5.4.2R would only allow rated debt from a PSE to be considered eligible collateral, unless the additional requirements outlined in BIPRU 5.4.5R are met.

Similarly, we think that all PSEs are intended to be treated as eligible unfunded credit protection providers and, if there are any that do not fall within the definitions of BIPRU 5.7.1R, we will add guidance to ensure that these are also considered eligible.

Residential mortgages

Q14: Do you agree with the treatment we propose for the various different exposures to residential real estate?

5.12 The joint-industry response recognised we had been flexible and pragmatic in our approach to industry concerns about the complexity of the CRD in relation to residential mortgage exposures.

5.13 However, respondents do not support our proposal that where firms have exposure to mortgages on residential property in a non-EEA state – which we deem to be CRD-equivalent – the more conservative of either local rules or UK rules will apply. Nor does the industry support our proposal to apply a 100% risk weight to residential mortgage exposures in a non-CRD-equivalent country.

5.14 The industry noted that if a country is recognised as CRD-equivalent then local rules should apply ensuring a level playing field. One respondent expressed particular concerns about our proposal being damaging to emerging markets. It also noted that our proposal would require duplication of systems for these markets, introducing further complexities into what is already a complex area.

5.15 **Our response:** We welcome respondents' generally supportive comments concerning our approach to the treatment of residential mortgages.

In relation to the question of residential mortgages in non-EEA countries, we have given careful consideration to respondents' concerns, in particular about competitive issues and further systems complexities. As a result, we propose to modify the stance outlined in CP06/3.

Where the rules of a jurisdiction in which the property is located are CRD-equivalent, firms should apply the treatment for residential mortgage exposures in that local jurisdiction. We think this should ease the industry's concerns surrounding system complexities and it should also ensure that firms can operate on a level playing field. We believe we can permit this increased flexibility while safeguarding prudential standards.

Where the jurisdiction in which the property is located is not CRD-equivalent, firms may continue to apply the current risk weight of 50% rather than the 100% proposed in CP06/3 as long as firms make their own judgement as to the appropriate loan-to-value (LTV) subject to a maximum LTV of 80% – and comply with the rules set out in BIPRU 3. We think that a risk weight higher than 35% is justified when a jurisdiction has not been deemed equivalent and we do not have knowledge of local market conditions.

5.16 We have proposed that where a property is used for both commercial and residential purposes, it can be treated as secured by residential real estate if the property's main use is residential and the value of the property is not significantly affected by its commercial use.

5.17 Respondents stated that our proposal is practical, easy to apply and would capture those exposures which should be treated as residential real estate. However, they asked that we recognise the same principles of materiality and reasonableness that had been developed in other areas. Others would prefer greater clarity and suggested that we apply the 40% residential/other use ratio as set out in the Mortgage Conduct of Business (MCOB) guidance.

5.18 **Our response:** We think that the definition of 'significant' is one for firms themselves to determine in the first instance. This approach would be consistent with the principles-based approach that the industry has generally supported in implementing the CRD.

As such we propose to maintain our stance outlined in CP06/3 not to issue any further guidance on mixed-use properties other than that already set out in BIPRU 3.4.88.

5.19 One respondent noted that it was not clear why the 'unsecured' portion of a mortgage should be risk weighted as a retail exposure at 75%; instead it thought the CRD text indicated that 100% would be more appropriate. Another respondent thought the 35% risk weight applied to the 'secured' portion of a residential mortgage exposure should only apply if the LTV was less than 60%.

5.20 **Our response:** Our interpretation of aggregate loss data and other aspects remains that an 80% LTV threshold is prudentially appropriate. Generally, the industry accepts that this threshold seems prudent. So we propose to maintain the stance outlined in the draft BIPRU 3 text.

Q15: Do you think the treatment of residential real estate outlined in this chapter and the draft Handbook text is sufficiently clear?

5.21 The joint-industry response noted that presentations we made to the industry on the treatment of residential real estate helped improve the clarity of this complex area. The industry strongly encouraged us to include the examples, diagrams and charts presented in the Handbook.

5.22 Given the complexity of the treatment of residential mortgage exposures, industry sought clarification that firms could apply a risk weight of 100% to all exposures.

5.23 Respondents also noted that it remained unclear as to how eligible collateral will affect residential real estate exposures, particularly where they become past due. The industry noted worked examples would be helpful.

5.24 The joint-industry response pointed out the treatment for past due residential mortgage exposures did not seem to allow for a lower weighting to be applied if the firm is using mortgage indemnity insurance (MII) as a credit risk mitigation.

5.25 **Our response:** We recognise the different treatments allowed under the CRD for exposures secured by mortgages on residential real estate mean this has become a complex area.

We agree with respondents that additional use of diagrams and/or worked examples would serve to improve clarity, particularly in the area relating to past due residential real estate exposures. As such, where possible and appropriate, we are including worked examples and additional guidance in the Handbook.

Some respondents noted they would welcome clarification from us that firms could risk weight all mortgage exposures at 100%. Should firms determine it would be preferable to apply a risk weighting of 100% to all, or part of their non-past-due exposures to mortgages secured on residential real estate, we think the CRD allows for this. But firms will need to be consistent in their approach.

We think there remains a degree of confusion about the treatment of the 'secured' portion of a past-due exposure, where the exposure is secured by something other than residential real estate. Where a firm has eligible credit protection – either unfunded or funded, including eligible MII – on a past-due exposure, the portion covered by the protection should be considered 'secured' for the purposes of BIPRU 3.4.84 (past-due items) and the appropriate treatment for this portion will be determined by the provisions of BIPRU 5 (credit risk mitigation). We are adding guidance to the Handbook to reflect this.

Past-due exposures

Q16: Do you agree with our proposal not to extend the past-due day count for certain exposures on the standardised approach beyond 90-days?

Q17: Do you agree with our proposal that all exposures more than 90-days past-due should be risk-weighted as past-due items?

5.26 Although the industry in principle supported a level playing field for implementing the CRD, it supported our proposal not to adopt the national discretion to extend the past-due day count for certain exposures beyond 90 days. The industry recognised the extension would be transitional only and, given that most firms have already planned for a 90-day past-due treatment, there was little appetite to request a change.

5.27 The joint-industry response acknowledged that under the amended CRD we had to define a threshold over which exposures were defined as past due. However, it did not support a proposal to treat all exposures over 90 days as past due as this would lead to a difference in treatment between the internal ratings based (IRB) and standardised approaches.

5.28 **Our response:** Given the industry's support for our proposal, we maintain the stance we adopted in CP06/3 not to extend the past-due day-count for certain exposures on the standardised approach beyond 90 days.

One of the key factors underlying our proposal to introduce a threshold of zero for all past-due exposures under the standardised approach was that introducing a materiality threshold, at this late stage, could increase systems costs given that firms had already been advised that exposures in excess of 90-days past-due would be risk weighted as such.

For firms adopting the standardised approach as their general approach, we do not consider that our proposal will cause undue difficulties, in particular as this is the basis on which firms have been making their preparations.

For firms on the IRB approach intending to make partial use of the standardised approach, we have been in further dialogue with the relevant expert group. This has resulted in changes in the IRB approach (see paragraphs 7.91-7.93). In our discussions with industry representatives, there has been a shared view that these changes do not read across to the standardised approach because of their dependence on an internal systems approach. Accordingly, we propose to maintain our current proposals for the standardised approach. We do not consider this will give rise to undue difficulties.

Retail

5.29 Apart from one respondent, the industry generally welcomed the flexibility we adopted in determining what constitutes 'significant' for retail exposures. Yet one respondent considered it was unhelpful.

5.30 The industry sought clarification as to which exposure class a charity would fall under.

5.31 **Our response:** We worked closely with the industry to find a definition of 'significant' that is flexible enough to allow for both small and larger-size firms. As the industry is generally satisfied with our proposal, we propose to maintain our stance outlined in CP06/3.

We confirm that the term 'small or medium-sized entity' included in BIPRU 3.2.10(1) can include charities. If charities do not qualify as a retail SME, they may be treated as a corporate; and if they do not qualify either as a retail SME or corporate, they could be classified as 'other items' under Article 79 and risk-weighted at 100%.

Simplified approach

5.32 One respondent welcomed the simplified version of the standardised approach, which recognises that implementing the full standardised approach may prove unduly costly for small, limited licence and limited activity firms. It asked that this approach be extended to all investment firms with only limited exposure to credit risk.

5.33 **Our response:** We recognise that firms with only limited exposure to credit risk may find it disproportionately costly to establish the systems needed to include the credit assessment of external credit assessment institutions (ECAIs) in their regulatory capital calculations.

So we propose to adopt the suggestion to extend the simplified approach to investment firms with limited exposure to credit risk. We are also willing to make it available to other firms where there are particular circumstances which would make it an appropriate choice. Such firms should be clear that, as they will not have nominated an ECAI, their use of credit risk techniques will be restricted: for example the financial collateral comprehensive method will not be available to them.

Multilateral development banks

5.34 The joint-industry response indicated that the list of 0% risk-weighted Multilateral Development Banks (MDB) in the CRD should have included a further entity. It raised the question as to how the list could be extended in the future. It also noted it would make more sense to include the list of 0% risk-weighted MDBs within BIPRU 3 rather than as a definition in the Glossary.

5.35 **Our response:** For the list of MDBs receiving a 0% risk weight to be extended, there would have to be a change to the CRD which would take place via the specified mechanisms. Following that, the UK would have to amend its Handbook via a rule change.

We think it is more practical to maintain the relevant list in the Glossary. We do not consider this gives rise to material additional complexity. Accordingly, we propose to maintain our approach.

BIPRU has been amended to be clear that only the list of MDBs in the Glossary receive a 0% risk.

Other mortgage-related issues

Home information packs

5.36 We have been discussing with the industry the proposed introduction in 2007 of home information packs (HIPs) and how these, together with the use of automated valuation models, might interact with the valuation requirements in the CRD and BIPRU.

5.37 **Our response:** In our discussions to date with the industry, we have indicated that consistent with a principles-based approach we consider this to be an area where the issue of further guidance from us is unlikely. And that it would be for firms to ensure the requirements of the CRD and BIPRU are fully and effectively complied with – for example in relation to valuation by an independent valuer at or less than market value.

Trade associations have subsequently indicated that this approach is sensible, but they would still like further discussion with us about possible further guidance.

We are of course willing to continue our discussions with the industry in this area.

Intra-group exposures

Q18: Do you agree with our clarifications of the minimum conditions under which a firm may use a 0% standardised risk-weight for intra-group exposures?

5.38 Where a firm has an intra-group exposure held on the standardised approach and the conditions are met, the firm may choose to apply a 0% risk weighting to that exposure instead of applying the normal standardised risk weightings. The requirements and guidance for the 0% risk weighting are set out in BIPRU 3.2.25R – 3.2.36G (CP06/3 reference). The 0% risk weight can be operated independently of the choices the firm makes for the integrated groups treatment for intra-group exposures available within the concentration risk regime (BIPRU 10.8 – 10.10).

5.39 The IRB approach permits an IRB firm to transfer certain intra-group exposures from the IRB approach to the standardised approach, providing the conditions are met (BIPRU 4.2.26(6)R and BIPRU 4.2.34G). Once an intra-group exposure is held on the standardised approach, it can be risk-weighted using the 0% rate providing the conditions for the 0% standardised approach risk weighting are met.

5.40 Respondents welcomed the decoupling of the treatment for intra-group exposures within the integrated groups treatment in the concentration risk regime from the 0% standardised approach risk weighting. Additionally, the pragmatic approach to the interpretation of the 'prompt transfer/repayment' criterion within the eligibility conditions (BIPRU 3.2.30-31 – CP06/3 reference) was welcomed. There were some requests and suggestions for reordering the guidance text.

5.41 The joint-industry response commented that many firms manage integrated groups arrangements and intra-group exposures centrally and in recognition of this requested that we consider creating a separate section in BIPRU for all paragraphs relating to integrated groups rather than have them scattered through BIPRU 3, 4, 8 and 10.

5.42 The joint-industry response stated that the criterion (BIPRU 3.2.25(1d) – CP06/3 reference) which set a geographic limit on the availability of the 0% risk weighting should not be widened from that contained in the CRD in Article 80(7d). It added that the reference to a firm's 'main interests' needing to be situated in the UK should be removed as it was superequivalent. It thought firms considering using the 0% risk weight for their intra-group entities would not necessarily have their main interests in the UK and so would be ineligible.

5.43 One respondent asked for clarity about the treatment applicable to intra-group exposures of a non-UK solo-consolidated subsidiary for the 0% risk weighting.

5.44 One respondent recognised that our proposals did implement the articles in the CRD, but it stated that the application of the same risk weighting to cross-border intra-group exposures as to cross-border third-party exposures failed to recognise the benefit to firms from membership of a strong well-managed integrated group. The respondent thought that if cross-border intra-group exposures were not to receive a 0% risk weighting, the risk weighting of cross-border exposures to group entities should be reduced by the amount of capital invested in those cross-border group entities. The respondent also thought the 0% risk weight should be available to intra-group exposures held on IRB.

5.45 The joint-industry response requested that definitions relevant to the conditions for the 0% standardised risk weighting (BIPRU 3.2.25R – CP06/3 reference) should be included in full in an Annex to BIPRU 3 and so clarify the relationship between parent and subsidiary undertakings, rather than cross-referencing to other publications. It stated it should be possible for firms to be able to find out their obligations by reading the Handbook without having to undertake further research. Additionally, it thought guidance should be added to the effect that 'subsidiary' includes 'indirect subsidiaries'.

5.46 The joint-industry response stated that the provision of guidance for different consolidation types that would assist a firm and its exposure to qualify for the 0% risk weighting was overly complex and unnecessary (BIPRU 3.2.28G – CP06/3 reference). This is because BIPRU 3 was relevant to firms at the solo rather than consolidated level. Other respondents commented that the guidance was helpful.

5.47 The joint-industry response stated the reference to 'scope of consolidation' in (BIPRU 3.2.28G – CP06/3 reference) was incorrect and should instead refer to 'supervision on a consolidated basis' with reference to Article 113 (2) of the CRD. In addition, the respondent commented that deconsolidated subsidiaries are also subject to supervision on a consolidated basis, which implied that such subsidiaries should qualify for the 0% standardised risk weighting.

5.48 The joint-industry response requested clarity on the sequencing of the notification to us of a firm's intention to operate the 0% standardised risk weight (BIPRU 3.2.29 – CP06/3 reference) with the waiver application for firms with portfolios going on to IRB. It thought the one month notice period should begin at the point at which a firm informs us it intends to use the 0% risk weighting and not the date at which the IRB permission is granted.

5.49 **Our response:** We note the comments welcoming the decoupling of the integrated groups treatment in the concentration risk regime from the 0% risk weighting for qualifying intra-group exposures. We also note the welcome given to the 'pragmatic approach' to the guidance provided. The decoupling of the treatments and the guidance were developed in discussions with an industry expert group. In response to requests, we propose to reorder some of the guidance so that it is presented in the same order as the rules to which it relates.

The 0% standardised approach risk weight, the ability to transfer certain intra-group exposures from IRB to the standardised approach, and the modification of large exposure limits for certain intra-group exposures have been discussed together as a package of measures as the policies were developed. However, they are all separate treatments which, if the conditions are met, a firm can choose whether to exercise independently of the choices it makes for any of the other treatments. We decoupled the proposals in response to industry representations.

We do not agree that collecting together all intra-group materials into one chapter within the Handbook would add significant, positive benefits. To do so could be taken to imply that a firm must use all or none of them. Additionally, there are a number of other treatments that contain intra-group aspects. There would be no clear basis for including

or excluding 'treatments' from such a chapter. Handbook users seeking to find all standardised approach, IRB approach or concentration risk materials in comprehensive and complete chapters would be disappointed to have to work through an 'intra-group' chapter as well. However, we propose to produce a short explanatory guide for intra-group aspects similar to that produced for the standardised approach.

We note respondents' comments about including a requirement for locating a firm's 'main interests' (BIPRU 3.2.2.25 1(d) – CP06/3 reference). It is the intention that firms incorporated in the UK should be able to use the 0% risk weighting. Therefore, we propose to amend the Handbook text to make this clearer by adding a specific reference to firms incorporated in the UK.

We confirm that, in our view, if an entity has been solo consolidated into a UK firm in line with BIPRU 2.1, for the 0% risk weighting the exposures of the solo consolidated entity can be risk weighted as if they were the parent's exposure. This would be the case if the solo-consolidated entity were a UK or non-UK firm. We do not propose to add additional guidance to the Handbook. (We take the same view about the integrated groups treatment in the concentration risk regime).

In setting out the Handbook proposals for a 0% standardised risk weighting we are implementing a national discretion. The CRD[1] sets out the conditions under which the treatment is available which include a 'geographic limit' that the firm and its counterparty are in the same Member State. It does not provide for the 0% risk weighting to be available to cross-border intra-group exposures. We do not propose to make amendments in this regard.

We agree that all relevant 'defined terms' should be included in the Glossary as for other parts of the Handbook.

We do not propose to add guidance or create a new definition of an 'indirect subsidiary' – subsidiary and parent undertakings and other entities are defined in the Glossary. However, we confirm that under the relevant definitions 'subsidiaries' can include 'indirect subsidiaries'.

The Council Regulation reference was incorrectly stated in the draft BIPRU text in CP06/3. The reference should be Council Regulation of 29 May 2000 on insolvency proceedings (1346/2000/EC) – and it is the relevant European legislation for insolvency proceedings.

We do not agree with the comments made about including text to describe different consolidation types. By setting out the different consolidation types, we provide some clarity on the consolidations that enable a firm to qualify for the treatment. Earlier feedback previously commented that this text was helpful.

We do not agree with the comment that the reference to 'scope of consolidation' in BIPRU 3.2.28 (CP06/3 reference) is incorrect. The underpinning CRD text requires that the firm and its counterparty are included in the same consolidation on a full basis[2].

1 CRD Article 80.7.

2 CRD Article 80.7 (b).

We do not agree that deconsolidated subsidiaries qualify for the 0% standardised risk weighting. This is because the CAD waiver[3] removes a main element of the consolidated supervision regime – that is the need to meet the consolidated financial resources test – and so the firm would not meet the criteria for full consolidation.

We confirm that it is intended that the one month notice period that firms must give us before they first commence using the 0% risk weight should start when the firm notifies us of its intention to use the risk weight rather than the date at which the firm's IRB permission is granted.

We can clarify that the 0% risk weighting which applies to intra-group exposures within the UK will not apply to exposures to subsidiaries in Gibraltar.

The draft BIPRU text at 3.2.29(5) (CP06/3 reference) proposed that notifications for the 0% risk weight for qualifying intra-group exposures should be provided as part of the regular capital adequacy reporting process. However, this it is not currently possible. The notification will need to be made separately. The Handbook text has been amended to reflect this change.

In response to requests, we propose to include an updated version of the flow diagram in Annex 7 of CP06/3 in an Annex to BIPRU 3.2.

Other issues

5.50 One respondent expressed concern that the concession for short-term exposures to institutions was not extended to third countries, though the CRD does not refer to jurisdiction. In light of the comment made, we have reviewed the directive provision in question and concluded that a wider interpretation is available which we think is justified. Accordingly, we have amended the BIPRU text.

5.51 One respondent noted that our decision to implement the 'credit-based assessment method' (CBAM) (option 2) to risk weight exposures to institutions, would mean that an 'A' rated institution would be assigned a disproportionately high risk-weight of 50%. It also noted that the various clauses, for short-term exposures, introduced further distortions into this area of the standardised approach.

5.52 In CP189, we proposed to adopt the CBAM as it is more risk-sensitive and consistent with the risk-based philosophy in the CRD. We have explained in detail our commitment to taking the more risk-sensitive approach. The vast majority of respondents were supportive of this approach. Therefore, we propose to maintain our decision to adopt this method.

5.53 The joint-industry response expressed concern that the BIPRU text stating exposures, or part of an exposure, secured by a mortgage on commercial premises would be risk weighted at 100% could have implications for SMEs has charges over commercial property. It also asked us to clarify the treatment where exposures are secured on premises located outside the UK or the EEA.

3 CRD Article 22.

5.54 We propose to amend the BIPRU text slightly to make it clear that where a firm has an exposure secured by a mortgage on commercial property, that exposure should be risk weighted at 100% as set out in BIPRU, unless the exposure can properly be considered to fall within one of the other exposure classes set out in BIPRU 3.2.9. Where the exposure is secured by a mortgage on commercial premises located in a non-EEA state the CRD requires a 100% risk weight.

5.55 The joint-industry response sought further guidance about BIPRU 3.4.117 (cash) and BIPRU 3.4.118 (equity). Both of these provisions represent copy out of the relevant CRD provision. We do not propose to include further guidance at this stage.

5.56 The industry noted it would like clarification that the definition of asset sales and repurchase agreements referred to in BIPRU 3.6.2 (CP06/3 reference) is consistent with the definition for repurchase agreements in the Glossary. The definition for asset sales and repurchase agreements referred to in the Bank Accounts Directive sets out circumstances in which a repurchase transaction should be treated as an off-balance-sheet item. BIPRU 3.6.2 which implements Annex II of the CRD by way of copy out, indicates the relevant conversion factor for such off-balance-sheet items.

5.57 Respondents felt there was a potential difference between the wording of the Basel Accord about documentary credits – 'for example documentary credits collateralised by the underlying shipment' – and the wording of the CRD and BIPRU: 'documentary credits in which underlying shipment acts as collateral'. While we do not consider that additional BIPRU guidance is necessary, we are open to discuss further with the industry how to implement this provision.

5.58 Many respondents commented on the CP06/3 text relating to the monitoring and reviewing of property values. We are including an amended version of the CP text as guidance in the Handbook.

BIPRU 3 changes

Reference	Comments	Response
3.2.16	Additional clarity requested.	Sentence added regarding 'groups of connected clients'.
3.3.5(G) 3.4.46	Reference would help improve readability.	Include reference to the Handbook.
3.4.25 3.4.61 3.4.74	Interpretation difficult.	Redrafted to improve clarity.
3.4.40	Interpretation difficult.	Redrafted to improve clarity.
3.4.41	Interpretation difficult.	Diagram has been added to the Annex to improve clarity.
3.4.62(3) R	Protection agreement is not a standard industry term.	Sentence added to improve clarity.
3.4.64R	Additional clarity requested.	Added guidance on monitoring and reviewing property values.

Reference	Comments	Response
3.4.65R		Added guidance on property insurance.
3.4.72		Worked example added to improve clarity.
3.4.74 and 3.4.82		Reference to handbook added.
3.4.75	Unclear which rule is being referred to.	Reference included.
3.4.78	Concern about interpretation.	Additional sentence to improve clarity.
3.4.86		Additional guidance on eligible collateral.
3.4.92		Moved to past due items.
3.4.95		Removed.
TP12.5-6	Request for clarification.	Redrafted.
3.4.112		Additional guidance.
3.2.25(1)(d)	This inclusion of 'main interests situated within the United Kingdom' may exclude some firms.	Addition of 'or is incorporated in the United Kingdom' to the counterparty condition. It is intended that firms incorporated in the UK should have access to the 0% risk weight.
3.2.26 – 3.2.36	Request for reordering of guidance.	We have reordered some of the guidance text.
3.2.29(5)		Deletion of reference to a notification being included within the capital adequacy report.
Annex	Request for flow chart from Annex 7 CP06/3 to be included into the Handbook.	Propose to include updated version of the flow chart for the 0% risk weighting provided by (BIPRU 3.2.25 – 3.2.36 – CP06/3 ref).

6 Recognising and mapping external credit assessment institutions

Introduction

6.1 Respondents generally welcomed our approach to recognising external credit assessment institutions (ECAIs) and to mapping their credit assessments to CRD credit-quality steps. In particular, they supported an approach based on the *CEBS Guidelines on the recognition of External Credit Assessment Institutions* (CEBS guidelines)[1].

6.2 Respondents indicated they would appreciate sight of shadow recognitions and mappings as early as possible.

6.3 Having received informal applications from three ECAIs within the early timeframe referred to in CP06/3 and carried out an assessment in line with the CEBS guidelines, we are now in a position to indicate that we propose to recognise that firms can use the credit assessments of Fitch Ratings, Moody's Investors Service and Standard and Poor's for regulatory capital purposes under the standardised approach and the securitisation ratings based approach.

6.4 We are also in a position to set out our proposed 'mapping' of these ECAIs' credit assessments to the credit quality steps set out in BIPRU. Full details can be found later in this chapter

6.5 We expect to formalise these proposals once the Treasury's legal transposition of the relevant ECAI provisions is complete[2]. However, in line with the CEBS guidelines, we expect the above-mentioned ECAIs to keep us fully informed of any material changes to their methodology.

6.6 Our proposals are without prejudice to any applications – current or future – that may be received from other ECAI applicants. Such applications will be considered on their merits in line with the CRD and CEBS guidelines.

1 20 January 2006.

2 See the Treasury's consultation and partial regulatory impact assessment on transposing the CRD: www.hm-treasury.gov.uk/consultations_and_legislation/capital_requirements_directive/consult_capitalrequirements_index.cfm (also includes the summary of responses to consultation).

Response to individual question

Unsolicited ratings

Q19: Do you think our proposed approach on the use of unsolicited ratings is appropriate?

6.7 The joint-industry response supported our proposal on the use of unsolicited ratings. However, it would welcome further clarification of how we will determine and communicate restrictions on their use. It did not think it should be up to firms to assess the quality of unsolicited ratings.

6.8 **Our response:** We recognise the industry's concerns about the practicalities of using ECAIs' ratings in their systems. We also agree firms should not need to assess the quality of unsolicited ratings.

We ask ECAIs to include in their common application packs an outline of their transparency policy on solicited and unsolicited ratings so firms are able to identify those that are solicited and those that are not.

We are proposing to amend BIPRU 3.5.2 and BIPRU 3.5.3 to reflect that the unsolicited ratings of an eligible ECAI are not to be used for the purposes of BIPRU 3 if we consider them to be inferior in quality to the general quality of solicited assessments or if we consider that the ECAI's strategy on unsolicited assessments places undue pressure on the rated entity to pay for a rating.

In respect of the three ECAIs discussed above we do not propose to exclude their unsolicited ratings from use by firms.

6.9 The joint-industry response sought further clarification on the status of CEBS guidelines.

6.10 **Our response:** This clarification is provided in paragraphs 1.18-1.19 of the Overview. We believe that ECAI recognition is one instance where incorporation of CEBS guidelines by reference is justified by the benefits it delivers in terms of clarity, cross-EU consistency, and a reduction in the administrative burden. We think that by adopting fully the approach outlined in CEBS' common approach to recognising eligible ECAIs we are acting in the interests of all concerned.

This approach should reduce the administrative burdens and achieve greater consistency in recognition and the mapping of ratings to credit quality steps across Europe, creating a more equal playing field for banks on the standardised approach. We understand that industry is generally supportive of this approach and indeed would like it to be extended beyond Europe.

6.11 The joint-industry response noted that CP06/3 did not address whether we can indirectly recognise an ECAI already recognised in a non-EEA state.

6.12 **Our response:** The CRD does not provide for the possibility of EEA Member States indirectly recognising ECAIs already recognised by competent authorities in non-EEA states. We therefore suggest any firms planning to make use of such ECAIs should let us know as soon as possible.

6.13 Respondents indicated that in the event of de-recognition of an eligible ECAI, they would wish for clear communication and timely warning from us.

6.14 **Our response:** We agree that clear communication in such circumstances is very important. We will also, of course, endeavour to provide firms with timely notification.

6.15 The joint-industry response noted it would like us to publish in June the results of the shadow recognition process regardless of whether this is complete.

6.16 **Our response:** The mapping of ECAIs' credit assessments to credit quality steps is set out at the end of this chapter.

BIPRU 3 changes

Reference	Comments	Response
BIPRU 3.3.2		Amended as suggested
BIPRU 3.3.5		Reference to handbook included
BIPRU 3.5.3	It should not be up to firms to assess the quality of unsolicited ratings	3.5.3 has been redrafted
BIPRU 3.5.11		Redrafted

Standardised approach: mapping of ECAIs' credit assessments to credit quality steps

Long-term mapping

Credit Quality Step	Fitch's assessments	Moody's assessments	S&P's assessments	Corporate	Institution (includes banks)			Sovereign
					Sovereign method	Credit Assessment method		
						Maturity > 3 months	Maturity 3 months or less	
1	AAA to AA-	Aaa to Aa3	AAA to AA-	20%	20%	20%	20%	0%
2	A+ to A-	A1 to A3	A+ to A-	50%	50%	50%	20%	20%
3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	100%	100%	50%	20%	50%
4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-	100%	100%	100%	50%	100%
5	B+ to B-	B1 to B3	B+ to B-	150%	100%	100%	50%	100%
6	CCC+ and below	Caa1 and below	CCC+ and below	150%	150%	150%	150%	150%

Short-term mapping

Credit quality step	Fitch	Moody's	S&P	Risk weight
1	F1+, F1	P-1	A-1+, A-1	20%
2	F2	P-2	A-2	50%
3	F3	P-3	A-3	100%
4	Below F3	NP	B-1, B-2, B-3, C	150%
5				150%
6				150%

Securitisation

Long-term mapping: Standardised approach

Credit Quality Step	Risk Weights	Fitch	Moody's	S&P
1	20%	AAA to AA-	Aaa to Aa3	AAA to AA-
2	50%	A+ to A-	A1 to A3	A+ to A-
3	100%	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-
4	350%	BB+ to BB-	Ba1 to Ba3	BB+ to BB-
5	1250%	B+ and below	B1 and below	B+ and below

Long-term mapping: IRB approach

Credit Quality Step	Risk Weights			Credit Assessments		
	Most senior tranche	Base	Non-granular pool	Fitch	Moody's	S&P
1	7%	12%	20%	AAA	Aaa	AAA
2	8%	15%	25%	AA	Aa	AA
3	10%	18%	35%	A+	A1	A+
4	12%	20%	35%	A	A2	A
5	20%	35%	35%	A-	A3	A-
6	35%	50%	50%	BBB+	Baa1	BBB+
7	60%	75%	75%	BBB	Baa2	BBB
8	100%	100%	100%	BBB-	Baa3	BBB-
9	250%	250%	250%	BB+	Ba1	BB+
10	425%	425%	425%	BB	Ba2	BB
11	650%	650%	650%	BB-	Ba3	BB-
Below 11	1250%	1250%	1250%	Below BB-	Below Ba3	Below BB-

Short-term mapping: Standardised approach

Credit Quality Step	Risk Weights	Fitch	Moody's	S&P
1	20%	F1+, F1	P-1	A-1+, A-1
2	50%	F2	P-2	A-2
3	100%	F3	P-3	A-3
All other Credit assessments	1250%	Below F3	NP	All short-term ratings below A3

Short-term mapping: IRB approach

Credit Quality Step	Risk Weights			Credit Assessments		
	Most senior tranche	Base	Non-granular pool	Fitch	Moody's	S&P
1	7%	12%	20%	F1+, F1	P-1	A-1+, A-1
2	12%	20%	35%	F2	P-2	A-2
3	60%	75%	75%	F3	P-3	A-3
All other Credit assessments	1250%	1250%	1250%	Below F3	All short-term ratings below A3, P3 and F3	All short-term ratings below A3

Collective investment undertakings (CIUs)

The mapping for CIUs is the same as the mapping for long-term fundamental credit ratings. In respect of Fitch, we propose to recognise their 'fund credit ratings'; in respect of Moody's, we propose to recognise their 'managed funds credit quality ratings'; and in respect of S&P, which issues two kinds of relevant credit assessment, we propose to recognise their 'fund credit quality ratings' and their 'principal stability fund ratings'. This is in line with the meaning of 'credit assessment' as elaborated in paragraph 172 of the CEBS guidelines and covers assessments of fixed income funds including money market funds.

Fitch and Moody's use the same rating scale for their managed funds credit quality ratings as for their fundamental credit ratings. While S&P's uses slightly different rating scales for principal stability fund ratings (subscript 'm') and for fund credit quality ratings (subscript 'f'), the rating scales are identical in terms of number of rating categories.

Credit Quality Step	Risk Weights	Fitch	Moody's	S&P Principal stability fund ratings	S&P Fund credit quality ratings
1	20%	AAA to AA-	Aaa to Aa3	AAA (m) to AA- (m)	AAA (f) to AA- (f)
2	50%	A+ to A-	A1 to A3	A+(m) to A-(m)	A+(f) to A-(f)
3	100%	BBB+ to BBB-	Baa1 to Baa3	BBB+(m) to BBB-(m)	BBB+(f) to BBB-(f)
4	100%	BB+ to BB-	Ba1 to Ba3	BB+(m) to BB-(m)	BB+(f) to BB-(f)
5	150%	B+ to B-	B1 to B3	B+(m) to B-	B+(f) to B-
6	150%	CCC+ and below	Caa1 and below	CCC+ and below	CCC+ and below

7 Internal ratings based approach to credit risk

Introduction

7.1 In CP06/3 we consulted on our revised proposals for implementing the new internal ratings based (IRB) approach to credit risk. This included the output of an intensive dialogue that had taken place with the industry during 2005 – including expert-group work on such aspects as:

- low default portfolios (LDP);
- loss-given default (LGD) estimates;
- aggregation requirements for retail exposures;
- the use of external models; and
- economic cycle stress testing.

We also set out the revised IRB rules and guidance in BIPRU 4 for comment.

7.2 We found respondents' comments on our IRB proposals in general positive and constructive. We are pleased they share our view that the dialogue has been helpful in developing practical solutions in a range of difficult areas and in significantly enhancing the shared understanding between the industry and us. We also very much welcome the detailed attention that respondents gave to the draft BIPRU text both on the substance and to suggest improvements for clarity. We have thoroughly considered all of these comments and have made a range of amendments to improve the text. These are discussed further below – either in the issue-specific sections or in the general sections at the end of the chapter.

7.3 We note that in a number of areas respondents request further and/or continuing dialogue with us. These requests fall into two categories: a small number where dialogue was requested in advance of publishing this PS to provide further detail on the industry's comments; and others where respondents considered it desirable to have continuing dialogue to promote further common understanding about the practical implementation of and compliance with the IRB requirements.

7.4 Accordingly, we have had further dialogue with industry representatives about a number of aspects of their comments before publishing this PS. This included discussion about comments on LGD estimates, the 'materiality threshold' for the definition of default, and the economic cycle stress testing requirement. In addition, we have received recommendations from the industry expert group for estimates of conversion factors (EADs). These aspects are discussed in detail below.

7.5 We also are fully supportive of continuing dialogue with industry representatives to enhance our shared understanding of the IRB requirements on areas such as economic cycle stress testing, LGD estimates, and conversion factor/exposure at default (EAD) estimates. However, it is not our intention to introduce further rules or guidance as a result of this. The Handbook text should now be regarded as near-final for implementation.

General Issues

Minimum standards; approach to approvals

7.6 While welcoming our overall approach to implementation outlined in CP06/3, the joint-industry response indicated firms were experiencing difficulties in understanding how to achieve the minimum standards in a practical sense. The response indicated it was difficult to know 'which parts are critical, what the priorities are, and what level of attainment would constitute an acceptable application'. The response requested we take 'a holistic approach'. It also expressed concern about how we would manage the 'legal risk' arising from different internal interpretations. It asked whether remedial work would be managed through a process linked to the IRB permission or through the Arrow process. The joint-industry response suggested there must be a point when it shifts from the former to the latter. The response also urged us not to prioritise consistency of outcomes over diversity of industry practices – something which the response perceived as a risk.

7.7 We are alive to the concerns expressed by respondents on these issues. We do not of course have the power to waive the minimum requirements as set down in the CRD and incorporated in the Handbook. However, it is the case that within those minimum requirements and the guidance we have set out, there is a good degree of open texture. This reflects our desire and that of the industry to avoid over-prescription. There is, moreover, a degree of flexibility deriving from the 'materiality' provisions of the CRD and the BIPRU text and from other provisions such as those for using conservatism in certain cases to ensure that capital requirements are not understated. More generally, there is the question of our approach to assessing a firm's compliance with the minimum requirements which respondents identify as a further area of potential variability.

7.8 We agree this is an area of challenge both for firms and for us. In general, this challenge derives precisely from our view that it is necessary and desirable to avoid over-prescription and undue legalism and from the need to strike the appropriate balance between consistency of standards applied and the diversity of firms' approaches.

7.9 Accordingly, we are devoting significant effort to our engagement with those firms which have indicated their intention to apply for a waiver to use the IRB approach. Through our visits to and dialogue with these firms, we have been able to discuss their progress and to identify areas where we think there may be (significant) weaknesses and discuss their plans for addressing these. This approach has been welcomed by the firms concerned and provides assistance in addressing the uncertainties about which respondents expressed concern. We will be continuing with this approach – focused on the specifics of individual firms' situations – in the period leading up to and during the approvals process. However, it should be noted that the primary responsibility remains with the firm itself – our dialogue with a firm is of necessity targeted rather than comprehensive – and the final decision remains with the relevant FSA committee. Please see also our comments at paragraphs 18.4-6.

7.10 At the general level, we have identified a number of areas which significantly inform our overall judgement as to whether a firm has achieved compliance with the requirements not just in a rule-by-rule way but on a holistic analysis. In this regard, we have stressed the importance of firms' approaches to downside risks and, in particular, their estimation of downturn LGDs and their carrying out of good quality economic cycle stress tests, supported by well-thought through capital management plans. We have also indicated that the use test and internal governance will have a particular importance in demonstrating that firms have achieved convincing risk measurement and management standards.

7.11 We have discussed with the industry, through the Credit Risk Standing Group (CRSG) and the High-Level Basel 2/CRD Advisory Group, how we might approach situations where we identify issues which, while not indicating non-compliance with minimum standards, we consider sufficiently important to address in the waiver decision. We are in the process of identifying a number of options that could assist firms in bridging the gap in such circumstances. These may include conditions applied to waivers such as applying more conservative parameters for certain models, requiring delayed roll-out of portfolios with shortcomings or applying a bespoke capital buffer or multiplier to models in Pillar 1. However, we stress that use of these conditions is not a substitute for ensuring compliance with minimum standards. At this stage, a number of firms are recognising that they still need to make considerable progress on crucial areas of their waiver applications: we think this framework will provide a practical means of facilitating progress on such outstanding issues. We will communicate clearly in writing the issues which the waiver conditions are designed to mitigate. This means the basis for any conditions will be fully transparent to firms and will allow firms to have a clear understanding of the remedial work required for the conditions to be lifted.

7.12 Once a firm receives approval for its waiver, it should expect that we will want to monitor the implementation of the new regime as part of normal supervisory activity. Where conditions are applied to a waiver, we expect progress by firms in meeting conditions will be monitored by their usual supervisory contact.

CEBS guidelines

7.13 Respondents continued to raise concerns about the status of CEBS guidelines.

7.14 **Our response:** This issue is covered in a general way in Chapter 1. Where the IRB approach is concerned, the issue centres around the CEBS guidelines on validation[1]. As stated in CP06/3, we have paid close attention to the contents of these guidelines in finalising BIPRU 4 and we consider that our rules and guidance are consistent with them. As respondents pointed out, we incorporated some aspects of the guidelines directly into our draft rules and guidance. In other areas, however, we consider that, while consistency has been achieved, the nature of the CEBS guidelines does not lend them to copy out within a principles-based Handbook. We can confirm it is for firms to determine the way in which they comply with the rules in BIPRU, which remain the only source of requirements. We continue to think firms may find the CEBS guidelines a useful source of understanding of some of the requirements contained in the IRB framework.

Corporate governance

7.15 The industry had a number of comments in this area. These are covered in Chapter 19 of this PS.

Estimates & validation – general issues

Validation of estimates

Q20: Do you support our proposed approach to the validation of estimates?

7.16 As stated in FS05/1, in CP06/3 we proposed to implement the validation principles of the Accord Implementation Group (AIG) published in January 2005 and which are included in CEBS GL10. Given the relatively detailed nature of the CEBS validation material, we did not propose including its content in the Handbook in its entirety, but we said we would refer to this material in interpreting firms' compliance with the CRD.

7.17 Respondents were generally supportive of the approach proposed and thought the material included in the Handbook was at an appropriate level. They suggested we could make it clearer that the material applies equally to probability of default (PD), LGD and EAD. A number of more detailed comments were also made:

- Respondents requested confirmation that independent input in the context of BIPRU 4.3.28 does not require validation to be undertaken by parties external to the firm.
- Respondents asked us to ensure the copy out requirement (in 4.3.33) to use other qualitative validation tools and comparison with relevant external sources is interpreted in a way which minimises the burden upon firms.
- Respondents wanted to understand more about the value of benchmarking, especially in areas such as LDP.

1 *Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches*, April 2006.

- Respondents stated that firms do not expect to have to undertake independent recalculation of data, and that validation should be from sampling and not restatement.
- One respondent suggested there should be more emphasis placed on the ability of models to predict outcomes and less on detailed testing of every step of their construction, that the emphasis on conservatism in 4.3.28 was misplaced, and suggested we adopt the CEBS wording which mentions the need for an appropriate mix of accuracy and conservatism.

7.18 **Our response:** We welcome the industry's generally positive response to these proposals, and intend to maintain the position set out in CP06/3. We confirm that the material applies equally to PD, LGD and EAD, and propose to amend BIPRU 4.3.27 accordingly.

We confirm that BIPRU 4.3.28 does not imply any requirement for validation to be undertaken by parties external to the firm.

We agree that the BIPRU 4.3.33 requirement to use other quantitative tools and comparison with relevant external sources should not be interpreted in an unduly burdensome way. The need for other tools will be less where more reliance can be placed on outcomes analysis. However, the CRD does state that some comparison with data external to a firm is appropriate to obtain, for example, satisfaction that estimates represent long-run averages.

Benchmarking exercises – for example, comparison of internal ratings with those for the same borrowers of an external party, such as an external credit assessment institution (ECAI) (BIPRU 4.3.28) – can be a valuable diagnostic tool that helps firms identify potential weaknesses in their rating and risk quantification systems by comparison with the estimates produced by an alternative measure. This should result in firms identifying the extent of differences between the two estimates and being able to form views on whether the extent of those differences is appropriate. Where there is sufficient data to draw conclusions about the performance of risk measures, the use of benchmarks will also enable firms to draw conclusions about the relative performance of their internal measures. As an example, a firm might be able to reach a view, from its relative measure of discriminative power when compared to an external model, whether its internal rating system is meeting its performance aspirations.

On the need for independent recalculation (BIPRU 4.3.27), it is not possible to be too specific on this point as what is necessary will vary from case to case. However, as a general principle, sampling is likely to be enough unless the results of the sampling, or other information, suggests further investigation is needed to obtain sufficient confidence in the process in question.

We think our approach is consistent with a philosophy of placing due emphasis on the ability of a model to predict outcomes. As noted above, our view is that the need for other validation tools will be less where more reliance can be placed on outcomes analysis. Moreover, we agree there should be an appropriate balance between accuracy and conservatism, and do not think BIPRU 4.3.28 suggests otherwise.

Low default portfolios

> Q21: Do you support our proposed approach to low default portfolios as proportionate and effective?

7.19 We proposed adopting the main elements of the proposals for the estimation of PDs on LDPs which had been developed by an industry expert group. These included sub-dividing such exposures into three categories, where:

a) PDs can sensibly be estimated through using external sources (of default data) in methods set out in the CRD;

b) PDs are estimated and/or validated by the firm through using market price related data; and

c) there is no or insufficient data, internally or externally, available to the firm to directly derive PD estimates.

7.20 For exposures in category c), firms would need to use statistical techniques to calculate the distribution of defaults implied by their experience, estimating PDs from the upper bound of a confidence interval aimed at producing a conservative estimate. These statistical PDs should then be adjusted to take account of differences between the observed default rate and PD in line with the Handbook definitions.

7.21 Most respondents were supportive of the outcome. One trade association respondent reported that it was exploring with the industry the case for a trade-body led default database. One individual respondent doubted how a statistical approach, where there is lack of internal and external data, could be applied in practice and suggested we accept industry practice – which relies on triangulation of what data there is – and on judgement.

7.22 The joint-industry response asked that a clear link be made between the proposals of the expert group – with particular reference to the availability of the approach based on market data not mentioned in BIPRU – and also that a reference to LDPs should be made in 4.3.75.

7.23 The response queried whether BIPRU 4.3.91 had removed the flexibility to use a point in time rating system, as it suggested that PD should be adjusted to through the cycle.

7.24 The joint-industry response thought paragraph 7.16 in CP06/3 was overly prescriptive. This stated that it was unlikely we would be convinced a firm had considered all relevant information if it had used data from only one ECAI. The response acknowledged that this is derived from the CRD requirement to use all relevant information, but argued the information should be material as well as relevant. The response gave the specific example of bank and sovereign portfolios, where it argued that the agencies have the same default coverage, so estimates are likely to be the same. The response suggested that in such areas, we should concentrate on ensuring bank estimates are suitably conservative, highlighting the challenge of the complete absence of default data for ratings from AAA to A.

7.25 **Our response:** As the general proposals are widely supported by the industry, we propose to implement the approach set out in CP06/3. This already seeks to distinguish between cases where there is enough data to produce reliable PD estimates and those where there is not, and to accommodate adjustments to the statistical PDs in the latter case where these can be justified; the use of pure judgment cannot be validated in such circumstances and is not permitted by the CRD.

In response to the comments received we have included a reference to LDPs in BIPRU 4.3.75 'sometimes referred to as Low Default Portfolios'. Wording will also be included in BIPRU 4.3.91(1) (b), referring more explicitly to measures based on market price data.

We confirm there is no intention in these proposals to remove the flexibility to use point in time rating systems.

As a matter of general principle we agree that immaterial information need not be included in estimates even if it is relevant. We have accordingly built concepts of materiality into our interpretation of material drivers and all relevant information as discussed below. In the specific example quoted, we acknowledge that the various ECAIs can be expected to have similar coverage for banks and sovereigns. This would suggest their data should also be similar. However, the practice we observe is for the ECAI default data that firms are using not to be limited to that similar experience, in part because the lack of data on sovereigns and bank defaults means firms include agencies default data on other types of borrowers also. We agree that there is a particular challenge arising from the lack of agency default data on the highest-rated borrowers and think that continuing discussions with the industry through the CRSG will be useful.

Definition and materiality of default

7.26 In CP06/3 we set out our definition of default (BIPRU 4.3.54) revised to take into account the late-introduced CRD requirement for competent authorities to define materiality thresholds. This included a proposal that an exposure be considered material if it exceeded £100 in the case of retail, or £1000 in the case of non-retail.

7.27 Respondents indicated they did not wish materiality in this regard to be defined and that they believed that our definition of material obligor, rather than material obligation as required by the CRD, was superequivalent.

7.28 Respondents also commented that aggregation of exposures as determined in the definition of default will be very costly to achieve and is superequivalent to the CRD, which states aggregation 'which reflects a reasonable level of risk'.

7.29 **Our response:** We have discussed our approach to this issue with industry representatives in the aggregation expert group. Following this discussion and further internal review of the nature of the obligation placed upon us by the late amendment to the CRD – which required us to establish thresholds of materiality for obligations which are past due – we do not think it is necessary for us to set a fixed quantitative threshold to be applied to firms. Instead, we will rely on firms' internal policies for determining materiality of defaults for internal risk measurement and management purposes. We have amended BIPRU 4.3.54 accordingly.

It will generally be the case that these internal polices will need to address materiality in relation to firms' total exposures (not merely overdue amounts) to an obligor. However, we have also amended BIPRU 4.3.54 to clarify that, where an obligation approach is being used (i.e. the approach allowed for Retail exposures that seeks to assess the probability of a borrower/obligor defaulting on a single exposure as opposed to any of the exposures extended by the firm), materiality may be determined with reference only to the exposure covered by that rating and not total exposures to the obligor. We also wish to reassure the industry that there has been no amendment to the previous clarification, as set out in 4.3.56, that amounts overdue due to administrative oversight and in excess of normal thresholds may be excluded from the definition of default.

Material drivers

Q22: Do you support our proposed approach to material drivers as representing a proportionate implementation of the 'all relevant information' and other requirements of CRD Annex VII, part 4, paragraph 49?

7.30 The CRD requires estimates of PD, LGD and CFs to be plausible and intuitive and based on the material drivers of the risk parameter in question. In CP06/3 we proposed an approach to implementing this requirement that formed part of the wider CRD requirement to include all relevant material information in firms' estimates. Firms would need to collect data on what they considered to be the main drivers of a risk parameter and include the most material in their estimation process. They should be able to demonstrate why the data sources chosen provide sufficient discriminative power and accuracy and why additional potential sources would not be expected to materially improve the power and accuracy. The level of justification for excluded sources would not require an intensive analysis of all factors, and we did not expect that investigating additional drivers would be pursued to an unreasonable extent.

7.31 Respondents thought the proposed guidance did reflect the industry's concerns to some degree and were pleased to see recognition of materiality through the linking of the need to include additional information to its potential to produce an improved estimate. But respondents expressed residual concerns about the potentially burdensome nature of demonstrating compliance with the requirement, noting that the CRD takes no account of the costs and benefits of acquiring additional information. Respondents thought there was some contradiction between the CP and the BIPRU text, but this could be adequately addressed by incorporating the qualifying phrase …that firms' justification of omitted information… 'does not require an intensive analysis of all factors' in BIPRU 4.3.76.

7.32 **Our response:** We acknowledge this is a difficult area and appreciate that the industry recognises we have tried to accommodate their concerns. As pointed out, the CRD requirement does not incorporate costs and benefits considerations, although we believe we have been able to apply the latter component to some degree through 'materiality'. As requested, we have inserted the proposed wording into 4.3.76. We will otherwise leave the draft Handbook wording unchanged.

Use test

Q23: Do you support our approach to the 'use test' as a pragmatic approach to ensuring that firms have confidence in the internal ratings they use for IRB purposes?

7.33 The use test embodies the concept that both supervisors and senior management can have more confidence in IRB estimates when they are integral to the firm's measurement and management of the credit risk in its business.

7.34 In CP06/3 we reaffirmed the need for IRB estimates to play an essential, though not necessarily exclusive or a primary role, in risk management, credit approval and decision-making processes. However, we also acknowledged that there would be instances when firms may be using different estimates. Such differences may be justifiable, provided firms document and demonstrate the reasonableness of these.

7.35 In their feedback, firms welcomed the flexibility and recognition that there may be differences between models used for internal purposes and those used for calculating regulatory capital. However, some were concerned that this is contradicted by some of the explanatory text within CP06/3 paragraphs 7.32-3 which they felt was impractical. In particular, they said that it was not possible to have identical rank ordering or calibration without two models being identical initially.

7.36 In general there was support for the Handbook provisions in this area but with some requests for clarification of the text in BIPRU 4.2.7.

7.37 Respondents did not support the requirement that provisioning be regarded as an important aspect of the text. They considered that the differences between accounting standards and the IRB approach militated against this.

7.38 In summary, the industry asked us to be flexible in our approach to the use test and acknowledge that a variety of practices could achieve compliance through high-level principles rather than a prescriptive checklist.

7.39 **Our response:** We regard the use test as a central component for granting a waiver, as it is essential for firms to demonstrate their belief in the validity of their IRB estimates. At the same time we agree that satisfaction of the use test should not be considered a mechanical exercise but should have a holistic element.

We agree with respondents that the enumeration in the BIPRU text of core and broader aspects is helpful for both firms and supervisors. Accordingly, we propose to retain these provisions with some modifications of the drafting to meet respondents' requests in this regard.

We continue to place significant emphasis on firms' ability to demonstrate the reasonableness of any differences between parameters used for internal purposes and those used for the IRB capital calculations. This reflects the fact that the requirements elaborated in the CRD will not necessarily reflect the modelling criteria developed for internal purposes. Where the IRB rules provide firms with freedom of choice we will expect to see consistency between the approach for internal and for regulatory capital requirement. Firms must continue to demonstrate how IRB estimates play an essential – though not necessarily an exclusive or primary role – in internal processes.

Concerning provisioning, the difference between accounting standards and the IRB approach is already acknowledged in BIPRU 4.2.7G(2a(iv)) and we expect the estimates may not be the same. Again, what is needed is an identification of the differences and a convincing explanation that they are reasonable.

For example, starting from a best estimate of expected loss on defaulted loans against the impairment provision on an individually assessed loan, we would presume that the estimates of recovery and the timing of them would be the same. However, what may be different is the treatment of costs and a discount rate, where the accounting and regulatory rules begin to differ. Likewise, when assessing collectively assessed provisions and the LGD on performing loans there will be bigger differences but in the same way these are also capable of explanation. In view of our approach we are not persuaded of the industry's comment in this respect.

Concerning the comments on the discussion in CP06/3 7.32 – 33 our intention was not to suggest criteria to be followed when parameters are not the same, rather to set out a high-level taxonomy of the use test concept. We did not intend to indicate that inputs, rank ordering and calibration had to be identical. Only where they were not, firms would have to demonstrate the reasonableness of differences as explained above.

Conservatism

7.40 Respondents indicated that they continued to have concerns about BIPRU 4.3.85 which refers to the need for conservatism in certain circumstances. They considered that the presence of judgemental conservatism could hinder validation.

7.41 **Our response:** We note respondents' comments in this regard. However, conservative adjustments are not required as a matter of course, but rather 'where necessary, related to the expected range of estimation errors so that capital requirements are not understated'. It is not our view that this will add a disproportionate additional challenge in validating estimates.

Credit risk control unit

7.42 One comment suggested that there was inconsistency between the copy-out requirement (in BIPRU 4.3.13) for the credit risk control unit (CRCU) to be responsible for the design, selection, implementation, oversight and performance of the rating system and the AIG validation principle, which states that the CRCU is responsible for independent model review and should be free from undue influence.

7.43 **Our response:** The comment did not fully repeat the content of AIG Validation Principle 6, which states that the activities of the review process may be distributed across multiple units. This is the interpretation we apply to the activities of the CRCU as set out in 4.2.2 (which also says that the CRCU should be appropriately independent and free from undue influence) and 4.3.13. We think this allows any potential inconsistency to be addressed in practice.

Ratings assignment

7.44 The joint-industry response stated that firms were unclear of the meaning of the copy-out language in BIPRU 4.3.44 which says that the criteria for assigning ratings to grades and pools should be consistent with internal lending standards and policies for handling troubled obligors.

7.45 **Our response:** We interpret BIPRU 4.3.44 as meaning that there needs to be a sufficient degree of consistency between the rating criteria and the criteria by which decisions are made on lending decisions and handling troubled obligors to demonstrate that the firm believes the rating criteria are appropriate measures of risk. This is consistent with our philosophy for the use test. Please refer further to our response on that subject, in paragraphs 7.33-39.

Expert judgement

7.46 Respondents expressed concern that the copy-out language in BIPRU 4.3.71, which prohibits the use of estimates based purely on judgemental considerations, will restrict firms' ability to use any form of expert judgement model. The industry requested further dialogue with us on expert judgement models and the standards expected.

7.47 **Our response:** We view judgement as a desirable and indeed essential part of any internal ratings process. For example, the judgement of experts is needed in any model development process; and the requirements for various adjustments – such as straightforward averages of historic experience (BIPRU 4.3.73), or combining of estimation techniques (4.4.25) – also need expert judgement. Moreover, we view a properly controlled override framework as a positive part of an internal rating system. However, as noted, the CRD does not allow estimates to be based purely on judgemental considerations.

In our view, the CRD does not seek to prohibit the use of expert rating systems. But they must meet the overriding requirement, reflected in BIPRU 4.2.2(1), for rating systems to differentiate and accurately and consistently measure risk. The ability of expert-judgement approaches to meet this requirement usually needs to be proved by their performance over time. However, in practice, such approaches are often used in situations where there is insufficient data to be able to demonstrate that they meet the requirement. In summary, while we do not wish to discourage the use of expert judgement, there are challenges deriving from the CRD, in effectively incorporating significant reliance on expert judgement in low default contexts. We would welcome further dialogue with the industry in this area.

Ratings review

7.48 Respondents challenged the practicality of the copy-out requirement in BIPRU 4.3.79 for estimates to be reviewed when new information comes to light. They suggested it should be reasonable for firms to have a policy in place, which would usually result in consideration of new information being deferred until the annual review.

7.49 We agree that a firm should have a policy which addresses when new information should be considered. This should take account of materiality considerations. So, as an example, and as required by the copy out text in BIPRU 4.4.16, we would expect information on large corporate borrowers that suggested a significant change in their credit quality to result in an urgent review of their borrower rating (as well as other actions). However the receipt of updated financial information which does not indicate any major change would not be expected to result in any further consideration until the annual review.

7.50 The joint-industry response asked how often LGDs and exposure values should be subject to more frequent calculation (as mentioned in BIPRU 4.4.17). This is with reference to firms' need to run the algorithm each time they undertake a capital calculation, an earlier comment on BIPRU 4.4.16 in the joint-industry response on CP05/3, and the copy-out requirement in 4.3.79, for estimates to be reviewed when new information comes to light.

7.51 **Our response:** The guidance added in 4.4.17 is intended to respond positively to the helpful comment in the joint-industry response to CP05/3, which asked that we made clear that LGD and EAD would be subject to more frequent recalculation by virtue of their connection to drawn balances which can vary on a daily basis. These will be revised as appropriate whenever a new capital calculation is generated. Other elements that impact the calculation of EAD and LGD, for example the conversion factor to be applied to a particular facility, would not be updated as frequently and fall under the general approach outlined in 4.3.79.

Estimates & validation – specific issues

Use of external data and external models

Q24: Are the standards for the use of external models and external data set at an appropriate level? What changes, if any, would you recommend?

7.52 Respondents generally supported the guidance in BIPRU 4.3.50. Industry members felt that the language 'at least as high as' is a more prescriptive definition than 'should not be lower' in CP 7.43 and request the latter CP text is used in BIPRU.

7.53 Some industry members were uncertain about the minimum standards that will be applied to external data.

7.54 One respondent had concerns about the granularity of property valuation models used. It thought there was a need to distinguish between high and low loan-to-value (LTV) and to recognise those areas or properties which may fall below average distribution of house price appreciation. There was a need for valuation models to take into account these factors when monitoring valuation to ensure that the lender was alerted when the value decreased.

7.55 **Our response:** 4.3.50 provides guidance on BIPRU 4.3.48R. 4.3.48R provides guidance on internal rating systems and the use of models.

We note the slight difference in wording between the CP and BIPRU text and propose to change the latter to: 'The standards required by BIPRU 4 for an external model should not be lower than those for internal models'.

Areas of BIPRU 4.3 describe certain characteristics needed for external data which may be used for internal rating systems and models.

External data and models will need to reflect sound and relevant (fit for purpose) criteria; robustness and reliability; and historical and predictive performance. Guidance given in BIPRU 4.3.80, 4.3.88R(1), 4.3.89 and 4.3.126 is intended to ensure that data entering a pool is consistent and does not contain distortions as a result of different contributors' practices. BIPRU 4.3.126 contains guidance about interpreting the requirements relating to comparability in BIPRU 4.3.80R. The population of exposures represented in the data used for estimation, the lending standards used when the data was generated and other relevant characteristics must be comparable with those of a firm's exposures and standards.

We think that the guidance contained in the BIPRU text is appropriate and do not propose more. However, for further assistance, firms may wish to refer to the Basel Committee's March 2006 newsletter on the use of vendor products in Basel 2 IRB systems (http://www.bis.org/publ/bcbs_nl8.htm).

Data and models should factor in levels of LTV as it is recognised that, among other things, defaults and LGD will vary accordingly.

Loss given default

Q25: Is the level of guidance on loss given default appropriate? Are there any areas where you would like to see additional guidance?

7.56 In CP06/3 we proposed adding Handbook text in a number of areas. This reflected our response to the work of two industry expert groups that considered LGD-related issues during the second half of last year and work in CEBS that is reflected in GL10[2].

7.57 In particular, we proposed implementing the main principles in the recommendations made by the Basel Committee in June 2005 which clarified supervisors' expectations for the economic conditions which firms' LGD estimates should relate to. CEBS has since adopted the same principles in GL10. This required firms to have a process for:

- identifying economic downturn conditions;
- assessing whether there are adverse dependencies between default rates and recovery rates; and
- including such dependencies, if identified, and so producing LGD parameters consistent with economic conditions.

7.58 Most of the other material was relatively technical in nature.

2 Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Basel (IRB) Approaches, April 2006.

7.59 Respondents were appreciative of the fact that the BIPRU text largely represented the discussions and conclusions of the industry expert group and welcomed recognition in CP06/3 of the practical and conceptual challenges faced by the industry and supervisors in LGD estimation. However, there were a number of comments about the general nature of the CRD requirements for firms to use their own estimates of LGD, and specific elements of our proposals.

7.60 The joint-industry response commented that there was a general recognition by the industry that the prescriptive and granular requirements for LGD assessment were impractical given the infancy of estimation and validation techniques. It requested a pragmatic approach and continued dialogue through the expert group.

7.61 The joint-industry response referred to industry opposition to a Pillar 1 treatment of downturn conditions in the estimation of LGD. It also objected to including as a rule in the Handbook (BIPRU 4.3.99), the guidance on downturn LGD requirements which emerged from the AIG/CTF joint-working group. The response asked for a rationale for our decision in this regard and for 4.3.99 to be changed to guidance. The response also highlighted the practical challenges of operationalising the requirements to produce downturn LGDs and asked for further discussion in the expert group to reach a shared understanding of these challenges.

7.62 Respondents asked us to review our position, as described in paragraph 7.47 of CP06/3, for firms to estimate directly the LGD and CF appropriate for a downturn, instead of deriving this through a set formula that converts an average LGD into an LGD appropriate for a downturn. Respondents also asked us to consider the specific proposal by the US authorities in their draft notice of proposed rule-making (NPR) to allow firms to derive downturn LGDs by a formula of '0.92 times default weighted average LGD plus 8%'. The expert group has since proposed that we should permit firms to derive downturn LGDs by any of the following:

a) estimating them directly; or

b) converting default-weighted average LGDs into downturn LGDs through the use of internally developed formulae; or

c) as a fall-back option, converting default-weighted average LGDs into downturn LGDs through the use of the formula proposed by the US authorities.

7.63 One individual respondent asked for either explicit guidance in the Handbook or a reference to the work of the mortgage expert group on the treatment of downturn LGD for residential real estate.

7.64 The joint-industry response repeated the request of the expert group for firms to be allowed to use exposure weighted averages, instead of default weighted average, although it acknowledged that the CRD refers to default-weighted averages. If that proposal is not accepted by us, it requested that the expert group reconsider how weighting LGDs by defaults should apply when aggregating from account to pool level. The response also noted that BIPRU 4.3.119 refers to default weighting within a pool, and questioned whether this applies for current or historical estimates.

7.65 In relation to the requirement to include data from incomplete workouts, respondents suggested this should depend on what firms consider material and realistic to include, based on their experience of loss for particular exposure types. Respondents suggested it might be more appropriate to include incomplete workouts for retail exposures than for corporate exposures, given that the outcome is generally less certain in the latter until workout is complete.

7.66 With reference to our proposal to allow firms to exclude cures from LGD calculations – provided firms can demonstrate that capital requirements are not reduced – respondents asked that the inclusion/exclusion of cures should be consistent for both LGD and PD estimation, with an appropriate cross-reference made to this guidance in the relative section on the estimation of PDs. Respondents also suggested that this would require firms to undertake calculations on both a 'cures in' and 'cures out' basis, which would require extra work from firms. Respondents asked us to interpret this provision in a way which minimises the burden on firms.

7.67 The joint-industry response suggested that the expert group should consider the requirements for, and implications of, a 'very low or zero LGD estimate', as set out in 4.3.106.

7.68 One respondent requested the addition of specific guidance to make it clear that the reference in BIPRU 4.3.110 to the need to consider the dependence of risk between the obligor and collateral – and to address cases of significant dependence in a conservative manner – is not meant to preclude cases where the borrower occupies the pledged property and it has other uses.

7.69 Some respondents state that they were unable to find a glossary definition for historical average rules.

7.70 **Our response:** We welcome the industry's support for our approach to the development of proposals in this area. We acknowledge that the requirements for LGD estimation are challenging. As reiterated in CP06/3 (7.4), we will not demand compliance with best practice in all aspects at the start of the new framework. However, firms wishing to use their own estimates of LGD need to be able to comply with the requirements of the CRD. We look forward to continued dialogue in the expert group to achieve further consensus on how the regime may be implemented in a way which is both consistent with industry capabilities and our own obligations to implement the CRD appropriately. This should include the particular issues around estimation of downturn LGDs.

We are aware that there remains some opposition to the need for the LGD used to be appropriate for downturn conditions. However, this is a clear requirement of the CRD (as reflected in BIPRU 4.3.98). BIPRU 4.3.99 describes at a high level the steps necessary to produce downturn estimates where appropriate. Incorporating this process as a rule emphasises the nature of the requirement which firms must carry out if they wish to use their own estimates of LGD. We believe it would unhelpfully cause confusion to reclassify this provision as BIPRU guidance at this stage. We do not think our approach is inconsistent with that of other supervisors. We note respondents' support for our approach to allow steps (a) to (c) in BIPRU 4.3.99 to be complied with in an integrated manner.

We have inserted additional guidance (BIPRU 4.3.99) which will make clear that firms may derive downturn LGDs either directly or through internally developed formulae which convert default-weighted average LGDs into downturn LGDs. However, as discussed in the expert group, we emphasise that the second option is itself very challenging as it requires firms both to ensure that the default weighted average estimate itself includes sufficient observations from downturn periods, and to be able to demonstrate convincingly that a formula may be expected to result in estimates appropriate for a downturn for the exposures to which it is applied. Discussions with the industry over the last two and a half years have also highlighted the challenges in deciding the appropriateness of formulae of this type. Against this background, and at this late stage, we do not think we can endorse a specific formula as a fallback option. We also note that the US proposal is itself subject to consultation and there can therefore be no certainty at this stage that it will be agreed to be appropriate even for the exposures of US banks.

We think including the work of the mortgage expert group in the Handbook is too detailed to be appropriate. This is also the view of most of the industry.

The overall objective is to produce a definition of default weighted average for what LGDs or conversion factors are expected to be over the long run for exposures in a pool or grade, based on historical experience, as set out in 4.3.73. If the estimate on an exposure-weighting basis was significantly different from that on a default-count basis, this would suggest that exposure size was a driver of loss (or EAD as relevant) and that the estimates being produced were not accurate for either the smaller or larger exposures. The exposures would need to be segmented by size for a pool to meet the requirement for homogeneity. However, in response to the points raised by the industry, we have now inserted additional guidance after 4.3.73 which accommodates calculating historical averages on the basis of exposure weighting, provided the final estimates used in line with 4.3.73 are on a default-count basis. We are also willing to discuss in the expert group how aggregation from account to pool level should be carried out, as we agree this is a complex area where the issues have not been fully explored.

In practice, we expect information from unresolved workouts on performing exposures is likely to be of most direct importance in validating that the estimates being used by firms remain up to date. We believe it would be inappropriate to ignore the latest information available to firms until the workouts in question have been completed. In subsequent discussions, the expert group agreed that this is not an issue which requires any change in the BIPRU text, but should be reviewed by the group based on experience and feedback from our visits to firms.

We confirm that, where cures are excluded from estimates of LGD in line with the provisions of 4.3.104, they may also be excluded from PD estimates. We have added appropriate guidance accordingly following BIPRU 4.3.92. However, we have kept exclusion from PD estimation optional, as we think, in some cases, firms will not want to adjust PD models that they have already built and which are in full compliance with the CRD requirements for PD models not to exclude cures.

We do not think the proposal to demonstrate that capital requirements are not reduced should be unduly onerous, as our expectation is that this should usually be the case. This is because the resulting combination of lower PDs and higher LGDs should normally produce higher requirements because of the way in which the treatments of PD and LGD interact under the IRB approach. Accordingly, what we expect to see is relatively high-level analysis demonstrating that this effect should apply in a particular case. We remind firms that one exception to the assumption that the resulting capital requirements can be assumed to be higher concerns mortgage exposures whose LGDs are subject to the transitional 10% floor.

We will be pleased to engage in further dialogue with the expert group on the subject of very low or zero LGDs.

As regards the dependence of risk between the obligor and collateral, the requirement in 4.3.110 is to consider the degree of dependence and address this in a conservative manner. It is not to prevent firms from taking any account of collateral in such cases. Ease of alternative use is a factor that we would expect to see reflected in recovery estimates.

Historical average rules are defined in BIPRU 4.3.73(2).

We have deleted references to the CRD from BIPRU 4.4.58, 4.4.62, 4.6.42 and 4.6.48 and have changed the cross-references to BIPRU text in these paragraphs from 4.3.85 to 4.3.116.

Retail issues

Retail definition

Q26: Do you support our approach to the definition of retail as appropriate and proportionate?

7.71 Respondents expressed support for our proposals for Retail SME borrowers as practical and pragmatic with the following comments.

7.72 Some respondents cited section 4.6 and commented that 'obligor' is referred to in a number of areas. Some requested a change as they thought that that 'obligor' has no distinct meaning and that we should be clear where it means account and/or customer. One respondent commented that 'obligor' has various meanings across industry (e.g. in relation to purchased receivables).

7.73 The industry commented that 4.6.4(8) should state that the treatment of Retail SME exposures in excess of €1mn only relates to the application of the corporate capital curve and does not require firms to risk manage such exposures as if they were corporate exposures. In addition, the industry highlighted an incorrect reference in this guidance: 'it should be treated as a corporate exposure, unless, in accordance with BIPRU 4.1.30 R(1) the excess is immaterial because of its size or because it is temporary.' 4.1.30 does not appear in BIPRU.

7.74 Respondents also sought further clarification on how defaults under one facility would influence the PDs assigned to another facility where an obligation approach was being used, as described in BIPRU 4.6.22.

7.75 **Our response:** We think it is appropriate to maintain 'obligor' in section 4.6. We have reviewed the text of BIPRU 4.3 in light of the comments received and consider it unnecessary to alter the word 'obligor'.

Concerning purchased receivables, such transactions involve a triangular relationship between the participants, namely the institution, seller, and an obligor. We believe these parties are appropriately identified in the text.

The reference to 4.1.30R(1) in 4.6.4(8) has been corrected to 4.1.25.

We are sympathetic to the point raised by the industry in relation to changing the risk management of exposures in excess of €1mn. However, our flexibility here is limited by the CRD requirement, as reflected in BIPRU 4.6.4(8)), for such exposures to be treated as corporate exposures. 4.6.4(8) allows alleviation where the excess is immaterial or temporary. In addition, no change will be necessary if the rating systems firms use for Retail SME exposures also meet the corporate standards. We expect this to be quite feasible and, where this is the case, there would be no need for the risk management of such exposures to be changed. We are aware that the capital requirements will in any event be higher for these exposures because of the use of the corporate capital curve.

We have amended the language in 4.6.22 to make our expectations clearer.

Qualifying revolving retail exposures (QRRE)

7.76 In CP06/3 we advised firms how we were interpreting the qualifying standards for QRRE, which were broadly consistent with those set out in CEBS GL10. These included the need for firms to consider data on the mean and standard deviation of loss rates on QRRE relative to other retail portfolios and so demonstrate the low volatility of their losses. However, we did not specify the precise form of the calculation. Firms needed to consider their compliance with the QRRE qualifying conditions as part of their self-assessment under the IRB waiver application process.

7.77 Respondents asked for confirmation that BIPRU 4.6.46 should be interpreted as implying that there is no need to aggregate exposures across credit card, overdraft and other obligations in assessing compliance with the 4.6.44 requirement that QRRE exposures must not be greater than €100,000. Respondents also asked for clarity in relation to the aggregation of individual and joint accounts in determining the maximum exposure to a single individual for QRRE qualification. They suggested it was appropriate for firms to aggregate these exposures in the same way they quantify the extent of risk to their customers for internal purposes.

7.78 **Our response:** BIPRU 4.6.46 merely explains that credit cards and overdrafts are products that are eligible for treatment as QRRE provided that all the other qualifying requirements are met. It is not correct to imply that there is no need to aggregate all QRRE exposures in assessing compliance with the requirement that (total) QRRE exposures to an individual must not be greater than €100,000. However, we confirm that it is not necessary to aggregate other than at the firm level.

On the second point, we agree with respondents that it is appropriate for firms to aggregate these exposures in the same way they quantify the extent of risk to their customers for internal purposes, in considering whether individual and joint accounts need to be combined in assessing compliance against the €100,000 limit.

Economic cycle stress testing

Q27: Do you support our revised proposals for how firms should take account of the variability of their capital requirements with the economic cycle?

7.79 In light of the industry's concerns about our proposal in CP05/3 for firms to carry out stress tests to determine their capital requirements in a mild recession and to hold capital to cover any deficit indicated, we engaged in extensive dialogue with the industry to review these concerns and their proposals.

7.80 After cost-benefit analysis, extensive dialogue with the industry and consideration of opposing arguments, we decided that 'mild recession scenario plus automatic capital add-on' was not the best method of meeting our policy objectives. Rather, given our key concern that firms can survive a significant but plausible deterioration in economic circumstances with their ability to meet their credit risk regulatory requirements intact, it would be better to examine whether firms have sufficient capital resources to meet their projected capital requirements during all stages of the economic cycle.

7.81 We proposed that firms carry out stress tests and scenarios with this requirement in mind and, in particular, address the impact of ratings migration on capital requirements during a significant deterioration in the economic climate, such as might be experienced once in 25 years. However, firms would be able to offset clearly demonstrated mitigating actions against any resulting capital add-on, agreed during the calculation of individual capital guidance (ICG) under Pillar 2.

7.82 While respondents welcomed the move away from automatic capital add-ons and the ability to apply credibly evidenced offsetting actions, the industry stated that our policy of stress testing against '1 in 25 year' downturn situations remains superequivalent.

7.83 In addition, respondents thought it was not useful to define a stress test by reference to expected frequency of occurrence of a recession, and stated that each downturn is composed of a set of economic circumstances which have no predictable relationship from one recession to the next.

7.84 The industry also took issue with Annex 4 of CP06/3 which states that once in 25 years is 'defined as a recession roughly equal in severity to the early 1990s', and questioned how this would apply to international banks for which the UK recession of the 1990s may not have been particularly severe compared to recessions in other jurisdictions.

7.85 The industry requested recognition that the test should be applied at the level of the institution and that the aggregated impact was not equal to the simple sum of each business's figures. Respondents also asked for clarification how the test fits with the requirements for downturn LGD and the burden of proof which firms will need to evidence before they can offset a capital requirement resulting from the test with

mitigating actions within a firm's capital management plan. In particular, respondents asked us to consider the type, nature and quantum of the mitigants which firms may include within their capital management plans.

7.86 In summary, the industry argued for a revised policy taking account not only of recessions of varying degrees of severity, but also the effects of geographic diversification and rating philosophy.

7.87 **Our response:** As stated in CP06/3 we encourage firms to use a range of stress tests and scenario analyses to capture the full complexity of possible stress situations and to identify what their regulatory capital needs will be during a significant downturn and throughout the cycle. We consider that this is wholly consistent with our core responsibilities as prudential supervisors and with firms' responsibilities to be in a position to manage their affairs prudently through plausible changes in the business cycle. We consider our approach to be consistent with the recently published CEBS CP dealing with stress testing[3].

Over the last year, we have had a great deal of constructive dialogue with the industry on this subject. We established an expert group to discuss our policy objectives as well as industry concerns. Through this medium, we have successfully worked to develop our proposals which now effectively decouple the automatic link between the results of the stress test and regulatory capital add-ons.

The central component of our revised proposal was to ensure that firms are able to meet their capital requirements throughout a period of severe but plausible economic downturn. However, to ensure an appropriate degree of certainty and consistency (for both supervisors and firms alike) we considered it appropriate to provide an indication of the order of severity of the recessionary circumstances that the stress tests should be designed to capture. Accordingly, we included the requirement to test against a 1 in 25 year type event in BIPRU 4.3.38 (2).

In addition to opposing any requirement that went further than a 'mild recession', respondents indicated opposition to our description of the required economic recession to be tested against as one that 'might be experienced once in 25 years'. We have met again with the relevant industry expert group to discuss this. We understand that their concerns here relate to such aspects as: the apparent 'statistical imperative' of this description; a view that severity should not be identified by reference to frequency; and a belief that stress tests should be forward-looking rather than backward-looking.

Having given the matter detailed consideration, we consider that it is appropriate to retain the description 'such as might be experienced once in 25 years'. We consider that this is the most suitable way of providing some useful indication as to the severity we wish to see addressed. However, we do recognise some of respondents' concerns in this regard. Accordingly we intend to include the following additional guidance in the BIPRU text:

For clarification the description of the economic recession contained in paragraph 4.3.38(2) should not be taken as stipulating one approach (e.g. statistical) over other approaches (e.g. scenario analysis) in the identification of the relevant recessionary circumstances. The requirement is to identify – in a forward-looking manner – severe but

3 www.c-ebs.org/press/09062006.htm.

plausible downturn conditions relevant to business lines and jurisdictions and to determine the likely impact of those conditions on a firm's credit risk regulatory capital requirements as described in 4.3.38.

We recognise that the economic cycle is not uniform or consistent, as it relates to different asset classes and jurisdictions. So we encourage the use a range of tests and scenarios. Accordingly, our reference to the UK of the 1990s in Annex 4 does not appear as BIPRU text. We fully acknowledge that, whereas the early 1990s will represent a useful benchmark for some firms and some lines of business, it will not be the appropriate scenario in other cases. Firms are free and indeed expected to select scenarios of the required severity pertinent to their own circumstances.

As business cycles do not coincide, we do not expect a firm's aggregated result will be equal to the sum of each business's test. But we will expect to see an explanation of how each firm's scenarios would be translated into IRB parameters and grade migration for application to each of the rating systems which are to be used for IRB purposes and subsequently in the capital calculation. However, the natural process of diversification then applies, reflecting the non-coincidence of the cycles relevant for each portfolio, such that the sum of the overall stress test is not the sum of the stress tests applied to each of the individual portfolios. This will result in a 'gross' result demonstrating what the impact will be upon the IRB capital requirements for the existing portfolio and will be carried out as part of the waiver approval process.

The results of the 'gross' stress test will then be examined as part of ICG to determine the impact of firm's mitigating actions. The core aims of the proposals are to ensure quality stress testing and effective capital management planning. As stated in CP06/3, we expect firms to provide good evidence that they have a documented capital management plan addressing the elements they seek to rely on, approved at an appropriate level. Supervisors will need to be satisfied that the plan is well-considered and realistic. Where the plan meets those requirements, we believe it will be uncommon for our expectation about any additional capital the firm should hold to differ from the firm's own view.

The factors which firms may legitimately put forward in this respect may include:

- projected balance sheet growth or shrinkage;
- growth (shrinkage) in profits and losses;
- raising new capital; and
- the ability to reduce distributions.

However, firms will be required to provide good evidence of the reasonableness of assumptions made as to their willingness and ability to take any future action that they rely upon for these purposes. This should take the form of a documented capital management policy approved at an appropriate level within the organisation (BIPRU 2.2.40).

The Handbook already acknowledges that to the extent to which the economic conditions assumed in the stress test coincide with the economic conditions assumed for the production of downturn LGDs, the latter may be expected to be similar or the same in respect of the LGD component of stress test (BIPRU 4.3.39). In such circumstances, firms

merely need to articulate how the LGD estimates used for regulatory capital purposes will vary with changes in the cycle. It is our sense that how firms' LGD estimates will vary over the cycle is not well understood at present. This of itself does not therefore imply a further increase in the impact of the 'gross' stress test.

While no further rules or guidance will now be produced, we are fully supportive of continuing dialogue to enhance our shared understanding of how to implement these requirements.

Other IRB Issues

Explicit maturity adjustment

Q28: Do you consider that there are other types of transaction that should be subject to a one-day floor? If so, please provide detailed reasoning, in particular about the non-relationship nature of such transactions in the context of the UK market.

7.88 We advised firms that we proposed adopting the treatment set out in the Trading Book Review (TBR) and subsequently adopted in the CRD where a one-day floor was effectively substituted for the one-year floor for certain collateralised OTC derivatives, margin lending and repurchase transactions. We consulted on whether and in which circumstances we should apply the national discretion extending this treatment to other short-term exposures where the effective maturity might match the contractual maturity and met certain conditions set out in Annex VII, Part 2, paragraph 13 of the CRD.

7.89 Respondents could not at this time propose other kinds of transaction that should be allowed in under one year maturity treatment but, to cater for future identification of short-term exposures, suggested that reference should be made to an Annex which would remain blank until exposures are deemed appropriate for inclusion.

7.90 **Our response:** We do not think it is desirable to include a blank Annex in the Handbook. However, such an Annex could be introduced if and when suitable transactions are identified in the future.

Rollout/partial use of IRB approach

7.91 In CP06/3 we set out our rules regarding rollout of the IRB approach (BIPRU 4.2.20), stating that adoption must be carried out 'within a reasonable period of time as set out in the *IRB permission*'.

7.92 The industry feedback commented that a pragmatic approach should be taken for purchases of new business during the rollout period.

7.93 **Our response:** We agree that this will entail the agreement of a revised rollout plan. We will adopt a pragmatic approach while maintaining the objectives of the provisions.

IRB treatment of ECA guarantees

7.94 The industry questioned whether exposures guaranteed by external credit agencies (ECAs), such as the Export Credit Guarantee Department (ECGD), and which are accepted to be sovereign risk:

a) should be given the same treatment as direct exposures to the relevant sovereign. In effect, for countries other than the UK – for which the BIPRU 4.2.26(5) exemption to use the standardised approach with its likely 0% risk weighting applies – this would be derived from firms' IRB sovereign risk models. For countries treated as Zone A under the current framework, this would generally result in a small (but higher than the present) risk weighting; or

b) may, as a general type of exposure, be exempted from IRB under BIPRU 4.2.26(10) and treated under the standardised approach, which would likely give a 0% risk weighting for the major developed countries as they have AAA/AA ratings.

7.95 **Our response:** There is no explicit linkage in either the CRD or, consequently, our copy-out BIPRU between the 4.2.26(10) exemption (state and state reinsured guarantees) and the other more general sovereign exemption (BIPRU 4.2.26(2) which is subject to materiality considerations) or to ECA guaranteed financing. If firms are able to assess the borrower risk of sovereigns more generally under IRB, we see no justification for applying a different approach for this particular sub-category of sovereign risk exposures. Accordingly, our interpretation is that option a), as described in the previous paragraph, should apply.

Experience requirement

7.96 In CP06/3 we set out approach to the experience requirement. This requires firms to have three years' experience of using rating systems broadly in line with IRB requirements before qualifying to use the IRB approach, though the requirement is reduced by a national discretion in the first few years of implementation. We also indicated the main elements of the requirement – operating a system of a type set out by the directive, complying with requirements for senior management knowledge and complying with use test requirements. These requirements were also inserted into the Handbook following 4.2.11.

7.97 Responses were generally favourable but some participants believe the wording of current guidance may discourage firms from enhancing their models. Accordingly, they seek clarification that as models evolve the 'clock' will not start again in relation to the test.

7.98 **Our response:** We confirm that the experience requirement is only related to the initial IRB approval of a firm's portfolios and not subsequent changes. In addition, while we discussed adopting the national discretion in CP06/3, we intend to make this clearer in the Handbook text. This will include a reference in the experience requirement rule (BIPRU 4.2.11) to the transitional provisions reducing the three year experience requirement to one year for firms wishing to use Retail or Foundation IRB approaches until the end of 2009 and for two years for the advanced approach until the end of 2008.

Conversion factors

7.99 In CP06/3 we made a number of relatively minor comments on conversion factors. We advised firms that our interpretation of the CRD was that own estimates of conversion factors extended to all product types, and not just a limited range of instruments. We summarised the results of the TBR and in particular welcomed comments on whether more guidance was needed on the treatment of any settlement-related exposures not covered by the TBR. We advised firms of the guidelines on conversion factors in CEBS CP10 and of the work of the new UK industry expert group looking at issues surrounding EAD/conversion factors.

7.100 There was no specific feedback on the comments in CP06/3 or BIPRU text relevant to conversion factors in the formal responses. However, the joint-industry response indicated that their comments on this material would be incorporated into the paper subsequently produced by the industry expert group on this subject and endorsed by the CRSG.

7.101 **Our response:** We are considering how to respond to the issues raised. Most do not require amendments to BIPRU text. One exception is a request to delete the reference in BIPRU 4.3.120 to settlement exposures as being included in the exposures to be covered by conversion factors. We remain of the view that settlement exposures should, to a greater or lesser extent, be subject to our requirements in this regard. However, we would like to pursue further with the industry the appropriate scope of this requirement. Accordingly, we propose to delete the express reference in 4.3.120 to settlement exposures, as we do not think the explicit reference is determinate.

Maturity

7.102 In BIPRU 4.4.67 we set out our rules regarding maturity calculations for exposures to corporates, institutions and sovereigns.

7.103 Some industry members were concerned that the resources required to meet the requirements would be disproportionate to the real economic benefit of using a more sophisticated approach. In particular, the industry commented that our implementation of the European directives uses the national discretion requiring all IRB exposures to use cash-flow schedule to measure maturity rather than the more straightforward approach available.

7.104 **Our response:** We think that our approach in this respect may have been misunderstood in the above response. The discretion is to apply the explicit maturity treatment, and does not prevent the use of the simpler conservative maturity estimate as set out in BIPRU 4.4.67(6).

Collective investment undertakings (CIUs)

7.105 CRD Article 87(11)(12) provides treatment for calculating the risk-weighting of CIUs based on the characteristics of its constituent exposures. Article 87(11) prescribes guidance in circumstances where firms can identify these characteristics by ‘looking through’ to the underlying exposures, but Article 87(12) provides treatment when the identity of the exposures is unknown.

7.106 A number of respondents commented that the copy-out language of BIPRU 4.9.11, which incorporates Article 87(12), is unclear and contradictory, for it also prescribes a 'look through' treatment despite the fact that the nature of the underlying exposures is unknown. The industry asked how this can be applied in practice.

7.107 **Our response:** We agree that the language in this area is far from clear. For some months these linguistic uncertainties have been explored by CEBS through the CRD Transposition Group (CRDTG). The output of this is published on their website[4].

The CRDTG was launched by the Commission in late 2005. The objective of the CRDTG is to facilitate correct and coherent transposition of the CRD in Member States' legislation. To this end, the CRDTG responds to questions on CRD interpretation posted on its website. This process aims to identify possible differences in national transposition where these could cause problems, and to develop proposals on how to address these problems.

We support the work of this group and so have sought to adopt its recommendations. Given the complexities inherent in this area we have included a flowchart at the end of this chapter to help firms understand the guidance and will insert additional guidance in 4.9.11.

Equity exposures

7.108 In BIPRU 4.7 we outlined our approach to equity exposures under the IRB approach. This included the definition of equity exposures and the different approaches available for calculating risk weighted exposure amounts.

7.109 The industry commented that there was no definition of ancillary service undertakings in the BIPRU text.

7.110 **Our response:** The definition can be found in the main Glossary to the FSA Handbook as 'an ancillary insurance services undertaking, an ancillary banking services undertaking or an ancillary investment services undertaking'. These three undertakings are also separately defined in the main Glossary.

7.111 The industry commented that the definition of private equity exposures was unclear with respect to hedge funds.

7.112 **Our response:** We consider the relevant distinction is between equity exposures that are in sufficiently diversified portfolios and those that are not. We do not intend to give guidance on the meaning of 'sufficiently diversified portfolios' but would suggest that hedge funds are in general less likely to be well diversified.

7.113 The industry questioned the approach taken where credit protection is obtained on an equity position. When applying collateral, respondents were unclear how this would be accounted for under the simple risk weight approach as the CRD – and so BIPRU – is silent on this issue.

4 www.c-ebs.org/crdtg.htm.

7.114 **Our response:** We see the same issue applying to other equity approaches, and our understanding is that collateral cannot be recognised in the same way for equity exposures as credit risk exposures. However, we are unclear about the circumstances under which a firm would have a collateralised equity position in the banking book. In our view, collateral on such a position would need to be undertaken via a collateralised guarantee. If this is the case, the unfunded credit protection approach should be used to determine the exposure to the protection provider, and the collateral rules used to take account of collateral. If there is a direct collateralisation of an equity exposure, we would encourage a discussion to ensure that an appropriate treatment is applied. In addition, the industry sought clarification as to whether the treatment for unfunded credit protection under the PD/LGD approach prevents firms from adjusting the LGD. It is the case that the CRD prevents firms from adjusting LGD.

7.115 The industry sought clarification on the definition of an 'equity position'.

7.116 **Our response:** This should be read to mean the same as 'equity exposure' rather than a trading book position.

Equity derivatives

7.117 In BIPRU 4.7.10, we outlined our approach to the use of credit derivatives and short cash positions held in the non-trading book to offset long positions. Some industry members commented that this rule lacks clarity.

7.118 We intend to align our approach in this area to that used for large exposures: only firms with internal market risk models may use delta-weightings positions to calculate exposure values for equity positions.

Specialised lending

7.119 In BIPRU 4.5, we outlined the IRB treatment of specialised lending, including structure of a rating system, assignment of exposures, calculation of risk weighted exposure amounts and calculation of expected loss amounts. The industry made a number of comments on this.

7.120 Respondents were particularly concerned that the BIPRU text refers back to the Basel Revised Framework and suggested that this text is included in BIPRU. In which case, 4.5.12 (giving a brief summary of the factors that should be taken in to account when attributing a risk weight to specialised lending exposures) would become redundant. We will endeavour to take account of these comments when redrafting the Handbook.

7.121 The industry were concerned by how they might demonstrate their 'underwriting characteristics and other risk characteristics are substantially strong for the relevant category' as required by BIPRU 4.5.10 R (2).

7.122 **Our response:** We consider that the guidance provided in BIPRU 4.5.11G sufficiently clarifies 4.5.10R.

7.123 The industry also requested that BIPRU 4.5.11G give further guidance for as to how a firm can demonstrate that 'its standards exceed those of the slotting criteria'.

7.124 **Our response:** We note that this issue was considered prior to CP05/3 and that the guidance added was agreed upon. While we appreciate that there may be some degree of uncertainty in applying this guidance, we feel that over time a standard will develop to ensure that this is applied consistently across firms.

7.125 The industry suggested credit quality steps were used rather than credit grades in BIPRU 4.5.11(3) to give consistency with other areas of BIPRU and allow flexibility if and when the mapping of credit quality steps evolves over time.

7.126 **Our response:** While we agree with the principle expressed by respondents, we note that the grades referred to in BIPRU 4.5.11 are unlikely to correspond with the credit quality step boundaries. While we are committed to using credit quality steps for a wide range of purposes, we feel that the most transparent method in this area is to reference rating grades as proposed in CP05/3. We think this Handbook text, being guidance, will be sufficiently flexible if our view on specialised lending exposures changes over time.

7.127 Some respondents expressed concern that the specialised lending slotting treatment could only apply to lending through a special purpose vehicle (SPV). They gave other examples of lending, particularly involving income producing real-estate, to suggest that these should also be considered specialised lending.

7.128 **Our response:** We agree that the intention of the rule was not to exclusively apply to lending via an SPV and we do not think the Handbook implies this. The provisions of BIPRU 4.5.3R outline the principles that must be considered when determining whether an exposure qualifies as specialised lending and BIPRU 4.5.3R(3) in particular states that the income generated by the assets should be 'the primary source of repayment' of the exposure, but not necessarily the sole one – which may be the case with an SPV.

We note that CEBS guidance states some requirements 'do not need to be met in full', recognising that it is difficult to precisely define what is a specialised lending exposure. As such, we feel that it would be extremely difficult to capture all scenarios that should be considered specialised lending by simply adding further guidance. We note that respondents suggest we take an approach that recognises the economic substance of a transaction, and we hope that where there is uncertainty, we can work with firms to understand the substance of a transaction to ensure consistent application of the rule.

Leasing

7.129 In CP06/3 we set out our view as to the most appropriate interpretation of the ambiguously drafted provision of the CRD relating to the calculation of capital requirements for residual values arising under lease contracts.

7.130 The joint-industry response requested that we include our proposed interpretation more clearly in the BIPRU provisions. The Finance and Leasing Association sought a more favourable treatment which would equate 't' with the full lease term. They suggested that not adopting this approach would lead to a different treatment in the UK than elsewhere in the EU.

7.131 **Our response:** We continue to think the approach we proposed in CP06/3 is the more appropriate one. We agree with the joint-industry response that we should amend BIPRU 4.9.6 to make our approach clear in the text. We have, as we indicated in CP06/3, discussed the matter with other competent authorities and are confident that our proposed approach is not more conservative than is generally the case elsewhere in the EU.

Intra-group exposures

7.132 BIPRU 4.2.26(6) allows the permanent exemption of certain connected exposures from the IRB approach to the standardised approach. Exposures not transferred to the standardised approach continue to be risk weighted using the IRB approach.

7.133 The joint-industry response requested greater clarity as to how a group should assign intra-group exposures between the standardised and IRB approaches.

7.134 **Our response:** It is for firms to determine (subject to the conditions) which exposures are transferred to the standardised approach. Firms should have a policy that provides for the identification of the exposures to be transferred to the standardised approach and those that are to remain on the IRB approach. The policy should be consistently applied. We do not intend to add any additional guidance on this matter. We consider that to do so could potentially run the risk of unintentionally restricting the ability of firms to transfer eligible exposures from the IRB to standardised approach.

Credit risk mitigation in the IRB approach

7.135 Most comments in this area related to the applicability of the specific credit risk mitigation (CRM) rules to advanced IRB portfolios and covered two issues.

7.136 The first set of comments related to the navigability of the CRM rules for firms using advanced IRB, particularly when and how the rules of BIPRU 5 and BIPRU 4.10 apply to these firms.

7.137 **Our response:** We acknowledge there is a great deal of complexity between these rules, but we have found it particularly difficult to add further guidance that is both clear and accurate. Any Handbook changes suggested by respondents have been included where practicable, but we must recognise that the CRD itself has many interdependencies between its requirements and these are inevitably reproduced through the copy-out process. We hope the addition of a navigational aid in this area will assist all firms which need to find relevant rules and guidance relating to CRM issues.

7.138 The second set of comments particularly concerned our discussion in CP06/3 of an adjusted exposure approach for financial collateral. Firms are concerned that our approach suggests that particular LGD estimation techniques are not available to firms using advanced IRB. Our intention was simply to confirm that for advanced IRB, unlike foundation IRB, the secured LGD used in the calculation of risk-weighted exposure amounts must meet all of the relevant minimum requirements for an own-estimate of LGD.

7.139 Respondents did not suggest the addition of specific Handbook guidance in this area and we do not intend to include any as our discussion merely restates existing Handbook requirements.

7.140 The joint-industry response also recommended clarification that a property valued on an enterprise basis in line with guidelines from the Royal Institute of Chartered Surveyors (RICS) would be acceptable. BIPRU 4.10.6, relating to the Foundation IRB approach, states that the value of the property should not materially depend on the credit quality of the obligor. This is to ensure that the full value of the collateral can be realised when the obligor defaults. We do not intend to endorse a particular valuation methodology, but we recognise that when the value attributed to the property for these purposes (which may be less than the market value) will not be adversely affected by the default of the obligor (even when the market value of the property would be affected), this value can be used for the purposes of the requirement and we will add guidance to this effect. A similar question relating to the use of own estimates of LGD (BIPRU 4.3.110) is addressed separately under paragraph 7.70 of this chapter.

7.141 Respondents asked us to clarify that the 'borrower' in the rules relating to purchased receivables as collateral corresponded to the 'seller' in the general rules relating to purchased receivables.

7.142 **Our response:** One section of BIPRU relates to a firm having purchased receivables onto their balance sheet (BIPRU 4.8) and the other relates to using receivables as collateral (BIPRU 4.10). In the former case, the 'obligor' is the receivables obligor to whom there is an exposure. The 'seller' is the seller of the receivable. In the latter case, the terms 'borrower' and 'obligor' are interchangeable and refer the counterparty to which there is an exposure. The term 'receivables obligor' is used to describe the obligor in the receivable transaction that is being posted as collateral. As the two types of transaction are very different (even though they both involve receivables) and have a completely different context, we do not think it is inappropriate to use the term 'obligor' for two different roles.

Other issues

CRD criticisms

7.143 We also received a number of comments which were explicitly criticisms of the IRB framework as set out in the CRD, as opposed to our implementation of the CRD. Examples of these included the requirement for LGDs to be appropriate for an economic downturn and the calibration of the capital requirements for credit card exposures. Criticisms of the CRD itself are outside the scope of this consultation and so we do not provide fuller feedback in this regard.

BIPRU 4 changes

Reference	Comments	Response
4.2.7	Requests for further clarification of Use Test language.	BIPRU text refined in conjunction with Feedback Statement Text.
4.3.27	Request for BIPRU to make clearer that validation requirements apply equally to PD, LGD and EAD	Text has been amended to make this clear
4.3.38 (2)	Requests for a change to the 1-in 25 year calibration of the ratings migration stress test to be changed.	While we were not willing to comply with this request, additional guidance has been inserted to clarify this requirement.
4.3.50.G(3)	The language 'at least as high as' is a more prescriptive definition than 'should not be lower' in CP 7.43 and request the latter CP text is used in BIPRU	The FSA agrees that 'at least as high as' is a more prescriptive definition than 'should not be lower' in CP 7.43. We propose to change the text to: 'The standards required by BIPRU 4 for an external model should not be lower as those for internal models.'
4.3.54	Respondents did not want us to define a quantitative materiality threshold for days past due in the Definition of Default. They also wanted this provision to be applied at the level of obligation, as opposed to total exposures to an obligor, where an obligation approach to rating is being used.	Text has been amended to reflect our revised position that firms have internal policies for determining materiality of defaults for internal risk measurement and management purposes. The text has also been amended to make it clear that materiality may be applied at the level of individual obligation, where such a rating approach is being used.
4.3.76	Request that the process for analysing material drivers be limited by inclusion of language in the CP06/3 Chapter 7, but not repeated in BIPRU text	We have added, 'This does not require an intensive analysis of all factors' to 4.3.76 (3)
4.3.91	Request that BIPRU be amended to make clear the acceptability of approaches to PD quantification based on market data for Low Default Portfolios	Text has been amended to make this clear
4.3.99	Request to permit firms to derive downturn LGDs by any of: estimating them directly; or converting default weighted average LGDs into downturn LGDs through the use of internally developed formulae; or, as a fall-back option, converting default weighted average LGDs into downturn LGDs through the use of the formula proposed by the US authorities.	Additional guidance has been inserted which specifically allows firms to derive downturn LGDs through internally developed formula which convert default weighted average LGDs into downturn LGDs, as well as directly. We did not feel able to adopt the proposed US formula at this stage.
4.3.73	Requests for firms to be allowed to use exposure weighted averages as opposed to default weighted averages for LGD (and EAD).	We cannot fully accommodate this request as, if the exposure weighting produced a materially different answer, it would produce inaccurate measures of LGD for the exposures. However additional guidance has been inserted which accommodates the calculation of historical averages on the basis of exposure weighting, provided the final estimates of what LGDs are expected to be over the long run are on a default count basis.
4.3.92	Requests that the inclusion/exclusion of cures should be consistent for both LGD and PD estimation, with an appropriate cross reference made.	Text amended to make clear that where cures are excluded from estimates of LGD, they may (but not 'must') also be excluded from PD estimates
4.3.120	Request to delete reference to settlement risk from exposures to be covered by conversion factors	We remain of the view that settlement exposures should be covered to some extent and this needs further discussion. However, we have deleted the explicit reference as this is not determinate.
4.9.11	Collective Investment Undertakings. Industry request clarification of the CRD requirement to 'look through' to the underlying assets when the constituent components of the fund are unknown.	Agree. Additional guidance has been inserted.

Diagram outlining the IRB treatment of CIUs

Article 87 (11) are **both** of the following statements true?

1. **Does the CIU comply with the following conditions (Annex VI, part 1, paragraph 74 -75)?**
   - (a) the CIU is managed by a company which is subject to supervision in a Member State or, subject to approval of the credit institution's competent authority, if:
     - (i) they are managed by a company which is subject to supervision that is considered equivalent to that laid down in Community law; and
     - (ii) co-operation between competent authorities is sufficiently ensured;
   - (b) the CIU's prospectus or equivalent document includes:
     - – the categories of assets the CIU is authorised to invest in,
     - – if investment limits apply, the relative limits and the methodologies to calculate them;
   - (c) the business of the CIU is reported on at least an annual basis to enable an assessment to be made of the assets and liabilities, income and operations over the reporting period.
2. **Is the credit institution aware of the underlying exposures of the CIU?**

Yes

Is the credit institution able to calculate the risk-weighted exposure amounts and expected loss amounts in accordance with the IRB Framework? I.e. can they give individual ratings for each asset?

Yes

Credit institution may calculate the risk-weighted exposure amounts and expected loss amounts in accordance with the IRB Framework.

No

For equity exposures: Credit institution shall calculate the risk weighted exposure amounts and expected loss amounts in accordance with the IRB 'Simple Risk Weight Approach' as set out in Annex VII, Part 1, paragraphs 17 to 19 (190% - 370%).

For those exposures where the credit institution is unable to differentiate between private equity, exchange-traded and other equity exposures, it shall treat them as 'other equity exposures' (190%).

For non-equity exposures: The credit institution shall use the **Standardised Approach** where it is aware of the ECAI rating applicable to the exposures, subject to the following modifications:

- (i) exposures are assigned to the appropriate exposure class and attributed the risk weight of the credit quality immediately above the credit quality step that would normally be assigned to the exposure.
- (ii) exposures assigned to the credit quality steps which a weight of 150% would normally be attributed, are risk weighted at 200%.

No

If not fully aware of all the exposures

Ar 87 (12) Credit institution may, or rely on a **Third Party** to **calculate the average risk weighted exposure** amount of the underlying exposures, provided there is sufficient clear, up-to-date information (e.g. from the mandate etc) such that the correctness of the calculation is adequately ensured. Refer to CEBS Transposition Group guidelines http://www.c-ebs.org/crdtg.htm.

Where a mandate is available this can be used may be used in accordance with the requirements of annex VI, part 1, parag 77. This assumes the composition is the highest possible in accordance with the mandate and then allocates risk weights in accordance with Ar 87 (12) (2).

For equity exposures: Credit institution shall calculate the risk weighted exposure amounts and expected loss amounts in accordance with the IRB 'Simple Risk Weight Approach' as set out in Annex VII, Part 1, paragraphs 17 to 19 (190% - 370%).

For those exposures where the credit institution is unable to differentiate between private equity, exchange-traded and other equity exposures, it shall treat them as 'other equity exposures' (370%).

For non-equity exposures: The credit institution shall use the **Standardised Approach** subject to the following modifications:

- (i) exposures are assigned to the appropriate exposure class and attributed the risk weight of the credit quality immediately above the credit quality step that would normally be assigned to the exposure.
- (ii) exposures assigned to the credit quality steps which a weight of 150% would normally be attributed, are risk weighted at 200%.

Or, alternatively

If not fully aware of underlying exposures:

Ar 87 (12) Credit institution shall look through to the underlying exposures and calculate the risk weighted exposure amounts and expected loss amounts for all exposures in accordance with the IRB 'Simple Risk Weight Approach' as set out in Annex VII, Part 1, paragraphs 17 to 19.

For equity exposures: To be calculated in accordance with the 'Simple Risk Weight Approach'. Where the credit institution is unable to differentiate between private equity, exchange-traded and other equity exposures, it shall treat the exposures concerned as other equity exposures (370%).

For non-equity exposures: These are also assigned to one of the classes set out under 'Simple Risk Weight Approach' with unknown exposures to be treated as 'other equity exposures'., via a mapping process based on a risk assessment of the underlying exposure i.e. exchange traded debt rating to map to exchange traded equity rating 290%, where underlying exposures unknown, map to other equity 370%.

8 Concentration risk

Introduction

8.1 CP06/3 dealt with our proposals for concentration risk, including:

- the integrated groups regime;
- our implementation of national discretions not consulted upon in CP05/3;
- clarification of exposure values in light of the Basel/IOSCO Trading Book Review (TBR);
- our use of delta-weighted values for the treatment of options; and
- a degree of redrafting of BIPRU 10 for increased clarity.

8.2 As stated in CP05/3 and CP06/3, the proposals for concentration risk were based on the 'harmonised' framework proposed in CP97 amended in light of the comments received previously and the developments in the draft CRD.

8.3 In addition to the responses received on the specific questions in our consultation exercise, we invited respondents to provide comments and feedback on the full text of the BIPRU 10 on Concentration Risk. We received a range of helpful comments and have taken them into account in our final review of the draft text.

Response to individual questions

Exposure values

> Q29: Do you support our proposals for measuring exposure value in line with the CRD, including using the internal model method?

8.4 In CP06/3 we indicated to the industry that the draft Handbook text consulted on as part of CP05/3 did not fully capture the CRD provisions for measuring exposure values. This included, in particular, measuring exposure values for over-the-counter (OTC) derivatives generally and for credit derivatives.

8.5 In addition to this, significant developments had occurred since publishing CP05/3, such as the inclusion of the TBR in the text of the CRD. These developments saw a new standardised method introduced for calculating exposure values for OTC derivatives (defined as financial derivatives in the Handbook text) and a new internal model method for calculating the exposure values for OTC derivatives, securities financing transactions, margin lending transactions and long settlement transactions. Article 106 confirmed these new methods would also apply to calculating large exposures arising from these instruments and transactions.

8.6 In CP06/3, we asked respondents whether they supported the changes made to the BIPRU text in this area. All respondents confirmed they supported our proposal to bring the measurement of exposure values in the BIPRU text in line with the CRD.

8.7 Respondents stated that the description of netting given in CP06/3 paragraph 8.6 was not fully reflected in the text of BIPRU 10.4.

8.8 **Our response:** Based on the positive feedback we received from firms, we will continue with our proposed approach to exposure value calculation in the BIPRU text. In addition, we propose to clarify BIPRU by including text on how a long position in the non-trading book with an offsetting credit derivative will give rise to a zero exposure for counterparty and position risk.

Collateral concentration risk

Q30: Do you support our revised approach to collateral concentration risk?

8.9 As indicated in FS05/1, having listened to industry views on the non-trivial system costs and difficulties in obtaining the collateral concentration risk information, we proposed in CP06/3 to no longer require firms to include this information in their reporting under the concentration risk regime. Instead, we proposed to impose a new requirement on firms to have a documented policy for addressing the prudential concerns which arise in this context.

8.10 Having included this new approach in the draft text Handbook, we asked firms to confirm whether the new proposals provided the right balance of measures to address the prudential concerns without burdening them with excess reporting requirements.

8.11 All respondents fully supported our proposals not to require firms directly to report their collateral concentrations. They also agreed the new requirement to have a documented policy outlining how firms deal with collateral concentrations was proportionate.

8.12 Respondents highlighted a concern among firms that there may be an 'inferred' obligation on them in the text of BIPRU 10.12.1R to monitor indirect exposures to collateral issuers.

8.13 Stress testing of collateral was also raised in the joint-industry response as a concern for its members. The view was that this stress testing added more costs but little benefit to the risk management of their firms.

8.14 **Our response:** We welcome respondents' support for our revised proposals in respect of this issue. We are also satisfied that our proposals in this area are proportionate and effective to address the prudential concerns which arise as a result of a firm's collateral concentrations. We do not propose to make further amendments to the text. The stress testing of collateral by firms is a requirement which is drawn from the CRD itself. As such, it is binding on us and other Member State regulators.

Treatment of put options

Q31: Do you support our proposed approach for calculating the exposure value of put options?

8.15 In CP06/3 we included proposals which would allow firms with CAD1 or value-at-risk (VaR) model recognition to use an internal model for calculating the 'issuer risk' exposure generated by an option as a delta-weighted value of the underlying financial instrument. We also stated that when calculating the exposure generated by the put option, firms which use an internal model to calculate a delta-weighted value would only be entitled to use the current market price of the underlying financial instruments in their calculations. For firms without an internal model, we continued with our proposal to allow them to use the lower of strike price or current market price but no delta-weighted calculations. In calculating issuer risk, these firms were to assume a delta figure of one rather than one calculated by an internal model.

8.16 Our approach to the treatment of issuer risk arising from options was well received by all respondents who welcomed our decision to allow firms to use a delta-weighted value for their issuer-risk exposure calculations.

8.17 However, respondents sought clarification on the scope of this new treatment; that is, would firms be allowed to calculate a delta-weighted figure for a call option as well as a put option? The question arose as a result of the text of CP06/3 referring only to put options when describing the new delta-weighting treatment.

8.18 **Our response:** We welcome the industry's support for our proposal to allow firms to use an internal model for calculating the delta-weighted 'issuer risk' exposure generated by an option as a delta-weighted value of the underlying financial instrument. We confirm this new treatment applies equally to written put, purchased put and purchased call options as per the text in BIPRU 10.4.22. We will also make some small changes to clarify the BIPRU text relating to options.

Draft Handbook chapter on concentration risk

Q32: Do you support our proposed draft of BIPRU Chapter 10 on concentration risk?

8.19 In CP06/3 we outlined a number of changes to BIPRU 10 and invited firms to provide feedback on them. The changes made to the text were designed to reflect either amendments to bring existing BIPRU rules in line with the CRD, to clarify existing BIPRU text relating to certain issues or to add new text to incorporate a previously unused national discretion. The changes in the BIPRU text related to:

- Bills of Trade exemption to fully reflect Article 113(k) of the CRD[1];
- clarifying text about securities financing transactions and repo agreements[2];
- exemption for exposures to local and regional governments which are determined to be government risk in line with Article 115 CRD[3];
- an exemption for exposures to recognised third-country investment firms, recognised clearing houses, designated exchanges, recognised investment exchanges and designated investment exchanges[4]; and
- 50% exemption for exposures backed by real estate in other EEA member states which have taken up the exemption in Art 113 CRD[5].

8.20 **Our response:** All respondents on these aspects expressed full support for our intended changes to the BIPRU text. We intend to keep the text as it currently stands subject to adding a maturity and own funds condition to the exemption for exposures to third-country investment firms, recognised clearing houses, designated exchanges, recognised investment exchanges and designated investment exchanges. This will bring the exemption into line with the requirements of the directive.

Integrated groups regime

Q33: Do you support our clarifications concerning the conditions for availability of the preferential treatment of intra-group exposures?

Q34: Are the proposals for the integrated groups regime for concentration risk purposes sufficiently clear?

Q35: Do you support our proposals for addressing concerns regarding the timing of the introduction of the integrated groups treatment for concentration risk?

8.21 The integrated groups regime, where the eligibility conditions are met, provides for the modification of the large exposure limits in respect of intra-group exposures. A firm may choose to operate the regime, providing all conditions are met. Eligibility to treat exposures under the integrated groups regime for concentration risk is not related to whether an exposure is held on the standardised or the internal ratings based (IRB) approach.

8.22 In broad terms, an exposure between a firm and another firm that are both members of the same UK integrated group (UKIG) will be exempt from the large exposure limits. Where a UKIG firm has an intra-group exposure to a firm within the UKIG firm's wider integrated group (WIG) or that UKIG firm's residual block (RB), the exposure is subject to modified large exposure limits which permit a greater level of exposure than if the exposures were considered on the basis of a single firm's exposure to a single intra-group counterparty.

1 BIPRU 10.6.3(13).
2 BIPRU 10.4.27.
3 BIPRU 10.6.3(7).
4 BIPRU 10.6.3(9).
5 BIPRU 10.6.3(12).

8.23 BIPRU 10.8 sets the conditions and limits applicable where a firm establishes a UKIG and a RB, but no WIG has been set up.

8.24 BIPRU 10.9 sets out the conditions and limits applicable where a firm establishes a UKIG, a WIG and a RB. A WIG must be set up by a waiver process.

8.25 A transitional arrangement has been provided (BIPRU Transitional TP10 and TP11) which firms may choose to operate as an alternative to the integrated-groups regime set out in BIPRU 10.8-10.10, providing the relevant conditions are met. Under the transitional:

- for domestic (intra-UK) exposures, firms operate, in effect, the new integrated groups regime;
- for cross-border intra-group exposures, firms are able to continue applying existing Handbook rules and guidance (as included in the BIPRU Transitionals TP10 and TP11), which relate specifically to cross-border intra-group exposures; and
- the treasury concession rules (BIPRU 10.7) will apply.

The transitional arrangement will be available to banks, building societies and investment firms until 31 December 2009, subject to new EU legislation being introduced.

Single chapter to contain all integrated group/intra-group issues

8.26 The joint-industry response commented that many firms manage integrated groups arrangements and intra-group exposures centrally. They requested us to recognise this and consider creating a separate section in the Handbook for all integrated groups material.

8.27 Our response to this point is set out in Chapter 5 (standardised approach) at paragraph 5.49.

Decoupling of 0% standardised approach risk weighting from the integrated groups regime's modification of large exposure limits

8.28 The joint-industry response noted its full support for the de-coupling of the treatment of intra-group exposures for concentration risk from those for capital requirements. It also stated that including intra-group exposures risk-managed under the advanced approaches in the integrated-groups regime is a positive step for the associations' members.

8.29 **Our response:** We note respondents' comments welcoming the decoupling of the treatments, which were developed following discussions with an industry expert group.

Complexity

8.30 The joint-industry response stated that it considered the treatment of intra-group exposures was becoming clearer but it continued to be complex and had become more complex with the introduction of quasi-groups and concepts such as the 'UK consolidated group' and 'concentration risk group counterparty'. It also thought the proposals would not lend themselves to an automated approach and would rely heavily on a significant level of manual intervention. The response also stated that it would be disappointed if the integrated groups treatment were proposed as part of the large exposures review.

8.31 **Our response:** We are pleased that respondents think that the regime is becoming clearer.

We agree there is a degree of complexity attaching to the proposals. However, we have made, and continue to make, every effort to keep this to a minimum. To a large extent, complexity reflects the diversity of group arrangements entered into by the financial services industry and the prudential considerations to which this gives rise.

The terms 'UK consolidated group' is defined in the New Glossary definitions of the Handbook. The Glossary directs the reader to BIPRU 8.2.1. Within the context of the integrated groups treatment, the term is used in the Handbook materials (BIPRU 3.2.28 CP06/3 reference) that describe the consolidation types that qualify – subject to the other conditions also being met – for the integrated groups treatment. The term 'concentration risk group counterparty' is also defined in the New Glossary definitions and is a form of drafting 'shorthand' to describe the undertakings that qualify for the modification of the large exposures treatments available through the operation of the integrated groups large exposures treatment.

UK integrated group – conditions and eligibility

8.32 The integrated groups regime is set out at BIPRU 10.8 to BIPRU 10.10. The joint-industry response stated that firms found these requirements difficult to interpret and wanted us to set out in full the exemptions, limits and capital requirements applying at the solo, UKIG and consolidated level.

8.33 The joint-industry response sought clarification that a UKIG could consist of one single entity. It also thought it would not be possible to form a WIG without forming a UKIG. This was thought to be a particular issue for overseas firms that may be excluded from being able to take up the modification of the large exposure limits provided by the integrated groups treatment.

8.34 The joint-industry response noted there was a difference in the wording of the conditions for the formation of the UKIG as set out in BIPRU10.8 and the similar conditions set out in BIPRU 3.2 for the 0% standardised approach intra-group risk weighting. Specifically that BIPRU 10.8.3(4) refers to a counterparty being 'incorporated in the UK', while BIPRU 3.2.25(1d) (CP06/3 reference) refers to a counterparty being 'established in the UK'. Clarification was sought as to whether there was a difference in interpretation between the two sections. Additionally, the respondent stated the reference to the Council Regulation on insolvency proceedings was unhelpful and that the reference should be to 1346/2000/EC. It was noted that the document, while of direct effect, was not addressed to firms and its subject matter was not financial regulation. The respondent said that the conditions for eligibility should be included in full within the Handbook text.

8.35 The joint-industry response sought clarification on the inclusion of a solo consolidated entity into a UKIG.

8.36 The joint-industry response queried the interaction of the connected counterparty requirements (BIPRU 10.3.9) with the integrated groups regime for large exposures.

8.37 **Our response:** BIPRU 10.8 and BIPRU 10.9 have the effect of 'turning off' the limits set out in BIRPU 10.5. Instead, the limits are replaced with limits set out at BIPRU 10.8.7 and 10.9.6. These new limits operate at the level of the UKIG (that is, treating the UKIG as if it were one entity) making a qualifying intra-group exposures to firms in its RB and, where established, to firms within its diverse blocks (in the WIG). This is instead of applying the limits against the individual firm that makes the exposure. We included a flowchart and table in Annex 7 to CP06/3. We propose including an updated version within an Annex to BIPRU 10.

We confirm it is not possible to form a WIG without first having formed a UKIG. We also confirm that a UKIG can consist of one single entity.

We note the comment concerning the difference in wording of the conditions for the formation of the UKIG as set out in BIPRU10.8 and the similar conditions set out in BIPRU 3.2.25 for the 0% risk-weighting for intra-group exposures. As noted in paragraph 5.49, we intend to add text to BIPRU 3.2.25 (1d) to clarify that this includes a firm incorporated in the UK and this will have the effect of aligning the text. The Council Regulation on insolvency proceedings reference should be to 1346/2000/EC – it is the relevant European legislation in respect of insolvency proceedings

We confirm that, in our view, if an entity has been solo-consolidated into a UK firm in line with BIPRU 2.1, and that UK firm is a UKIG firm, then for the purposes of integrated groups treatment for concentration risk, the intra-group exposures of this solo-consolidated entity would obtain the same treatment as if the UKIG firm had made the exposure. This would be the case if the solo-consolidated entity were a UK or non-UK firm. (We take the same approach for the purposes of the 0% standardised risk weight).

The connected counterparty requirements in BIPRU 10.3.9 are not relevant to exposures subject to the integrated groups regime for large exposures. Where a firm meets the conditions and chooses to operate the integrated groups treatment (BIPRU 10.8 and BIPRU 10.9), the integrated groups rules have the effect of 'turning off' the limits in BIPRU 10.5 (which include limits relevant to a firm's exposures to connected counterparty exposures). The limits in BIPRU 10.5 are replaced by limits applicable to exposures of the UKIG to firms within its diverse blocks within its WIG or exposures of the UKIG to firms within its RB.

UKIG capital resources

8.38 Respondents sought further guidance on calculating on capital resources for a UKIG. In particular, within BIPRU 10.8.10, they thought it would be useful to have more guidance to determine which entities need to be deducted under that provision.

8.39 **Our response:** We note the request for further guidance for calculating capital resources for a UKIG. The techniques and provisions within BIPRU 10.8 are relevant to the approach to be taken for calculating capital resources of a UKIG. In the case of a UKIG, it is in effect a 'sub consolidation' and the solo level rules for calculating capital resources are not appropriate. In calculating a UKIG's capital resources, there is a need to adjust for transactions between members of the same UKIG if there would otherwise be double-counting or an overstatement of the UKIG's capital resources.

WIG diverse blocks

8.40 The joint-industry response welcomed the indication in CP06/3 that the reduced correlation is a major consideration in determining diverse blocks and asked if this could be included into the Handbook text. It also commented that there was little guidance on the proposed 'diverse blocks treatment' and firms would appreciate more material or discussion of what we expect in this area.

8.41 **Our response:** We note that respondents welcomed the comment in CP06/3 that diverse blocks indicated reduced correlation. We do not intend to provide more detailed guidance in the Handbook on this issue. This is because by doing so we may unduly restrict the availability of the treatment. However, as requested by the industry we are including some words of guidance in BIPRU 10.9.8 to mention that the diverse blocks should reflect appropriately low levels of correlation. A waiver is required for a WIG to be established and as part of that process a firm should discuss its proposals with us.

Guidance

8.42 The joint-industry response welcomed the pragmatic interpretation of the condition regarding 'the prompt transfer / repayment' criterion contained at (BIPRU 3.2.30 and 31 – CP06/3 references) for the 0% standardised risk weighting. It thought the same interpretation should apply within the context of the integrated groups regime.

8.43 The joint-industry response stated the diagrams and tables within Annexes to CP05/3 were useful and helpful in understanding the policy for the integrated groups regime and would like to see such materials included in the FSA Handbook. Respondents requested the inclusion of the treatment of exposures to and from branches in the table. They also suggested that including worked examples in the Handbook would be useful.

8.44 **Our response:** We note that respondents welcomed the guidance provided in connection with the 'prompt transfer/repayment' criterion. The materials at BIPRU 10.8 and 10.9 cross refer back to this guidance and so the purposive interpretation also applies in the context of the integrated groups treatment.

We note that respondents found the diagrams and table that appeared in Annex 7 of CP06/3 useful. We intend to include updated versions into an Annex to BIPRU 10.

Branches do not exist independent of the entity to which they are a part. The eligibility of the exposures of a branch for the integrated groups treatment for large exposures will depend on the status of the entity to which it is a branch.

We do not intend to include worked examples in the Handbook. However, we are willing to work further with the industry to develop examples that may be of assistance to firms.

Integrated groups – BIPRU transitionals

8.45 The joint-industry response stated that the BIPRU transitionals for the integrated groups regime were complex and not clear. Respondents suggested we had not achieved our stated objective to provide transitionals that would permit a firm to choose between adopting the proposed integrated groups regime or remain on the current large exposure methodologies derived from the current interim prudential

Handbooks. They considered this to be a priority technical issue as the application and impact of the integrated group large exposures treatment on large exposure calculations were a significant concern to many firms, particularly investment firms. The joint-industry response and another respondent noted three exemptions they thought should be included in transitional TP10 for securities and futures firms currently subject to IPRU (Inv) Chapter 10.

8.46 Respondents thought we should copy into the BIPRU Transitional at TP10 and TP11 all parts of BIPRU 10 that would apply in cases where an eligible firm chose to use the transitionals in TP10/TP11.

8.47 The joint-industry response sought clarification of the relationship between BIPRU transitional TP3 2007 capital requirements and the transitionals contained in TP10 and TP11.

Notification

8.48 Respondents did not understand BIPRU Transitional TP 10.22(3) and questioned its purpose.

8.49 **Our response:** We note that respondents did not agree all appropriate investment firm intra-group exemptions had been included in the proposed transitionals and proposed some additional measures to be included. Respondents identified the relevant exemptions to be carried forward for securities and futures firms should include IPRU (Inv) 10.192(1g), 10.192 (n) and 10.192(2c) which applies 10.192 (2a and b). Having considered the additional exemptions proposed by respondents, we intend to incorporate them into the BIPRU transitionals for cross-border intra-group exposures. We will include similar provisions for investment management firms, UCITS investment firms and personal investment firms.

In general, we think the transitionals for cross-border intra-group transactions are relatively clear. We do not consider it is practicable to amend them to achieve further clarity given that there are six different regimes that need to be transitioned. We do not, for example, agree with the proposal that we should copy into the TP10 and TP11 transitionals all of those parts of BIPRU10 that would apply if a firm chose to operate TP10/TP11. However, we are available to work further with trade associations on the effect of these transitionals.

We note the request for clarification of the relationship between BIPRU transitional TP3 2007 capital requirements and the transitionals for firms contained in TP10/TP11 for the integrated groups regime. The new integrated groups regime set out in BIPRU 10.8 and BIPRU 10.9 comes into effect on 1 January 2007. A firm that operates BIPRU 10 for concentration risk can choose, for qualifying intra-group exposures, to apply the normal large exposure limits in BIPRU 10.5 or to operate the integrated groups regime set out in BIPRU 10.8 -10.10. Additionally, instead of operating the regime set out at BIPRU 10.8 - BIPRU 10.10, the firm could instead choose to operate the transitional available in TP10 (TP11 for building societies).

A bank or investment firm which continues to operate under the interim prudential sourcebooks rather than BIPRU10 during 2007 as permitted by the transitionals at TP3 can, for its qualifying intra-group exposures, apply the appropriate transitional in TP10 (CP06/3 reference) instead of applying the large exposure requirements set out in the interim prudential sourcebook.

TP11 is relevant to building societies and is written as an exemption to BIPRU 10.5. If a building society were to apply TP3, then BIPRU 10 would not apply and so TP11 would not be relevant.

We have reviewed TP 10.22(3) and we propose to delete it.

Intra-group sale and repurchase and securities lending and borrowing transactions

8.50 In CP05/3, we put forward a proposal for a preferential treatment of certain cross-border intra-group sale and repurchase and securities lending and borrowing transactions. We suggested where such transactions met certain conditions – for including the counterparty in the consolidated group and the degree of collateralisation – we would treat such exposures as exempt from the concentration risk limits.

8.51 In FS05/1 and in CP06/3, we indicated our intention not to take this preferential treatment forward. This was based in large part on the fact that the original proposal was put forward when the TBR was not complete. We considered that in the absence of a more sophisticated approach, calculating exposure values using the comprehensive method was likely to give rise to unduly onerous capital requirements.

8.52 As indicated in FS05/1 and CP06/3, the TBR has now been completed and its outputs incorporated into our proposals. In particular, this has made available the internal model method for calculating expected positive exposure amounts. This we considered made available a more sophisticated methodology for calculating exposure values for these types of transactions and was therefore enough to meet firms' concerns in this regard. So we considered it was no longer necessary to maintain the more simplistic carve-out for intra-group securities financing transactions (SFTs).

8.53 Respondents commented that not including the preferential treatment in question could have a significant impact on firms not adopting the advanced approaches to SFTs and/or for firms with a delayed roll-out trajectory for such approaches.

8.54 **Our response:** We have considered the comments received and think there is a degree of merit in the arguments concerning those firms which have not, or not yet, adopted the internal model method. So we intend to reinstate the proposals for such firms. However, to avoid distorting the incentives, the availability of this preferential treatment will be subject to a requirement that decisions in respect of the partial use and/or roll-out of the internal model method and/or the booking of exposures are not artificially configured so as to reduce regulatory capital requirements through the use of the option. We intend to review this option as part of the EU large exposures review.

We therefore propose to allow a firm which is not making use of the internal model method for calculating exposure values for SFTs to treat as exempt from concentration risk limits – and from calculating the concentration risk capital component – exposures arising directly from intra-group sale and repurchase and securities lending and borrowing transactions, subject to the following conditions:

- the counterparty is a concentration risk group counterparty as defined in the Handbook glossary;
- in the absence of volatility adjustments applied under the comprehensive approach to collateral, the exposure would be no less than 90 % collateralised at all times; and
- the firm confirms to our satisfaction that decisions for the partial use and/or roll-out of the internal model method and/or the booking of exposures are not taken wholly or mainly with the aim of avoiding the large exposures limits or reducing regulatory capital requirements through the use of this option.

Intra-group exposures – treasury concession

8.55 A 'treasury concession' is set out at BIPRU 10.7. It enables a firm to treat qualifying intra-group exposures as exempt up to a maximum of 50% of the firm's tier one and tier two capital after deductions (BIPRU 10.7.1.(2)). The qualifying exposures are those that arise during the course of a firm carrying on either: (i) a treasury role for other members of its group; (ii) a firm lending to its parent surplus cash; or (iii) where a firm operates as a central risk-management function for members of the firms group for exposures arising form derivatives. The concession may also be used within the context of the integrated groups regime.

8.56 The joint-industry response noted that Article 113 (2) of the CRD underpins the proposals for the treasury concession. Given this, it queried our interpretation of 'supervision on a consolidated basis'. It commented that consolidated subsidiaries will be subject to supervision on a consolidated basis. There are also cases where the unconsolidated subsidiaries will also be subject to supervision on a consolidated basis.

8.57 The joint-industry response stated that firms opposed the maturity limit of one year included in the treasury concession at BIPRU 10.7.3 (1a). Respondents thought it arbitrary and would inhibit prudential management of liquidity and market risk where assets held by connected counterparties are of longer tenor. They proposed that the maturity limit be changed to reflect the tenor of the underlying asset. They also stated that firms opposed the limit in BIPRU 10.7.3(1a) limiting the concession to 'loans' and noted this is different from the current policy that does not contain the restriction and is instead expressed in terms of 'exposures'.

8.58 The joint-industry response stated firms opposed the terms of the concession where a firm lends to its parent, in particular that the balance must fluctuate regularly. Respondents stated that some businesses naturally produce a stable surplus, for example private banking, and it is not understood why these funds should not be used as a part of the treasury operation of the group.

8.59 The joint-industry response queried the concession for the restriction to exposures arising from derivatives. It stated that its members believed there should be the ability to transfer exposures for treasury management purposes whether on or off balance-sheet, using derivatives.

8.60 The joint-industry response stated that firms oppose introducing the restriction of treasury concessions to the non-trading book and if continued would represent a change from current policy and the proposal in CP05/3. Firms currently use the treasury concession for both trading and non-trading book exposures.

8.61 **Our response:** Consolidation on a full basis is key to our considerations and gives comfort that a group as a whole is well capitalised. A deconsolidated subsidiary will not qualify for the treasury concession. The CAD waiver (CRD Article 22) removes the main element of the consolidated supervision regime – that is the need to meet the consolidated financial resources test, and so the deconsolidated entity would not meet the criterion for full consolidation.

The treasury concession at BIPRU 10.7 offers a concession for qualifying intra-group exposures. To be eligible the exposure must meet one of the three conditions set out at 10.7.3 (1). In respect of the first concession 10.7.3 (1a) treasury role, we note that respondents seek to increase the maturity limit above one year. However, the one-year limit currently applies to the treasury concession. As set out in CP05/3, we are taking an approach where we are seeking to harmonise the concentration risk regime applicable to all firms. Where the underling CRD text has not undergone substantial change, we have proposed to carry forward the approach set out in CP97. Where there are changes to the directive text, or new national discretions are available, we have reviewed our approach and, where appropriate, made new choices. In the case of the treasury concession, the underlying directive text has not undergone any changes, so we continue to propose the approach currently available. We have also decided not to follow changes elsewhere in the CRD where 'short term' is considered to be three months or less. As a result, we do not propose to amend the maturity limit.

However, we agree with respondents that the reference to 'loans' within BIPRU 10.7.3 (1a) should instead refer to 'exposures'. That is the current policy, so we will amend the Handbook text to make this correction.

We note the comments in respect of the concession where a firm lends cash to its parent. The concession envisages a situation where a subsidiary, which does not routinely carry out a treasury type lending function for the group, lends surplus cash to its parent. The more usual 'treasury' type activities are catered for by BIPRU 10.7.3 (1a) and (1c). The concession is intended to be for temporary surpluses and not long-term funding by the subsidiary of its parent. The requirement for the surplus to fluctuate is evidential of the lending not being long-term, and that the subsidiary has not lost access to its assets. We agree there should be a reference to the lending of surplus cash to a firm that performs the treasury role and will amend the provision to include this.

Exposures arising from derivatives are eligible for the treasury concession if the conditions are met (BIRPU 10.7.3(1c)). The provision restates the concession currently available to banks. We do not intend to amend the provision.

The text at BIPRU 10.7.3 (2) as set out in CP06/3 restricted the treasury concession to a firm's non-trading book exposures. This is a drafting error and does not reflect the current policy. We will amend the text such that the concession set out in BIPRU 10.7 is available for both trading and non-trading book exposures.

On reviewing the BIPRU 10.7 text, we found we had inadvertently restricted the eligible counterparties by including a reference at BIPRU 7.1 (c) to the consolidation requirements set out in BIPRU 8.3. The eligible counterparties should be those that are a concentration risk group counterparty (BIPRU 10.7.1 (b)) which represents a wider 'set' of firms than that within the scope of BIPRU 8.3. We will delete the cross-reference to BIPRU 8.3.

Intra-group exposures – parental guarantee exemption

8.62 A firm may treat as exempt from the limits in BIPRU 10.5 an exposure which the firm's parent guarantees, subject to certain conditions (BIPRU 10.6.5 – 10.6.6R).

8.63 The joint-industry response queried why the parental guarantee was restricted to cases where third-party risks were transferred from a firm to its parent and why the exemption was not available to intra-group guarantees. It also asked why the exemption did not also extend to cover contingent exposures.

8.64 In addition, the response suggested that since an exposure covered by a parental guarantee would be recorded as an exposure against the parent firm, the exposure should be eligible for inclusion within the integrated groups treatment for large exposures and for the 0% standardised approach risk weighting.

8.65 **Our response:** The parental guarantee exemption is currently available to banks for exposures to counterparties outside the bank's groups. By including it into BIPRU 10, the concession will be available to other firms on the same basis. The treasury concession at BIPRU 10.7 already provides a concession for intra-group treasury activity. The integrated groups treatment provides a preferential treatment for exposure limits applicable to intra-group exposures.

The parental guarantee concession represents the current preferential concession and we propose not to delete or amend it.

On reviewing the BIPRU text setting out the parental guarantee, we found we had inadvertently restricted the eligible counterparties by including a reference at BIPRU 10.6.5(5) to the consolidation requirements set out in BIPRU 8.3. This does not reflect the current approach available to banks. We will delete the cross-reference to BIPRU 8.3.

Notifications

8.66 The BIPRU 10 text includes a number of requirements to provide a notification to us in certain circumstances. In some cases, the text proposed that the notification be included in the normal regulatory reporting forms. However, it is not currently possible to combine the notifications with the returns. Notifications will need to be made on a separate basis. We will amend the Handbook text to reflect this (BIPRU TP 10.26, BIPRU TP 11.12, BIPRU 3.2.29(5) and BIPRU 10.11.2).

Industry feedback on BIPRU text

Exemption where firms have taken a 100% position risk requirement (PRR) or counterparty risk requirement (CRR)

8.67 Respondents requested that we include an additional exemption from what constitutes an exposure in the text of BIPRU 10. The industry would like us to include a rule stating that firms need not include exposures to comply with the limits and rules in the concentrations chapter where firms have already calculated a 100% capital requirement equivalent to a deduction for position risk or counterparty risk as appropriate. Having viewed the feedback from respondents on this issue we can confirm where there is a capital charge equivalent to a deduction from capital, firms may apply the exemption from the concentration risk regime contained in BIPRU 10.2.2(1).

Stress testing of collateral concentrations

8.68 The joint-industry response highlighted the stress testing of collateral as a considerable concern for its members. They noted that stress testing added more costs to the risk management of their firms but with little benefit being achieved. They requested a review of this requirement in light of their concerns. This is a requirement is drawn from the CRD itself and, as such, is binding upon us and other member state regulators. We therefore have no plans to remove it from the concentration risk chapter.

Clarification of CNCom calculation

8.69 Many respondents commented that the section of BIPRU 10 relating to the calculation of the concentration risk capital component (CNCom) was unclear and should be revised. Respondents placed particular emphasis on the example provided in the BIPRU text and highlighted the existing examples in the IPRU sourcebooks as more helpful and clear. Having reviewed the text on calculating a firm's CNCom, we agree that certain clarifications could be made to the text. We will therefore amend the text in this area.

FSA policy on 'top slicing'

8.70 Respondents sought clarification on our policy approach to 'top slicing' in light of the harmonisation of the IPRU sourcebooks and the new credit risk mitigation (CRM) approaches. 'Top slicing' is the practice of systematically collateralising only those parts of a firm's exposures which exceed the 25% limit set down for the concentration risk regime. Our view is that 'top slicing' can give rise to prudential concerns. However, we propose to 'soften' the BIPRU provision (10.6.8) somewhat while retaining the reference to taking such activity into account under the SREP. We will consider the issue of 'top slicing' during the EU review of the large exposures regime, due to be concluded by the end of 2007.

Broadly-based and cash-settled indices

8.71 We intend to carry on with our proposed approach to the treatment of options on an index or basket of debt securities or equities, as currently contained in the BIPRU text. This treatment states that qualifying equity indices do not have to be broken down into their constituent elements for calculating issuer risk. Indices which are not qualifying equity indices must continue to be broken down into their component stocks for firms to calculate the issuer risk on the underlying security. We are constrained in this regard by the terms of the directive.

8.72 Respondents raised the question of whether we would broaden the scope of this exemption to permit the inclusion of options on broadly-based bond indices which meet the conditions set out in BIPRU 7.3.38. Having looked again at this issue we are unable to change our BIPRU proposal on options on an index as we are constrained by the directive in this area.

8.73 Respondents also requested the ability to decide whether to break down narrowly-based and non-cash-settled indices into their component parts. It is not our intention to introduce new provisions on this matter.

LGD-relevant aspects and the use of financial collateral

8.74 Respondents commented that the requirement contained in 10.6.15 on firms to be able to satisfy us that the effects of financial collateral can be separately estimated from other LGD-relevant aspects. Respondents also sought clarification on what we will expect by way of demonstration that the requirement is met. Firms wishing to take advantage of BIPRU 10.6.14 will have to demonstrate suitability of the estimates produced which will be reflected in their IRB permission. We do not propose to include further guidance at this time but are open to further dialogue on this aspect through the Credit Risk Standing Group (CRSG).

Maturity of OTC contracts within a netting agreement

8.75 Respondents sought clarification that the current policy would continue whereby, if there is one OTC contract within a netting agreement that matures in under one year, then all contracts covered by that netting agreement fall into the under the one year category for calculating replacement cost for capital purposes. The consequence of this is that all these under one-year OTC contracts would be eligible for the one year or under exemption for claims on asset items constituting claims or other exposures to institutions. We confirm our intention to allow firms to continue with this approach to maturity for OTC contracts within the same netting agreement.

8.76 We confirm that we do not propose to carry over the above provision into the new BIPRU text. We consider the correct approach is likely to be that firms should calculate the maturity of the OTC derivative contracts which are subject to a netting agreement as a weighted average using the notional amounts of each exposure for weighting the maturity of their OTC derivatives subject to a netting agreement. This is also consistent with relevant provisions in the IRB approach. We do not propose to amend the draft BIPRU text at this time and remain open to further discussion with industry on this point.

BIPRU 10 and Transitional changes

Reference	Comments	Response
10.1.2	Respondents suggested that the CNCom Calculation which is a capital treatment for excess exposures which arise in the trading book should be referenced in the application and purpose section of Chapter.	We agree with this proposal and will add relevant text in 10.1.2.
10.2.1(1)	Cross reference in 10.2.1(1) should be changed from BIPRU 3.7.2 to the correct BIPRU reference of 3.6.2.	We agree with this proposal and will make the relevant change to the BIPRU text.
10.2.2	Respondents requested additional exemption from what constitutes an exposure for the purposes of BIPRU Chapter 10. Firms would like a rule which states that where firms have calculated a 100% capital requirement for position risk or counterparty risk, then no exposure is said to have arisen for concentration risk purposes.	We will include guidance which allows firms who have taken a 100% capital charge to treat the exposure as being deducted from capital for the purposes of the exemption from the concentration risk regime contained in 10.2.2(1).
10.2.2(2)	Respondents requested a change in the text at 10.2.2(2) which would see the 48 hour time period for the exemption extended to cover 2 working days instead. The rationale for this view was that 48 hour commencing on a Friday would incorporate non-working days.	As this is copy out from the directive, we do not propose to change the wording of the exemption.
10.3.3(1)	Respondents requested a change to the wording in 10.3.3 (1) so that credit risk management becomes credit risk mitigation.	We accept this proposal and will incorporate the change in our updated version of BIPRU text.
10.3.7-10.3.9	Respondents requested the movement of BIPRU rules 10.3.7 to 10.3.9 relating to the summing of exposures to counterparty's, connected counterparty's and groups of connected counterparty's to the measurement part of the chapter i.e. 10.4.	We disagree with this proposal as we consider that these rules follow logically on from the rules 10.3.2 to 10.3.6 of whereby the term counterparties, connected counterparties and groups of connected counterparty's is described.
10.3.11(2) and 10.3.12(3)	Respondents requested that the term 'loan' in 10.3.11(2) and 10.3.12(3) which is used in the rules relating to exposures to trustees should be broadened by using the term 'exposure' instead, so that the types of exposures permitted is not restricted to loans.	We agree with this proposal and will make the relevant change to the BIPRU text.
10.4.6	Some respondents requested a summary provision setting out the basis on which to calculate non-trading book positions in a similar fashion as currently exists in 10.4.6 for trading book positions.	We are currently considering whether some clarification may be appropriate for the non-trading book calculations.
10.4.7	Respondents sought inclusion of a reference to the ability to net notional positions created by derivatives.	We agree that for the purposes of calculating issuer risk in the trading book, a reference to the ability of firms to net notional positions arising from derivative transactions should be added. We will make the relevant change to the BIPRU text at 10.4.7
10.4.7(2) a)	Respondents stated it was not clear how exposures covered by VaR models should be captured by section 10.4.7 relating to the determination of issuer risk.	We have clarified the BIPRU text in this area to make it clear that exposures covered by VaR models fall into this subsection.
10.4.8.(1)	Respondents stated they would like a more specific reference to GENPRU chapter in 10.4.8(1) which defines the value of a firm's counterparty exposures to be the value at risk in line with the calculation in GENPRU 1.3.	We do not intend to add specific references in 10.4.8(1). Firms are required to use GENPRU 1.3 and so should be familiar with the rules relating to the calculation of the value of risk of their exposures.
10.4.14	Respondents believe that the rule in 10.4.14 repeats the rule 10.4.6 which sets out the method calculating exposure to counterparty's in the trading book.	We agree that there appears to be some overlap in the text at 10.4.6 and 10.4.14. However there is a valuation aspect to 10.4.14 which is important. We shall review to see whether further clarification can be achieved.
10.4.24	Respondents sought clarification of the meaning of 10.4.24 (3)	We will amend this paragraph to make clearer that firms may use their models to calculate the delta-weighted value of the underlying.
10.4.25 and 10.4.26	Respondents sought clarification of the treatment of options on an index and the exemption from issuer risk calculations for certain indices.	We intend to carry on with our current approach to the treatment of options on an index as it is currently contained in the BIPRU text . We do not intend to broaden the scope of this exemption to include options on broadly-based bond indices as we are constrained by the directive text in this area.

Reference	Comments	Response
10.4.29	Respondents stated that the term 'must not incur' in relation to a firms exposures to undisclosed counterparties is inappropriate as under current methodology firms add theses exposures to their largest exposures to ensure that limits are met and LER capital is maintained. They request this section be reviewed.	We do not think this section needs amendment in the light of the requirement the rule puts on firms to satisfy themselves that they will continue to meet the limits in BIPRU 10.5 for non-trading book and trading book exposures. We do not propose changing the text in this area.
10.5.6	Respondents want the term capital resources in 10.5.6 cross-referenced to the rule on using Tier 1 and Tier 2 capital for non trading book exposures and using Tier 1,2 and 3 capital for trading book exposures.	We agree with this proposal and will make the relevant change to the BIPRU text.
10.5.18 to 10.5.20	Respondents commented that the section of BIPRU 10 relating to the Calculation of the Concentration Risk Capital Component (CNCom) was unclear and should be revised with particular emphasis on the example provided.	We agree with the respondents that certain clarifications could be made to the text to make the section more accessible for firms. We have therefore updated the text in this area and believe the concerns firms had in this area have been rectified.
10.6.8	Respondents have sought clarification on the FSA's policy approach to 'top-slicing' in light of the harmonisation of the IPRU sourcebooks and the new credit risk mitigation approaches.	Our view is that top-slicing can give rise to prudential concerns. However we propose to 'soften' the BIPRU provision (10.6.8) somewhat while retaining the reference to taking such activity into account under SREP. We will further consider the issue of 'top-slicing' during the EU review of the large exposures regime, due to be concluded by end 2007.
10.6.9	Respondents requested clarification as to why the use of the Financial Collateral Simple Method is restricted to exposures to counterparties which are not connected counterparties.	We have reviewed this limit on the use of the financial collateral simple method and agree that the restriction is not necessary. We will remove this restriction from the text of 10.6.9
10.6.5		Delete cross reference to BIPRU 8.3.
10.6.12	Cross Reference to Financial Collateral Simple Method needed	Cross reference to rule in BIPRU 5.4.15
10.6.19	Respondent's requested clarification on how often they are expected to undertake periodic stress tests referred to in 10.6.19(1).	We have included text in 10.6.19 which states that Firm's should determine the periodicity needed for the stress testing of it's credit risk concentrations with emphasis on having sufficient frequency to maintain the currency of their capital calculations and in any case at least once a year.
10.7.1 (1c)		Delete cross reference to BIPRU 8.3.
10.7.3 (1a)	Respondents said that 'loan' should be changed to 'exposure'	Agree. Will amend text to refer to 'exposures'.
10.7.3 (1b)		Inclusion of additional text to aid clarity that the concession is also available where a firm loans surplus liquidity to a firm that performs a treasury role on behalf of its group.
10.7.3 (2)	Respondents said that restriction to non trading book exposures was a change of policy.	Agree. Drafting error. We will delete the provision and as a result the concession will be available, as now, to qualifying trading and non trading book exposures.
10.8.3 (4)	Respondents thought counterparties that should qualify for inclusion in the UKIG would be excluded as a result of the drafting.	Inclusion of text to make it clear that a firm which is incorporated in the UK (providing the other conditions are met as well) are intended to qualify for the integrated groups treatment
	Council Regulation reference incorrect.	Agree. Drafting error. We will update the reference.
10.9.8	Respondents asked for more guidance in connection with diverse blocks	We intend to add minimal additional guidance
10.11.12		Amend text that refers to how a firm makes a notification to FSA.
Annex to BIPRU 10	Respondents requested the inclusion of flowcharts.	We intend to include updated versions of the flow chart and table that was contained in Annex 7 of CP06/3 and which set out some general considerations for the integrated groups.
BIPRU Transitionals TP10 and TP11	Respondents thought that not all relevant intra group exemptions had been included into the transitional at TP10.	We intend to include the additional intra group provisions. For securities and futures firms the list of exemptions comprises: IPRU (Inv) 10.192 (g); 10.192 (1n); 10.192 2c) which applies 192 (2a and b). Similar provisions will be added in for investment management firms, UCITS investment firms and personal investment firms.

Reference	Comments	Response
BIPRU Transitionals TP 10.22(3)	Respondents queried the intention and effectiveness of the requirement.	Agree it is not required. Intend to delete.
BIPRU Transitionals TP 10.26		Amend text referring to a firm making a notification to FSA.
BIPRU Transitionals TP 11.12		Amend text referring to a firm making a notification to FSA.

9 Counterparty credit risk

Introduction

9.1 In CP06/3 we consulted on the proposed rules contained in BIPRU 13 and BIPRU 14 for calculating counterparty credit risk exposures for financial derivatives instruments, securities financing transactions (SFT), unsettled transactions and free deliveries. The changes introduced by these new rules were primarily driven by the Trading Book Review (TBR) proposals published in July 2005[1].

9.2 We welcome the feedback we received on these chapters. Since the TBR proposals were published, no further work has taken place in this area at either an international or European level; nor is any further work proposed. In addition, the methodologies employed in the internal model method (IMM) for counterparty risk are still developing, since this approach was only recently introduced for regulatory capital purposes. So we consider it important to maintain a dialogue with the industry on developing standards in this area and to address practical implementation issues. We will continue to use the Trading Book Standing Group to discuss common issues and share our views.

General responses

Structure of BIPRU 13 and 14

9.3 The interaction of BIPRU 13 and 14 caused some confusion among respondents. BIPRU 13 contains details of the approaches that may be applied to non-trading book positions. These approaches may also be applied to trading book positions, but in the first instance firms should refer to BIPRU 14 which contains details of those issues specific to the trading book. BIPRU 14 then directs firms to use the appropriate approaches for credit risk (through BIPRU 3 or 4) which in turn requires firms to use BIPRU 13 to calculate exposure values. Further guidance will be added to the chapters to make this clear.

1 The application of Basel 2 to Trading Activities and the Treatment of Double Default Effects: www.bis.org/publ/bcbs116.pdf.

9.4 There were a number of other areas where respondents asked for clarification of requirements. As far as possible, while still respecting the general approach to copy out, we will provide additional guidance.

Credit derivative PFE add-ons

9.5 Transitional provision TP3.7(2) notes that the new potential future exposure (PFE) add-ons for credit derivatives to be applied by firms using the mark-to-market (MTM) method will come into effect from 1 January 2007 and will not be subject to the broader transition provision allowing firms to remain on current rules. While we understand the concerns some respondents have raised about the need to apply these add-ons for a limited period until such time as the new IMM is available, the transitional provision is a direct copy out of the CRD requirements. Unless the European Commission provides more clarity through the Transposition Group, we cannot waive or delay implementing the new add-ons. Firms that think they are likely to face significant difficulty in meeting the new requirements, including any consequential effects such as large exposures reporting, should contact their relationship manager immediately.

9.6 Banks currently have a restriction on their ability to net credit derivatives for counterparty risk purposes. Partly in recognition of the above issue, they may apply for individual guidance relaxing this restriction during the transitional period in 2007.

IMM implementation issues

9.7 Respondents raised a number of issues about implementing the IMM.

9.8 The IMM requires exposures to be calculated at a netting-set level (BIPRU 13.6.22). In performing this calculation, while respondents agreed that expected potential exposure (EPE) would need to be calculated at the netting-set level, they asked that firms have a choice as to whether to calculate Effective EPE at a counterparty level or a netting-set level. They argued that Effective EPE was primarily introduced to account for roll-over risk and was in itself only an approximation. Therefore, to provide greater flexibility and to reduce the complexity of the calculations, aggregating Effective EPE at a counterparty level was appropriate.

9.9 The CRD is clear that netting benefits may only be taken where the requirements in the Banking Consolidation Directive (BCD) Annex III part 7 are met. It also notes that exposures must be calculated at the netting-set level and the exposure value is a function of Effective EPE. This indicates Effective EPE should be calculated at the netting-set level. The intention is to incentivise greater use of netting agreements in line with good risk-management practice. However, BIPRU 13.6.9 notes that firms may use another type of model as long as they are able to demonstrate it is at least as conservative. Therefore, where firms are able to do this, an approach that involves the aggregation of exposures at the counterparty level could be used.

9.10 Respondents noted that the experience test requirement set out in BIPRU 13.6.51R was not consistent with the approach taken for internal ratings based (IRB) models since it required firms to be using the model (or a model generating the same distribution) one year before applying for an IMM permission rather than one year before the date the permission is granted. We agree with this comment and will update the rule to ensure it is consistent with the IRB approach. Some respondents also thought that this rule was not sufficiently clear. In line with our increasing use of principles-based rules, we do not intend to provide further detailed guidance, but will expect firms to demonstrate that they satisfy the intention of the rule which we think is clear.

9.11 Respondents asked us to be proportionate in interpreting the backtesting requirements under the IMM given the known limitations of backtesting for such models. We recognise these limitations and expect to place more emphasis on the overall model validation processes of any firm, of which backtesting will be but one element.

9.12 The CRD and our proposed rules do not explicitly state whether non-trading book exposures can be netted with trading book exposures. This is of particular interest to firms intending to use the IMM. Respondents noted that in practice firms tend to manage non-trading book and trading book exposures together for counterparty risk purposes. We therefore intend to provide further guidance clarifying that firms may indeed net positions across books in this instance. The capital rules also require firms to report the results for each book separately. Since it is not clear where the net position should be reported, we will clarify how this should be done. The net figure should be reported against the counterparty risk capital component if the gross trading book exposures exceed the gross non-trading book exposures – and against the credit risk capital component if the opposite is true. Firms will also still need to make sure that any trading book or non-trading specific requirements are met, for example, with regard to the definition of eligible collateral and large exposures limits – where there are hard limits on non-trading book exposures – and the restrictions on the use of credit derivatives as an internal hedge. While firms must ensure that these requirements are met, we intend to consider the implications of these issues further and provide additional guidance where possible.

Use of mid-market valuations

9.13 The previous rules contained in IPRU (Inv) Chapter 10 allowed firms to use mid-market valuations when calculating the counterparty risk requirements. We did not propose continuing this treatment since we believe that a consistent valuation approach should be used for all regulatory capital calculations. One respondent noted that for firms engaged solely in matched principal broking – that will not therefore typically hold open positions – it may be burdensome to require these firms to change their systems to conform to the new valuation basis. We will therefore consider a transitional provision for firms, meeting the criteria set out in BIPRU 1.1.10R(1)(a), to continue using mid-market valuations, for operation of at least one year (i.e. until 2008).

Long-settlement transactions

9.14 The new rules introduce requirements for long-settlement transactions for the first time. Therefore, a counterparty risk charge will need to be held against positions with a settlement period greater than the market standard or five days (whichever is smaller). A number of transactions that settle at longer periods – for example, private equity positions where settlement may be up to 25 days after trade date – will therefore be caught for the first time. The new rules are a direct reflection of the CRD requirements. We are therefore not able to waive or amend them. However, compliance with this requirement can be delayed until 2008 if firms take advantage of the relevant transitional provisions to remain on current rules during 2007.

Treatment of posted collateral

9.15 Respondents noted that the rules were not clear as to the appropriate treatment of post collateral and questioned whether it could be offset against negative current exposure under the MTM method. So we intend to provide extra guidance within the MTM method clarifying that a negative MTM value can be offset against posted collateral subject to compliance with all the provisions of BIPRU 5.

Calculation of expected loss

9.16 In BIPRU 14.2.15 to 14.2.17, we outlined our approach to the treatment of expected loss amounts under the IRB approach. Comments from the industry specifically relate to BIPRU 14.2.15(2) which states:

Unless the firm's IRB permission does not permit it, if the credit risk of the counterparty is adequately taken in to account in the valuation of a position included in the trading book the expected loss amount for the counterparty risk exposure must be zero.

9.17 The industry requested this rule means that the calculation of expected less should not be necessary. We can confirm this is the case.

9.18 However, determining the extent to which the counterparty credit risk has adequately been taken into account in the valuation of a position will be difficult. We are discussing how this issue might be resolved with the relevant working groups and firms.

System-wide failure of clearing or settlement system

9.19 BIPRU 14.3.5 and 14.4.7 provide guidance that in the event of a system-wide failure of a clearing or settlement system, firms may apply for a waiver from the counterparty risk capital requirements for unsettled transactions and free deliveries. Respondents noted that in such stressed circumstances requiring firms to apply for a waiver may not be appropriate.

9.20 We agree that the use of a waiver may not be appropriate in such circumstances. Instead, we intend to rely on provisions contained in the General Provisions (GEN) Sourcebook, and in particular GEN 1.3 for emergency situations. BIPRU 14.3.5 and 14.4.7 will be amended accordingly.

Response to individual questions

CRR internal model method

Q36: Do the rules and guidance on the CCR internal model method provide enough clarity to enable you to develop your model? Do you have any specific implementation questions where you need further guidance?

9.21 Respondents noted that pre-consultation work with the industry identified the main areas for additional guidance and there were no specific implementation questions at this point on which further guidance was required.

9.22 **Our response:** We do not propose adding further guidance, although some clarifications have been added as noted above. We expect dialogue with the industry to continue as the new internal model regime is implemented and will use the Standing Groups to share any common issues or themes that arise.

BIPRU 13 & 14 changes

Reference	Comments	Response
BIPRU 13 Title, 13.1.3 & 14.2.9	The interaction of 13 and 14 and the application of the chapters to non-trading and trading book positions was not clear.	Further guidance added to clarify application of BIPRU 13 and 14.
13.2.2	Concern that 'immediately' is not realistic.	Rule amended to 'as soon as is practicable'
13.2.3	Non-standard transactions may be included within a CCR IMM if allowed within scope.	New rule added to reflect this.
13.2.4	The examples of non-standard transactions provided did not provide added clarity.	Examples have now been removed
13.3.4	Confirmation requested as to whether long settlement transactions covers OTC derivatives or SFTs.	To the extent that a long settlement transaction has been treated under the rules relating to the transactions specified elsewhere in BIRPU 14.2.2, for example for OTC derivatives and SFTs, a firm does not need to apply two sets of capital requirements. Guidance to be provided to this effect.
13.3.9	Comment that rule does not note that combined use of models is possible on a group basis.	This requirement is covered in BIPRU 8.7.9. Cross-reference included here to aid handbook navigation.
13.4.5	A current IPRU(Inv) rule that allows firms to use mid-market valuations in calculating their capital requirement for counterparty risk is not being taken forward. Comment that this might have a disproportionate effect on firms simply doing matched principle broking and who as a result rarely have proprietary positions.	Transitional provision to allow firms only engaged in matched principle broking to continue using mid-market valuations for counterparty risk requirement purposes until at least 2008 to be included.
13.4.14	It is not clear whether a negative MTM exposure can be offset against posted collateral when determining the exposure value of that collateral under the MTM method.	Where the collateral rules are met (i.e. BIPRU 5) then the principle of offset works both ways. Guidance added to clarify
13.6.31	FSA should provide full justification for setting any alpha greater than 1.4	Further guidance clarifying that where the FSA sets alpha greater than 1.4, the reasons will be given in the firm's permission.
13.6.51	Use test should apply for 1 year prior to the date of the IMM permission not before application. This is consistent with IRB text (4.2.11).	Rule amended accordingly.
14.2.6 and 14.2.7	Use of copy-out of Directive results not clear.	Further guidance given based on Basel text.

10 Credit derivatives: specific risk in the trading book

Introduction

10.1 The aim of our policy is to produce a risk-based, proportional capital requirement that maintains an adequate incentive for firms to move to value-at-risk (VaR) model recognition. The calibration of the proposed rules will be fundamental in achieving this outcome.

10.2 While the feedback to CP06/3 was generally positive, the joint-industry response did raise a number of substantive points which have been discussed at the Credit Derivatives Standing Group (CDSG). We address these points in this chapter.

10.3 Navigation of the rules was considered difficult so a navigational guide will be added to the Handbook.

10.4 Additional guidance on the scope to waive rules was requested. Since waivers are already dealt with in the Supervision Handbook (SUP Chapter 8) it was not felt appropriate to repeat it in this, or any other, Handbook chapter particularly given policy on waivers may change with time.

10.5 Several firms have expressed concern on the tight timescale for implementing these rules, in particular the ability to make necessary system changes. Given this, we are proposing that these rules will not take force until 1 January 2008. Ahead of this date, any firm wishing to take advantage of this approach should discuss it with their supervisor.

Response to individual questions

Complying with the CRD

Q37: What other approaches could we adopt when applying the CRD minimum?

10.6 All respondents were clear that we should minimise superequivalence where possible. They stated that the method of ensuring equivalence with the rules resulted in the framework being overly prudent and unduly burdensome.

10.7 **Our response:** We are amending the way in which directive compliance is calculated. Instead of testing for directive compliance on a reference entity basis (the CP06/3 proposal) firms must now test for directive compliance at a product type level (e.g. single name credit default swap portfolio).

Architecture of the approach

Q38: Are these all the risks that should be considered? If not, what other risks should we consider?

Q39: How can we improve the architecture of our proposals?

10.8 Respondents supported the architecture of the proposed regime.

10.9 **Our response:** We will retain this architecture.

Single name credit default swaps

Default risk requirement

Q40: How could we improve the default risk requirement for single name credit default swaps?

10.10 Respondents disagreed with the time horizon used for default risk. The joint-industry response requested a one-year time horizon which is consistent with the default risk time horizon used for the Trading Book Review (TBR).

10.11 **Our response:** Initially we drew on the banking book approach to default risk. The TBR has since superseded this and we agree that consistency with the TBR is the correct outcome. We will therefore change the default risk time horizon to one year.

Valuation risk requirement

Q41: How could we improve the valuation risk requirement for single name credit default swaps?

10.12 Respondents challenged the robustness of the initial calibration exercise in particular the limited sample of credit default swap and bond volatilities.

10.13 **Our response:** During initial calibration sufficient market data on credit default swap volatilities was not readily available. This data is now available and a new calibration exercise will be conducted during the summer 2006. Ahead of this we will agree the methodology with the CDSG and analyse the results jointly. Calibration will remain subject to the stated aim of maintaining an adequate incentive for firms to move to VaR model recognition.

Basis risk

Q42: Do you agree with our position in relation to basis risk for credit event definitions and deliverable obligations?

Q47: Do you agree that the same approach is correct? If not, how can we improve the approach?

10.14 While respondents supported our proposals the joint-industry response requested that further consideration be given to the netting of non-identical positions where the positive basis risk works purely in favour of the firm. An example of this might be where bought protection covers a broader range of credit events than the sold protection.

10.15 **Our response:** Further work is required on 'positive basis risk' and will be taken forward through the CDSG. Until this work is concluded the policy will remain unchanged.

Multiple name tranched credit default swaps

Default risk requirement

Q43: Do you agree with the proposal to base the default risk requirement on the securitisation framework? If not, what other methods could we use to adequately cover the default risk?

Q44: Is using a scaling factor to recognise liquidity appropriate and have we properly differentiated between the different types of products in a manner that appropriately captures differences in liquidity? If not, how could we improve the approach?

10.16 Respondents cautiously welcomed the proposal but requested further time to consider in more detail the use of the securitisation framework and perhaps propose alternatives such as 'what-if' analysis.

10.17 Firms' main concerns related to the significant capital requirements for equity positions and super-senior positions.

10.18 **Our response:** We are proposing to continue using the securitisation framework as the basis for calculating the capital requirements for default risk on these products. However, if the industry were to propose a workable alternative, we would be willing to consider this and possible changes to the regime. We will progress this issue through the CDSG.

The treatment of equity and super-senior positions are directive requirements which we are unable to change.

Valuation risk requirement

Q45: Do you agree with the proposal to base the valuation requirement on a combination of spread and correlation stresses? If not, how else could we capture the risk for regulatory purposes?

Q46: Do you agree with the magnitude of the proposed stresses to spreads and correlation? If not, what changes should be made to the approach?

10.19 Respondents generally supported the proposal to shock credit spreads and correlation assumptions to produce a capital requirement. As with single name credit default swaps, firms were concerned that the calibration was not sufficiently robust.

10.20 The stress factors for correlation were recognised as being representative of stressed market conditions. However, firms pointed out that these stresses were based on the CDX index and did not specify shocks for the iTraxx index. Firms asked whether it was our intention to add different correlation shock scenarios for other indices such as the iTraxx.

10.21 **Our response:** The credit shocks will be recalibrated as part of the analysis described in our response to Question 41. However, at this stage, we do not intend adding new series of correlation shocks for iTraxx or any other indices.

Pillar 2 requirements

Q48: Do you agree that our Pillar 2 requirements adequately cover the risks that may not be covered under the Pillar 1 requirements?

10.22 The joint-industry response was concerned with some of the Pillar 2 requirements. In particular, it questioned the requirement for a firm to explain and demonstrate its credit-derivative trading strategies to supervisors. The response pointed out that individual supervisors are already able to ask firms for such information.

10.23 The joint-industry response was also concerned with the requirement that firms consider whether the level of default capital held was commensurate with the level of defaults expected where a firm uses an internal model for valuation purposes.

10.24 **Our response:** We are not proposing to make any changes to the Pillar 2 requirements, since the guidance on this point is meant to amplify the existing requirement for firms to deal with us in an open and cooperative way (FSA Principle 11).

The purpose of requiring firms to compare the default capital requirements with the default losses assumed in the valuation model is to put the onus on firms' management to demonstrate that they are holding adequate capital against defaults in the trading book.

BIPRU 7.11 changes

Reference	Comments	Response
7.11.25, 7.11.34, 7.11.36, 7.11.48, 7.11.49	Requirement to apply directive minimum on a reference entity basis should be on a portfolio basis.	We have amended the text to make this change.
7.11.34	Default time horizon should be one year.	We have amended the text to make this change.
7.11.64	The draft rules are hard to navigate.	Flow diagram added to Handbook.

11 Market risk

Introduction

11.1 In CP06/3 we consulted on the new policy for calculating the position risk requirement (PRR) for market risk in the trading book. The new rules, contained in BIPRU 1.2 and BIPRU 7, were largely based on the current rules and guidance applied to banks and investment firms. The main changes were due to a revised definition of the trading book and the addition of new requirements for collective investment undertakings (CIUs) in the CRD and from revised requirements driven by changes following the Trading Book Review (TBR), particularly covering the use of value-at-risk (VaR) models.

11.2 The feedback was largely supportive of the new rules and guidance and most comments were detailed and technical. Where possible we have taken these comments on board and the table at the end of the chapter provides details of the main changes that are being made. Other more substantive comments are addressed below.

11.3 With two exceptions, no further development of policy in this area is expected, either domestically or internationally. The exceptions relate to the implementation of the new requirement to model default risk for firms modelling specific risk and the review of the appropriate prudential regime for commodities firms. With regard to the former, a sub-group of the Basel Accord Implementation Group (AIG) is currently reviewing the principles behind the requirement to model default risk and liaising with industry bodies. As for commodities firms, the European Commission has initiated a review of the appropriate prudential regime for such firms. We are fully engaged in this review.

Response to individual questions

Definition of the trading book (BIPRU 1.2)

Q49: Are there any positions that you consider would incorrectly fall inside or outside the trading book under the proposed regime?

11.4 Although there were no responses to this question, the industry has expressed concerns that BIPRU 1.2.10G, which provides guidance on some items that we currently consider to be non-trading book, might in practice function more as a prescriptive list of non-eligible trading book items, and so as a barrier to innovation. The industry was concerned that the word 'immediately' in BIPRU 1.2.33R imposed too stringent a requirement.

11.5 **Our response:** We appreciate these concerns and in line with our move to a more principles-based approach we will delete BIPRU 1.2.10G and 11G. We will also replace 'immediately' with 'as soon as is reasonably practicable' in BIPRU 1.2.33.

Collective Investment Undertaking PRR (BIPRU 7.7)

Q50: Does the draft Handbook text give you sufficient clarity to enable you to apply the option PRR to CIU positions?

11.6 Some respondents found it difficult to follow the rules for options on CIUs. There was a request to locate all CIU rules together. Additionally, there was a request for us to define a CIU position.

11.7 **Our response:** The rules on options for CIUs will remain in BIPRU 7.6. We feel that all rules on options should be kept together in one chapter. But we have added additional cross-referencing and guidance to this chapter to make the rules clearer, particularly for determining whether a CIU PRR for an option position may be calculated or whether an Option PRR may be calculated.

We do not intend to provide a definition for CIUs. There are several areas in the Handbook which use the term CIU and we think that to provide a definition which covers all the instances where the term is used could lead to problems as new products are developed. So we propose to keep the term undefined to allow greater scope for future innovation.

Internal Value at Risk models (BIPRU 7.10)

Q51: Have you individually, or as a group, started to consider a methodology to calculate default risk? If so, how advanced is your development and, where you have been able to estimate it, what impact do you expect the charge to have on your capital adequacy calculation?

11.8 Respondents are still at the initial stages of capturing default risk and those firms considering this have been in contact with the AIG Trading Book sub-group.

11.9 **Our response:** We will continue to play a full role in the AIG Trading-book sub-group in helping to develop consistency around the implementation of this new requirement and particularly around the key principles that apply. In the meantime, where firms already model specific risk and run material default risk we will, where appropriate, continue our current policy of requiring firms to hold additional capital against this risk.

Q52: At present we require firms to have the capacity to perform back-testing against hypothetical profit and loss. We are considering making this a reporting requirement. What functionality changes would be required to produce the report on a regular basis?

11.10 Several respondents were strongly against this requirement. They thought it was burdensome and that insufficient explanation had been given to the benefit that both we and firms would gain from this. In addition, some respondents thought the requirement was superequivalent to the Capital Adequacy Directive (CAD) and questioned the level of cost-benefit analysis that had been undertaken.

11.11 **Our response:** We have, through the Trading Book Standing Group, discussed this issue in further detail with industry representatives. We presented our reasons for requesting the requirement and discussed the benefit of the information it would provide.

The new reporting stipulations are not superequivalent to the CAD but are an area where we have discretion. Indeed, the original Basel market risk amendment in 1996 urged all banks to develop the capability to backtest against actual and hypothetical profit and loss (P&L), so this is not a new concept.

We do not think the requirement will impose a significant extra burden compared to the current rules which already require firms to have the capacity to produce hypothetical P&L. However, we recognise this depends on the interpretation of 'capacity'. Additionally, the new model validation requirements and industry practice around P&L attribution also require firms to have capability in this area. Finally, a number of firms already produce both hypothetical and actual P&L. So we see the additional marginal requirement for most firms as having to set up the reporting capability for backtesting against hypothetical P&L.

We also think there are significant benefits to hypothetical backtesting, as it is the purest test of the internal consistency of a VaR model. With many new products coming into scope where the individual risk factors are difficult to segregate and model, it is becoming increasingly important for us to evaluate the overall efficiency of VaR models. We are strongly of the opinion that the practice of reporting hypothetical P&L backtesting to us will allow us to analyse and monitor VaR models more effectively, to conduct meaningful relative comparisons between the performances of firms' models and to improve our understanding of how VaR models react to market conditions. The information will therefore form part of the core data we use to assess models. It will enable us to gain confidence in the ability and robustness of VaR models which may in the long run help to simplify the capital and reporting requirements of firms. As noted above, we also think that firms will achieve significant internal benefits through backtesting both actual and hypothetical P&L.

We therefore intend to continue with our proposal to require firms to report both hypothetical and actual P&L. However, we realise firms may need time to set up the reporting framework, so propose to agree individually with firms start dates for reporting, which may be later than 1 January 2007.

Other changes

Q53: Will any of these other changes have a material impact on your business?

11.12 Respondents did not think the other changes mentioned would have a material impact on their business but did highlight certain areas where they considered the market risk rules could be improved upon or needed further clarification.

11.13 **Our response:** Where possible we are revising the rules to provide greater clarity. The main changes are reflected below.

Other significant issues

BIPRU 7.1 including notification requirements

11.14 We received some comments that the notification requirements in BIPRU 7.1 for non-standard or non-specified transactions may be unduly burdensome and impractical. Respondents suggested that reporting requirements could be integrated into the Trading Book Policy Statement.

11.15 **Our response:** We agree this would be a sensible approach and are amending the rules accordingly. However, we would note that the Trading Book Policy Statement rules still impose notification obligations for material changes.

11.16 Some respondents noted that the requirement to ensure firms have adequate capital on an intra-day basis could be met through the use of intra-day limits.

11.17 **Our response:** Guidance will be provided to this effect.

Interest rate specific risk PRA

11.18 Respondents noted that the table in BIPRU 7.2.44R is not straightforward to use. The language was unclear while the table needed significant restructuring to allow firms to navigate the requirements.

11.19 **Our response:** The table is a direct copy out of the CRD. We need to align the table in BIPRU 7.2.44R with the standardised approach to credit risk which also applies a copy-out approach. The Basel text is therefore inappropriate. Consequently we do not propose amending this table.

11.20 Respondents questioned the rule in BIPRU 7.2.46 which noted that, for higher risk issuers, firms should not recognise offsetting for general market risk.

11.21 **Our response:** This rule is a direct copy out from the CRD. In essence it looks to disallow the offset for general market risk as a proxy (although not a perfect proxy) for the higher risk associated with some issuers. Firms also have a choice between that approach and setting a higher, specific risk position risk amount (PRA). We therefore do not intend to amend this rule.

Qualifying equity index

11.22 Respondents questioned the tighter new definition of a qualifying equity index.

11.23 **Our response:** The new definition was included following a review of the current rules for compliance with the CAD which restricts the definition to indices traded on an exchange. In line with our stated policy of fully implementing the CAD we must therefore retain the new definition.

Commodities

11.24 We received some comments on BIPRU 7.4.38 to 7.4.41.

11.25 **Our response:** We do not intend to amend this section. The rules contained in this section are a direct reflection of CAD and as such must be included as rules and not Pillar 2 requirements. The guidance provided in 7.4.39 does also include the concept of materiality and does not require an additional PRR charge, but rather notes some of the conditions when such a charge may be appropriate.

Underwriting

11.26 Respondents commented that they found the new rules on over-allotment options pragmatic. However, we also received comments asking if underwriting rules in BIPRU 7.8 could be applied to syndicated loans.

11.27 **Our response:** The new trading-book definition allows loans to be included in the trading book. Provided that a syndicated loan can meet the criteria of the trading-book definition, BIPRU 7.8 may be applied. We have therefore removed the rule which excluded these loans from being underwritten.

Use of VaR models

11.28 We received a number of comments aimed at clarifying some of rules and guidance provided in BIPRU 7.10.

11.29 **Our response:** We have taken most of these comments into account. In particular, we are removing the requirement that a firm should be able to calculate any test portfolio specified by us and clarifying that the requirement to apply a soundness standard comparable to the banking book only applies to default risk, not the entire specific risk requirements. The table below sets out our response on some of the other more material changes.

BIPRU 7 changes

Reference	Comments	Response
BIPRU 7.1		
7.1.6	This requirement may be met through the use of intra-day limits.	Agreed and guidance to be provided accordingly.
7.1.11	Noted that immediate notification not practical and suggested integrating this requirement with Trading Book Policy statement.	Agreed and rules to be amended accordingly.
BIPRU 7.3		
7.3.24	Noted that the word 'reduced' is redundant. Industry wanted to net off both reduced underwriting and net reduced underwriting positions against equity.	We do not agree that the word reduced is redundant. The intention is to disapply netting to positions arising from the application of BIPRU 7.8. We do not therefore intend to amend our policy.
BIPRU 7.4		
7.3.49G	Noted that the guidance provided was not helpful as the test is hard to do in practice.	Guidance has now been removed.
BIPRU 7.5		
7.5.18(5)	Noted that this rule only refers to the subsection (4) above.	Agreed and cross-reference included accordingly.
BIPRU 7.6		
7.6.6(4)R & 7.6.38G	Further clarification requested as to how to apply the test when the look-through method is used.	Further guidance added to clarify.
BIPRU 7.7		
7.7.8R	Clarification requested that third country CIUs 'are eligible' rather than 'may be'.	Agreed and amended accordingly.
BIPRU 7.10		
7.10.21R	The purpose of this section is unclear, not least as the categories apparently include all possible products and the creation of definitive lists always creates issues.	The categories were listed in the waiver previously. They have been brought into the Handbook text to try and standardise the categories going forward. These may be amended in the waiver if deemed necessary.
7.10.38(2)R	This requirement is not realistic as notification to the FSA of any change to a correlation would result in thousands of notifications which would not benefit industry or regulators.	This requirement is consistent with current practice. Only material changes would have to be notified as this does fundamentally change the VaR model and it is no longer assessing the risks properly. No changes made.
7.10.45R	Firms would like to clarify whether this section refers to CIUs denominated in a non-base currency for the firm, or whether it refers to FX risk within the CIU.	This is copy out from the directive. The directive is specifically clarifying that the FX risk within a CIU should not be ignored when considering all risks within the CIU.
7.10.46(4)R	VaR models do not address liquidity risk. Nor is it the purpose of capital requirements to control liquidity risk; that is what the liquidity risk regime is for.	We agree with respondents that a VaR model should not capture liquidity risk. We have rewritten this text to state that firms should be able to demonstrate they have captured 'the risks associated with the illiquidity of the CIU itself should that be deemed necessary'.
7.10.47(8)R	The text mistakenly refers to 'specific risk' rather than 'default risk.'	This has been amended to reflect the directive.
7.10.54G	Firms do not understand this section and request clarity on whether we are proposing that firms create a buffer or whether valuation adjustments should be taken.	We wished to convey that under these circumstances either a buffer or equally a valuation adjustment may be taken. We have rewritten the text to make this clearer.
7.10.72R	The requirement that a firm should be able to calculate any test portfolio specified by the FSA does not appear to be contained within the CAD and firms are concerned by potential super equivalence.	We agree with industry and have deleted this requirement.
7.10.73R	The text did not reflect the directive text for illiquidity of markets in stressed market conditions.	This has been amended to reflect the directive.
7.10.137R	Firms would support consideration being given to allow non-specified risk classes being within scope, should it meet all other requirements (e.g. potentially House Price Index derivatives if market liquidity continues developing.)	We agree with this and will stipulate any additional risk classes in firms' waivers if we deem them suitable to be included in the VaR model.

12 Basic indicator and standardised approaches to operational risk

Introduction

12.1 The feedback to Chapter 12 of CP06/3 was generally very positive. This means that we only have a small number of changes to make to the relevant Handbook text in BIPRU 6.

12.2 There were a number of requests for clarification on certain rules. We have provided clarification where requested and most of our planned changes take this form. CRD text amendments arising from the EU jurists-linguists process do not result in any substantive changes to the relevant BIPRU rules.

Response to individual questions

Qualitative standards

> Q54: Do you agree with our interpretation of applying the concepts of size, nature, scale and complexity to the qualitative standards for operational risk?

12.3 Almost all respondents agreed with our interpretation that firms must consider their size, nature, scale and complexity when determining the qualitative standards for managing operational risk. A few respondents expressed concerns that this interpretation might result in firms being required to adopt a more sophisticated operational risk methodology than their preferred choice. A concern was also raised over the time available for firms to comply with SYSC 7 as amended in CP06/9 (previously titled SYSC 8 in CP06/3).

12.4 **Our response:** The support for this interpretation endorses the approach we have adopted. We reiterate our 'no prohibition, no compulsion' stance allowing firms the freedom to choose their operational risk methodology. However, a firm must also take account of the general risk management standards that will appear in SYSC 7 (see CP06/9) and comply with them from 1 January 2007. The relevant rules[1] are available in CP06/9. As they are directly copied out from the CRD (Article 22 of the BCD and

1 The relevant rules in SYSC are SYSC 3.2.23R, SYSC 3.2.24R, SYSC 3.2.26R and SYSC 7.1.15R.

paragraphs 11 and 12 of Annex V), we do not envisage there being any changes. The CRD has been available for a considerable amount of time, allowing firms to familiarise themselves with the requirements. Firms seeking to comply with the requirements must align them with their size, nature, scale and complexity.

Basic indicator approach

Income indicator for operating leases

Q55: Do you agree with our proposal for the treatment of operating leases when calculating the relevant income indicator?

12.5 Generally speaking, respondents supported our proposal.

12.6 **Our response:** We plan to implement this proposal in our Handbook.

Intra-group dividends

Q56: Do you agree with the proposal to exclude intra-group dividends and other intra-group income flows from the relevant indicator calculation following the amendments to the CRD?

12.7 There was virtually unanimous support for this proposal.

12.8 **Our response:** We intend to adopt this proposal in our Handbook.

Treatment of outsourcing

Q57: Do you agree with our proposals for the treatment of outsourcing and the definition proposed?

12.9 There was broad support for our proposed treatment of outsourcing. However, two questions were raised on the definition and scope of outsourcing. One respondent asked whether there was an equivalent proposal regarding their treatment of outsourcing fees in determining fixed overheads for investment firms using the fixed overheads requirement (FOR). Another commented that it thought outsourcing should cover all intra-group entities and not just those within the definition.

12.10 **Our response:** There is no equivalent treatment of outsourcing for investment firms using the FOR. We believe this would not be appropriate given the different nature of the FOR.

As for defining outsourcing, the position in the CRD is clear. The test is whether outsourcing is being contracted to a third party which is:

- a parent or subsidiary of the firm whose process, service or activity is being outsourced, or a subsidiary of a parent which is also the parent of the credit institution; OR
- subject to supervision under the CRD or equivalent requirements.

If the answer to either of these questions is 'yes', the outsourcing fees may be deducted from the relevant income indicator. If the answer to both of these questions is 'no', the outsourcing fees may not be deducted from the relevant indicator.

Extraordinary and irregular items

> Q58: Do you agree with our definitions of extraordinary or irregular items?

12.11 While the overall reaction was positive, one respondent questioned whether the definitions are consistent with the accounting definitions under IFRS. It was also queried whether the net profit or loss (P&L) on the sale of a business should be treated as an 'extraordinary' or 'irregular item'.

12.12 **Our response:** It is correct that there is no longer a definition of 'extraordinary item' under international accounting standards. This is why we have used the UK definition (from FRS 3) in CP06/3. However, in the UK it is generally accepted as virtually impossible for an item to meet this definition and, as a result, extraordinary items should hardly ever occur. The term 'irregular' (or exceptional) item does not appear under international accounting standards either.

Given the views expressed in paragraphs 12.15-12.18 of CP06/3, and in the absence of any compelling argument to the contrary, we do not think that net P&L from the sale of a business should be treated as an 'extraordinary' or 'irregular' item. In the circumstances, and following requests from the industry for guidance, we propose retaining our current definitions.

Income derived from insurance

> Q59: Do you agree with how we define income derived from insurance?

12.13 There was broad support for this proposal but one respondent wanted to see the definition expanded to incorporate the treatment of insurance income lines now included in the P&L as a result of disaggregating the balance sheet under IFRS 4.

12.14 **Our response:** For the avoidance of doubt, the following should be excluded from the calculation of the relevant income indicator:

- insurance premium income; and
- income received from insurance claims.

Only commissions received from selling insurance products should be included in the relevant income indicator.

The standardised approach (TSA)

Treatment of negative income

> Q60: Do you agree that the treatment of negative income using the TSA methodology is now consistent using Basel and the CRD?

12.15 Respondents unanimously agreed that the treatment of negative income is now consistent with Basel and the CRD.

12.16 **Our response:** We do not propose to make further amendments.

Q61: Do you agree that the capital calculation approaches employed under Basel and the CRD result in the same capital figure?

12.17 Respondents unanimously agreed that the different capital calculation approaches employed under Basel and the CRD result in the same capital figure.

12.18 **Our response:** The wording of the CRD was recently changed by the jurists-linguists process to reflect the Basel text. Our proposal not to make any changes to our approach is endorsed by all respondents.

Firms stopping or selling a business line

Q62: Do you agree with our proposal to permit firms that have stopped or sold a business line to apply for a waiver from BIPRU 6.4.6 R if calculating the relevant indicator would result in a significant overestimation of the operational risk capital charge?

12.19 Respondents wanted clarification that BIA firms, as well as TSA firms, would be permitted to apply for a waiver from BIPRU 6.4.6R if upon cessation of a business line, calculating the relevant indicator would result in a significant over-estimation of the operational risk capital charge

12.20 The industry also felt that applying for a waiver might not be the most appropriate process for a firm to go through to assess the residual amount of operational risk, should a firm decide to stop or sell a business line. Some respondents proposed to include a rule requiring firms to notify us of any adjustments to income that result from the cessation of a business line. Other respondents indicated that as part of the ICAAP, firms would have to account for any operational risk residue anyway.

12.21 **Our response:** We plan to introduce a rule in BIPRU 6.3 indicating that BIA firms, as well as TSA firms, would be able to apply for a waiver from BIPRU 6.4.6R if on the cessation of a business line, calculating the relevant indicator would result in a significant overestimation of the operational risk capital charge.

We also propose retaining the requirement for firms to apply for a waiver as it is thought this would be the most appropriate way to correctly assess the significance of the business line and the degree of operational risk residue. Firms applying for a waiver should recognise there may be potential for an additional capital charge as part of the Pillar 2 process to reflect any operational risk exposures that remain despite the sale or ending of a business line.

Business line mapping

Q63: Do you agree with our proposal to adopt a flexible approach to the allocation of activities to business lines?

12.22 Respondents indicated they agreed with our approach, with most deeming it proportionate and flexible.

12.23 **Our response:** We will maintain our stance and adopt a proportionate and flexible approach.

BIPRU 6.1-6.4 changes

Reference	Comments	Response
6.3.9 (new guidance)	Request that the waiver permitting TSA firms to exclude the income from a business that has been exited or sold, be extended to BIA.	We propose adding a rule in 6.3 saying that if a BIA firm has stopped or sold a business line and calculating the relevant indicator would result in a significant overestimation of the ORCR, the firm may apply for a waiver from rule 6.3.2R. TSA firms in a similar position may also apply for a waiver from rule 6.4.6R.
6.3.12R	As this is a rule, 'may' should be replaced with 'must'.	Agreed
6.4.3R	Text changed following revision of CRD text by jurists-linguists.	The ORCR under the standardised approach is the average over three years of the risk-weighted relevant indicators calculated each year across the business lines in 6.4.14R.
6.4.12R	Request that the word 'importable' be changed.	Agreed to change the word to 'imputable'.

13 Advanced measurement approaches to operational risk

Introduction

13.1 In CP06/3 we consulted on the qualitative and quantitative standards for the advanced measurement approaches (AMA) to operational risk. These included the use test, reporting, review process, expected loss, correlation, the impact of insurance and allocation of AMA capital.

13.2 We welcome the feedback on this topic. A number of aspects of the advanced measurement approaches are still evolving and we consider it important to maintain an active dialogue with the industry as we finalise our policies. In some instances the responses proposed changes to the draft Handbook text and where appropriate we will seek to accommodate these.

Response to individual questions

Qualitative standards

Q64: Do you agree with the areas where we propose to provide guidance for the AMA qualitative requirements?

13.3 While respondents generally agreed with the areas on which we propose to provide guidance, some expressed concerns about the section of CP06/3 dealing with the use test and the reporting of operational risk exposures and loss. In particular, respondents commented on the references to the level of understanding and nature of decision-making required of the governing body and senior management. Some aspects of this are also discussed in Chapter 19.

13.4 **Our response:** In view of the industry support for our guidance proposals, we will continue as planned. However, we would like to clarify that for reporting (CP06/3 13.9):

- the governing body and senior management should be able to understand the information presented to them and be able to take decisions based on it.
- we expect the governing body and senior management of AMA firms to be able to demonstrate that their understanding of the AMA is sufficient to enable them fully to discharge their responsibilities.

Quantitative standards

Q65: Do you agree with the areas where we propose to provide guidance for the AMA quantitative requirements?

13.5 Respondents generally agreed with the areas where we propose to provide guidance, although some expressed concerns about the sections of CP06/3 dealing with expected loss (limiting the business management style definition to high-volume business activities) and correlation and dependency (should firms seeking to demonstrate that correlation assumptions are plausible include an element of conservatism in the assumptions?).

13.6 **Our response:** In view of the industry support for our proposals, we will continue as planned. However, we would like to take this opportunity to clarify that:

- Expected loss (CP06/3 13.19-13.20) – all firms wishing to use the business management definition must be able to demonstrate they comply with BIPRU 6.5.15G to 6.5.17G. We think this is only possible for high-volume business activity and where a firm can demonstrate use of the business management definition as part of its internal management process.
- Correlation and dependency (CP06/3 13.23-13.25) – the draft handbook (BIPRU 6.5.11R(7) and 6.5.12R) requires a firm to validate its correlation assumptions using appropriate quantitative and qualitative techniques. A firm must be able to show its system for measuring correlations is sound, implemented with integrity, and takes into account the uncertainty surrounding any such correlation estimates particularly in periods of stress. In view of the current uncertainty surrounding such correlation estimates – particularly during periods of stress – we think it is reasonable to expect firms to take account of the potential impact periods of stress may have on their correlation assumptions.

Impact of insurance

Q66: Do you agree with our proposed approach on the impact of insurance?

13.7 All respondents agreed with our proposed approach on the impact of insurance. Some took the opportunity to welcome the concept of alternative risk transfer mechanisms while recognising the exact nature of these mechanisms is not yet clear.

13.8 **Our response:** As a result of the responses received we will continue with our proposed approach on the impact of insurance. We recognise that many of the issues associated with the section of the CRD dealing with the 'impact of insurance and other risk transfer mechanisms' have yet to be resolved and in some cases may not have even been identified. We have already spoken with a number of firms in an attempt to identify and resolve some of these issues, and expect the dialogue to continue for some time. We also plan to discuss this issue with other European regulators.

Combined/partial use

Q67: Do you agree with our proposed approach to combined use?

13.9 Respondents agreed with our proposed approach to combined use.

13.10 **Our response:** We will continue with our proposed approach to combined use. Firms should note that while the rules and guidance proposed in BIPRU 6.2.12 R-6.2.16G apply at the solo level, they would also apply at group level as though the group were a single entity.

BIPRU 6.5 changes

Reference	Comments	Response
6.5.7(1)G	It can be difficult for a firm to demonstrate that the operational risk measurement systems and processes provide benefits to the firm's business.	We propose to delete the part of paragraph (1) requiring firms to be able to demonstrate the benefits that arise from its operational risk measurement systems and processes. Nevertheless, a firm should still be able to show that its operational risk measurement systems and processes are not limited to determining regulatory capital and provide benefits to the firm.
6.5.13G	Proposal to delete 6.5.15 G and include some of the contents in 6.5.13 G.	We accept the proposal to remove material where there is obvious duplication and think that this is best done by deleting 6.5.13G and transferring the documentation requirement to 6.5.15G.
6.5.17G	Budgeting or pricing alone is sufficient for the purposes of capturing expected loss.	We think that budgeting or pricing alone are not sufficient and propose amending the paragraph to require firms to use a combination of budgeting and pricing.
6.5.20G	This paragraph is too prescriptive, introduces new terms (boot strapping), and could become a tick list, excluding other techniques that may as yet be undeveloped.	We propose to amend this paragraph so that firms must now consider whether the techniques are appropriate rather than having to have considered their use.

14 Capital requirements for groups

Introduction

14.1 In CP06/3 we consulted on our draft rules on group risk, which are set out in BIPRU 8. There have been no major changes in BIPRU 8 as a result of the European Transposition Group and jurists-linguist processes[1]. However, following industry feedback we plan to make some minor changes to the Handbook text to aid understanding. Set out below are the main issues raised by the industry on BIPRU 8 and our responses. Our responses to more detailed questions raised by respondents are in the table at the end of the chapter.

Main industry comment

14.2 Most industry respondents said they found the draft rules difficult to follow. The rules defining the scope of a UK consolidation group and non-EEA sub-groups was seen as especially difficult to interpret and a number of respondents asked for worked examples to be included to help understanding.

14.3 The joint-industry response sought clarification as to whether the flowchart in BIPRU 8 Annex 1R provided enough 'connection' to the Handbook text.

14.4 **Our response:** We will seek to make BIPRU 8 clearer by making a number of general amendments. These include removing duplicative rules and re-drafting certain rules to make their purpose clearer. For example, following industry comment, we have incorporated some of the rules in BIPRU 8.10R into the appropriate sections of BIPRU 8 and removed the rest of BIPRU 8.10. We have also amended BIPRU 8 where possible to include drafting changes proposed by the industry.

In defining the scope of a UK consolidation group, we have simplified the flowchart in Annex 1R and propose to include a number of diagrams as guidance. We think this flowchart provides sufficient 'connection' to the Handbook text but are exploring the ability to move the flowchart into the main body of the BIPRU 8 text.

1 Of interest to 'limited' investment groups seeking to apply for the BIPRU 8.4 waiver from consolidated capital requirements is that the jurists-linguists process did change Article 22 of the recast CAD to clarify that the Financial Holding Company (FHC) test applies to the parent FHC in a Member State of any investment firm. So, the directive text is now in line with BIPRU 8.4.1(7)R.

We propose providing new guidance[2] to help firms identify when a non-EEA sub-group exists. This guidance will be supported by diagrams and a worked example showing when several actual non-EEA sub-groups exist within a UK consolidation group. We propose to discuss this new guidance with the expert group and, if it is deemed helpful, will include it in the Handbook.

Scope of consolidation

14.5 The joint-industry response commented on paragraph 14.4 of the CP text which identified the significant new elements in BIPRU 8. They thought the concept and role of the UK consolidation group was new and should have been included in paragraph 14.4 and justified in CP06/3. They also thought the rules relating to aggregation and line-by-line aggregation were new and should have been included in paragraph 14.4.

14.6 **Our response:** The purpose of paragraph 14.4 was to highlight new elements not previously in the Handbook text. Both the scope and methods of consolidation were included in the CP05/3 Handbook text. We have not justified our approach to the scope of consolidation in CP06/3[3] because this is a requirement of the CRD which we must implement. This fact was recognised by the joint-industry response to CP05/3. The justification for our approach to consolidation calculation methodologies was also set out in that CP.

Integrated groups

14.7 The joint-industry response requested that the solo rules on integrated groups be included in BIPRU 8 and that Annex 7 of CP06/3 be updated to cover the UK consolidation group. They also sought clarification that where a firm seeks a waiver to the wider integrated group (WIG) concessionary treatments that only one application need be made, the approval of which will apply to the UK consolidation group and to all its solo entities.

14.8 **Our response:** We do not propose to change the existing Handbook structure or expand Annex 7, as most firms have indicated they will continue to use the transitional rules for integrated groups. However, we will discuss with the expert group the viability of expanding Annex 7 in the future.

The waiver application to use the WIG concessionary treatment for consolidated concentration risk requirements will need to be applied for by all UK BIPRU firms[4] in the UK consolidation group or non-EEA sub group[5]. This can be done through a single waiver application listing all the UK BIPRU firms in the relevant group[6]. This waiver application will have to explain how the WIG concessionary treatment will apply at group level. As highlighted in the diagram in paragraph 14.20 of CP06/3, some exposures of the UK consolidation group or non-EEA sub-group may not get the WIG concessionary treatment.

2 This guidance may replace the BIPRU 8.2 rules in parts.

3 As with non-EEA sub-groups in CP05/3.

4 As well as a non-BIPRU firm falling within BIPRU 8.1.1R(4).

5 This is because the obligations in BIPRU 8.3 to have adequate group capital resources to cover group concentration risk requirements fall on all BIPRU firms in the relevant group.

6 If a firm so wishes it could apply for a group and solo waiver using one application form provided this covers how it meets both the solo and group waiver requirements.

Investment firm issues

14.9 A number of trade association respondents said their members still found the Financial Holding Company (FHC) test in BIPRU 8.4.1R(7) difficult to follow and calculate. In particular, clarification was sought as to how to treat illiquid assets and long-term intra-group loans for the purposes of BIPRU 8.4.1R(7) when seeking a consolidation waiver.

14.10 **Our response:** To provide greater clarity on the FHC test calculation we propose providing a worked example and/or guidance in the Handbook. For the capital resource requirement calculation in BIPRU8.4.1R(7) a credit risk requirement (CRR) will need to be calculated on any illiquid assets held by investment firms, financial institutions, asset managers and ancillary service undertakings that would otherwise be within the scope of consolidation. This should include any long-term intra-group loans that are classed as illiquid assets.

14.11 Another trade association respondent sought clarification as to the rationale behind the change in the calculation of group capital resource requirements for non-ISD[7] venture capital firms between IPRU (Inv) 14 and BIPRU 8. The same trade association requested that we return to a notification process for excluding undertakings from consolidation on the basis their inclusion would be inappropriate or misleading.

14.12 **Our response:** We do not agree there has been a change between IPRU (Inv) 14 and BIPRU 8. The interpretation that non-directive, FSA-derived, solo capital resource requirements can be used to calculate a notional capital resource requirement for a financial institution in a BCD/CAD group does not comply with the existing BCD/CAD and will not comply with the recast BCD/CAD. Where firms have relied on this interpretation we would emphasise this approach cannot be used going forward. From 1 January 2007, non-BIPRU firms within a BIPRU firm group must calculate a notional capital resource requirement based on the actual solo requirement applying to the main firm in the group as determined in line with BIPRU 8 Annex 2R.

We set out in paragraph 12.4 of FS05/1 the rationale behind the change from a notification process to a waiver process when meeting certain of the criteria for excluding an entity from the consolidated capital resource requirements under Article 73(1) of the recast BCD. This was that these are subjective criteria which it would not be appropriate to implement by means of a notification mechanism.

Response to individual questions

CRD-equivalent regimes

Q68: Are there other non-EEA banking or investment firm regulators that you would like us to assess, for which risks and why?

14.13 The joint-industry response asked us to assess the Channel Islands and the Isle of Man for equivalence. It also requested clarification on the status of Gibraltar.

7 Investment Services Directive.

14.14 The joint-industry response sought clarification that, even if we had assessed the rules of a non-EEA regulator as equivalent, there was also a requirement for the group to calculate the capital resource requirement under our rules to ensure that it had no reason to believe that the local regulator's rules did not produce a lower figure than under our rules. If this were the case, it was felt this was a tightening of procedure and probably superequivalent.

14.15 It also sought confirmation that the contribution of all US banking subsidiaries to the consolidated credit risk requirement would be its risk-weighted assets scaled up by 125% of the Basel 8% minimum capital requirement.

14.16 **Our response:** We are in the process of assessing both the Channel Islands and the Isle of Man for equivalence. The outcome of these assessments and others will be reflected in updates on BIPRU 8 Annex 3R at Standing Group meetings between now and final publication.

We explained in 'Use of non-EEA regulators' requirements in group capital calculations'[8] our approach to CRD-equivalence. For a UK group to aggregate a local requirement calculated under the rules of a non-EEA regulator, two criteria have to be met. The first is that we have assessed the rules of a non-EEA regulator as being CRD-equivalent in principle. The second is that based on its individual circumstances the firm has no reason to believe that applying the local regulator's rules in practice will not give a CRD-equivalent result or cannot be made to give a CRD-equivalent result through the use of an add-on. We will only allow the local requirement to be included in the group calculation if both criteria are met. This approach is reflected in BIPRU 8.7.25R(2). It will be up to the firm to determine the method by which it satisfies itself that it meets the requirements in BIPRU 8.7.25R(2). This is a tightening of procedure compared to our current approach to equivalence but we do not believe that requiring firms to establish that local standards are equivalent in practice, based on individual circumstances, is superequivalent.

We will only deem a US banking subsidiary to be equivalent for credit risk if it is categorised as well-capitalised and it scales up its US Basel 1 credit risk requirement by 25% (i.e. 8% x 1.25), as set out in Annex 3R of BIPRU 8.

Use of advanced prudential calculation approaches

Q69: Are the rules and guidance clear about how the advanced prudential calculation approaches, both on their own and in combination with the simpler approaches, apply at group level? If not, where is more clarity needed?

14.17 We received no specific responses to this question other than a general observation made in the joint-industry response that unless firms had been involved with the discussions leading up to the release of CP06/3, they would find it more costly and more difficult to understand their obligations to us.

14.18 **Our response:** We propose to seek further clarity on which specific points the industry finds difficult to understand in forthcoming Capital and Groups Standing Groups to see if we can make further amendments to the Handbook to aid understanding.

8 Published on our website in December 2005.

BIPRU 8 changes

Reference	Comments	Response
CP06/3 14.7	Where a non-EEA regulator has not been assessed by the FSA as equivalent in principle but the FSA has granted a waiver based on a particular firm's own assessment of equivalence it would be helpful if this information was made public.	We must publish this information under FSMA. A related issue is whether the granting of this waiver leads us to assess this non-EEA regulator as being CRD-equivalent, in principle, for a particular or several risk types. If this were the case then we would seek to update BIPRU 8 Annex 3R as quickly as practicable. We are also considering ways of alerting the industry in advance of Annex 3R being formally updated to enable affected firms to immediately start using a non-EEA regulator's rules for relevant risks subject to meeting the conditions in BIPRU 8.7.25R(2).
8.3.1	The way this paragraph is drafted seems to imply that each firm in the group has to have enough consolidated capital to meet the group's capital resource requirements.	BIPRU 8.3.1 applies an obligation on all BIPRU firms within a group (not just the parent institution or FHC) to ensure that the group has sufficient capital resources to meet group capital resource requirements at the consolidated level of the parent in the UK. The text does not require each individual subsidiary within the group to hold capital sufficient to cover the group's capital resource requirements.
8.3.4	Requiring each firm that is a member of a UK consolidation group to ensure that the entire group of which it is a member is adequately capitalised is unrealistic. This is the responsibility of the parent.	As with BIPRU 8.3.1, the obligation is on all BIPRU firms within the group to ensure group capital resources are adequate. This obligation reflects the intention that the FSA should not be limited in its ability to take action if there was a deficit in group capital. For this reason, the obligation applies to all BIPRU firms (and a non-BIPRU firm falling within BIPRU 8.1.1(4)) in the group.
8.3.8	Does this rule mean that a firm wanting to take advantage of a group waiver should apply for that waiver at group level listing all the subsidiaries to which it will apply?	No, this rule means you cannot apply solo waivers on a group basis. But, the general point made by the respondent on group waivers is correct.
8.4.1(4)	Is the requirement in the draft definition of limited activity not to hold client money or assets a drafting error?	It is a drafting error. The requirement to not hold client money or assets will be removed from 1.1.10 (2) (b).
8.5.1	Guidance was requested on the impact of having a UCITS management company in the group, i.e. an entity outside the scope of CRD on a solo basis, but part of the group under consolidated supervision.	A UCITS management firm is exempt under Article 2 of MiFID so will not be classed as a BIPRU firm. But it will be classed as a financial institution under Annex 1 of the re-cast BCD. It will be within the scope of consolidation if it is part of a group that includes a BIPRU firm which triggers the application of BIPRU 8. The notional solo capital resource requirement applying to it will be determined in accordance with BIPRU 8 Annex 2R.
8.6.1	It should be the parent firm only that has the responsibility to calculate consolidated capital resources and not every firm which is a member of the group.	To meet the obligations in BIPRU 8.3 (see comments above) this requirement applies to all BIPRU firms in the group.
8.9.1	This rule should only apply to a non-EEA sub-group. Concentrations will have been eliminated if they are part of a UK consolidation group. So, there should be some explanatory text confirming that intra-group exposures need not be captured for LE purposes.	BIPRU 10 does apply at the UK consolidation group level to cover exposures of the UK group to external third parties. Also, we believe the operation of BIPRU 8.7.6R makes clear that intra-group exposures between members of the UK consolidation group or non-EEA sub-group would be excluded for the purposes of the consolidated concentration risk capital component. BIPRU 8.7.6R requires the component of the credit risk capital requirement that is due to concentration risk be calculated on the basis on the group as a whole and not the sum of the individual concentration risk capital components. This is why it can only be calculated using the FSA rules.

Reference	Comments	Response
8.9.7	As currently drafted the rule does not include the qualification 'when due' and should be amended accordingly.	BIPRU 8.9.9R has been amended to included a reference that BIPRU 8.9.7R should be interpreted based on the guidance in BIPRU 3.2.30G and BIPRU 3.2.31G. The result is that the 'when due' qualification is included.
8.10	Should this section be guidance rather than rules and if rules should they be moved to more relevant sections of BIPRU 8?.	Few of the original BIPRU 8.10 rules have been retained. Those that have been retained have been moved to more relevant sections in BIPRU 8.
Application of BIPRU 6.1.2G at group level.	What is the impact on consolidated requirements where one or more limited licence or limited activity firms in a limited group apply for a waiver to calculate ORR rather than using FOR on a solo basis?	This waiver would vary the permission of the limited licence/activity firm so that it is treated as a full scope BIPRU investment firm at solo level. The effect of this waiver will be that the previous limited group now contains a full scope BIPRU investment firm and at group level the group will be subject to group PRR +CRR+ ORR as set out in BIPRU 8 Annex 2R.

15 Credit risk mitigation and double default

Introduction

15.1 The credit risk mitigation (CRM) requirements can be found in a number of different sections of the Handbook, including those relating to both credit risk and counterparty credit risk. Most of the rules appear in BIPRU 5 with modifications to these rules as they apply to firms using the internal ratings based (IRB) approach found in BIPRU 4.10.

15.2 The changes to the CRM text following CP06/3 will be minimal, but we have added guidance on property valuation issues in the text on the standardised approach. The navigational aid we proposed will feature in a regulatory guide.

15.3 The issues relating to the IRB approach to CRM are discussed in Chapter 7.

Response to individual questions

Collateral

Property valuation

Q70: What are your views on our approach to property valuation?

Q71: Do you think that additional guidance is necessary for property valuation?

15.4 Respondents were positive about our proposed approach to property valuations. Many asked for the CP06/3 text to be included as guidance in the Handbook.

15.5 **Our response:** We have incorporated the CP06/3 text into BIPRU 3 on the standardised approach to credit risk (see Annex 4).

Approach to CRM issues

Q72: What are your views on our approach taken on CRM issues?

15.6 Most comments concerned our approach to mortgage indemnity insurance (MII), welcoming our recognition of MII as an eligible form of unfunded credit protection. Some respondents commented that additional guidance should be added to outline how MII should be treated under both the standardised and IRB approaches.

15.7 The joint-industry response commented on the requirements for concentration risk arising from the use of collateral. It noted that smaller firms would find it difficult to implement systems to monitor concentration risk across all business assets, and suggested that we 'adopt a flexible, proportionate and risk-based approach with regard to this requirement'.

15.8 **Our response:** While we agree that MII can be considered in the same way as other forms of unfunded credit protection, our general principle is that any unfunded credit protection is considered eligible provided it meets the relevant eligibility and minimum requirements. There will be no special treatment for MII and it will be treated in the same way as other unfunded credit protection.

However, we recognise that this is an area of great interest for some firms and we would be happy to work with them and relevant trade associations to generate worked examples of how to treat particular products.

In response to the comment about concentration risk, we note that the requirements in BIPRU 5 reflect those in BIPRU 10 (concentration risk). We agree that a flexible and risk-based approach should be taken, in particular to smaller firms that may only make infrequent use of collateral. But that this flexibility must be seen in the context of the whole of BIPRU 10.

BIPRU 3 changes

Reference	Comments	Response
3.4.63	Include CP text on property reviewing and monitoring.	We have included this as guidance.

16 Securitisation

Introduction

16.1 We will make a number of changes to BIPRU 9 following industry feedback. Many are to make the text clearer, though some result from changes in policy, for example on regulatory calls. But we have not been persuaded by some of the arguments for changes in policy, most notably those around significant risk transfer (SRT) and super senior tranches (SST).

16.2 This chapter is divided into three sections. The first deals with material and or complex policy issues not addressed by the detailed CP06/3 questions. The second gives our response to the detailed, individual CP06/3 questions. And the third lists in a table any other changes we intend to make to BIPRU 9.

16.3 We welcome the industry, via the relevant trade body, making full use of the frequently-asked questions (FAQ) process. While it has been convenient shorthand to label the process FAQs, in substance it will be tracking policy issues under discussion with the industry via the Securitisation Standing Group (SSG). At this stage, we view FAQs as the primary means by which we and the SSG can communicate progress on implementation issues to a wider industry audience.

Implicit support

16.4 Some respondents questioned the practical implementation of the implicit support guidance outlined in BIPRU 9.2.3G-9.2.8G. There was concern this could inhibit the actions of sponsors of asset-backed commercial paper (ABCP) conduits that provide liquidity and/or credit-enhancement facilities particularly when fulfilling contractual obligations to fund defaulted assets at above market value.

16.5 **Our response:** We did not intend to inhibit a firm from acting within its contractual provisions. In fact, one of the main purposes of the guidance was to ensure a firm could do this without falling foul of the implicit support requirement in BIPRU 9.2.1R.

We recognise the language used in BIPRU 9.2.3G may not have made this clear and will amend the guidance to reflect the suggestions of the joint-industry response.

Significant risk transfer

16.6 Feedback on SRT was received primarily through the joint-industry response. There was also feedback from one other respondent whose points were generally consistent with those made in the joint-industry response. There has been further dialogue and correspondence with the SSG on this matter, reflected in the comments made in this chapter.

16.7 The joint-industry response stated 'It is our understanding that the purpose of the significant risk transfer requirement is to address the issue of transactions where no risk has been transferred from the originator but there is a reduction in capital. However, our members continue to remain very unclear over the practical implementation of this guidance as well as the consistency of the implementation of the rule across the EU. Consequently we recommend deletion of BIPRU 9.4.2 and 9.4.6. We think that the key principle that should be highlighted is contained in BIPRU 9.4.5. It should be for the firm to be in a position to demonstrate that it has achieved significant risk transfer.'

16.8 **Our response:** SRT applies to originators who seek to exclude securitised exposures from the calculation of regulatory capital by applying the requirements of BIPRU 9, the securitisation framework. The aim of the policy is to allow firms the flexibility to recognise any amount of risk transfer, however small, in calculating risk weighted exposure amounts while ensuring it is not possible to undermine/arbitrage other parts of the framework. Consequently, if no risk has been transferred, no regulatory capital benefit can be obtained. And where there has been partial risk transfer an assessment of significance by the firm is required. Hence the guidance in BIPRU 9.4.2 – 'the proportional transfer of risk is broadly commensurate with, or exceeds, the proportional reduction in risk-weighted exposure amounts.'

It has become increasingly clear that the industry, while continuing to support the aim of the policy (i.e. no regulatory arbitrage), is concerned the 'proportional' wording introduces ambiguity to the SRT requirement (for example potential legal interpretations of the proposed guidance) and that the practical implementation of the guidance may be unduly burdensome, particularly given the ongoing nature of the requirement.

To address the concern of ambiguity, we would like to work with the SSG to provide examples of the requirement working in practice. We encourage firms who do find the guidance ambiguous to discuss this with us, so that a common understanding of its application is reached.

It was also not our intention to make the policy unduly burdensome. So we have agreed to make clear that, consistent with the joint-industry response, a firm should be responsible for demonstrating it has achieved SRT. We will not require any form of pre-notification or prescribe a method to be used by a firm to measure risk transfer.

Any clarification of guidance will be taken forward in our discussions with the SSG. Where agreed, we will make appropriate changes to Handbook text. As part of those discussions, consideration will be given to the differences in approach between the various parts of the regulatory framework (e.g. 'UL only' versus 'EL & UL').

Additionally, we will continue to consider the consistency of the implementation of the SRT rule across the EU and work with other European supervisors in developing policy in this area. While consistency is an issue, the SSG has made clear that a SRT policy that prohibited firms from retaining or repurchasing parts of the structure would be unwelcome. We agree that such a policy would not be appropriate as it would neither be consistent with the aims of the policy previously described nor principles based.

Therefore, subject to ongoing clarification of the practical implementation of the guidance, it will remain as currently drafted.

Definitions

16.9 The joint-industry response welcomed our proposal not to amend the definition of either 'originator' or 'sponsor' in the BIPRU text. However, we noted a comment about the wording in 16.22 of CP06/3 which suggested it was considered broad and ambiguous.

16.10 **Our response:** We would like to clarify that we do not consider this to be the case. In our view, any firm that excludes securitised exposures from its own balance sheet in calculating risk-weighted exposure amounts must be considered an originator.

Use of the IRB approach

16.11 The joint-industry response suggested we clarify that where a firm uses an advanced approach to credit risk and is an investor in a securitisation, it is able to use the internal ratings based (IRB) approaches to risk weight the securitisation positions.

16.12 **Our response:** We think the draft Handbook provision, which is copy out, is clear on this point. Only a firm using the standardised approach for the exposure class to which the securitised exposures would belong will be expected to use the methods under the standardised approach for securitisations.

Where the underlying portfolio contains a mix of exposures – some where the firm uses the IRB approach and others where the firm uses the standardised approach – the firm should generally use the approach which would apply to most of the underlying exposures.

Use of ECAI assessments

16.13 The joint-industry response suggested it should be possible for a firm to use different external credit assessment institutions (ECAIs) for different types of securitisation transactions, for example mortgage versus corporate loan structures. The response argued that different ECAIs have different specialisations and so it may not be appropriate to use the same ECAI across all types of transaction.

16.14 **Our response:** While we agree that different ECAIs have different specialisations, we do not think it would be possible under the CRD (or BIPRU) to allow what the joint-industry response suggested.

CEBS has discussed this issue and decided that ECAIs should be recognised on the basis of their 'securitisation' methodology. A firm must therefore choose whether to nominate an ECAI for the whole of its securitisation portfolio. The rules in BIPRU 9.8.5R-9.8.6R explain what must occur when a position has assessments from more than one nominated ECAI.

Capping exposure at deduction

16.15 The joint-industry response requested general clarification that, throughout the BIPRU text, the application of the 1250% risk weight is capped at full deduction of the relevant exposure.

16.16 **Our response:** We agree with the industry and propose that as an alternative to any risk weighting, not just 1250%, a firm should have the option to deduct the entire securitisation exposure from capital.

Glossary definitions

16.17 The joint-industry response recommended that we delete the definition under (1) of the term 'securitisation' in the Glossary.

16.18 **Our response:** We do not plan to do this, as we have not yet been able to determine the extent to which other Handbook provisions would be affected by such a deletion. Our initial analysis is that retaining this definition does not present a material risk. However, we note that only the second part of the definition would apply for the purposes of BIPRU 9. We will carry this forward as an outstanding action point.

Response to individual questions

Internal assessment approach

Q73: What are your views on our implementation of the internal assessment approach (IAA)?

16.19 The joint-industry response welcomed the re-ordering and grouping of the IAA requirements as it will make this part of the chapter easier to navigate.

16.20 Respondents disagreed with a hierarchy of approaches that required the application of the IAA or the supervisory formula method (SFM) 'consistently across transactions'.

16.21 **Our response:** The intention was to allow firms to choose between the two approaches for each individual transaction or position and then to stay on that approach. We agree that the guidance was not clear. We also agree there will be legitimate reasons for using one method then migrating to another. For example, a firm may begin using the SFM then migrate to the IAA once it has evidenced compliance with the IAA requirements. If the firm ceases to meet these requirements it would then return to the SFM.

We will change the policy to allow firms to choose the most appropriate approach for each transaction or exposure in line with the circumstances at the time. Switching between the two approaches simply to cherry pick the one with the lower capital requirement will not be considered as an acceptable basis for choosing the most appropriate approach.

Regulatory calls

Q74: What are your views on our approach to regulatory calls?

Q75: What notification period would be reasonable for pre-approval to exercise regulatory calls?

16.22 Respondents did not generally comment on our approach to limit the use of regulatory calls to CRD implementation but did disagree with requiring our pre-approval.

16.23 Respondents sought further clarification on differentiating between when the decision to exercise the call had to be made against when the call actually had to be exercised.

16.24 The joint-industry response requested explanatory guidance to be added to the Handbook text.

16.25 The joint-industry response stated that we have approved regulatory calls.

16.26 **Our response:** We have reconsidered our policy position and decided to drop pre-approval. We have also decided to remove the split between when a firm decides to exercise the call and actually exercising it. Instead, there will be a single deadline for both IRB and standardised banks by when these regulatory calls must be exercised, which will take into consideration the timing of the transitional floors. The deadline for exercising regulatory calls will be 31 December 2010. Guidance to this effect will be added to the Handbook.

Going forward, we plan to do further work in determining the interdependencies between call options more generally and the application of principles such as implicit support and SRT throughout the life of a securitisation.

It should be noted that whilst we permitted the use of regulatory calls due to uncertainty during the negotiation of Basel 2/CRD, none were specifically approved.

Super senior tranches

Q76: Do you agree with our approach to 'super senior' tranches?

16.27 Respondents expressed concern with our interpretation of what constitutes a SST. They suggested that our interpretation would 'force the reference position to be treated under column B of BIPRU 9.11.11R (the base case) upon the existence of a super senior tranche.'

16.28 **Our response:** After further dicussion, we are still unclear how both a 6% risk weight and a 7% risk weight can apply to tranches in the same transaction. We believe that the 6% risk weight is a replacement for the 7% risk weight where there is a reference tranche in CQS 1 and the risk weight is justified by the loss absorption qualities of the subordinate tranches. Only the 'most senior' tranche of a securitisation can attract a 7% (or 6%) risk weight and in the example where a thick, 'senior' tranche is issued to the market and the SST is retained by the originator, only the SST could ever be considered the 'most senior'. This would be the case whether a 6% risk weight or a 7% risk weight applied to the SST.

We have discussed this issue with other European regulators and will add guidance to the Handbook so that the reference position for a SST will receive a 12% risk weight. We will also add guidance to confirm that liquidity facilities structured to be the most senior positions do not need to be taken into account in BIPRU 9.11.14R.

Trading book instruments

Q77: What are your views on our approach to trading book securitisations?

16.29 Respondents welcomed our approach to securitisation positions in the trading book. Further clarification was requested on the treatment of swaps and other derivative positions when the counterparty is a securitisation special purpose vehicle (SPV).

16.30 **Our response:** We agree securitisation positions that qualify for the trading book should be subject to the trading book requirements. This would include for example a firm's interest rate swap market-making desk transacting with that firm's own securitisation vehicle or a third party.

However, it should be noted that in some instances the trading book requirements may cross-refer back to BIPRU 9. For example, the counterparty risk charge for financial instruments in the trading book (e.g. derivatives, long settlement positions and repo) as listed in BIPRU 14.22 must multiply the exposure value by the risk weights for either the standardised or IRB approach as set out in BIPRU 9.

We will clarify the guidance accordingly.

BIPRU 9 changes

Reference	Comments	Response
9.1.6	Amend wording to add clarity.	We will make the change in line with comments from respondents.
9.1.6	Change the example.	We agree with comments that the example could be confusing, and we propose to simply delete it.
9.1.10	Clarify treatment of securitisation positions in the trading book.	We will make changes in line with 16.30.
9.2	Move section 9.2 to follow section 9.6.	We will make this change.
	Amend wording to ensure that ABCP sponsors are not penalised.	We will amend the guidance in line with 16.5.
9.5.4	Clarify guidance on legal opinions.	We agree with respondents that our guidance to ensure continuing enforceability of legal opinions in securitisations may have led to undue burden. We will therefore add the example of an amendment of the underlying legal framework to illustrate where we would expect legal opinions to be updated.
9.11.14		Add guidance on liquidity facilities, see 16.28.
9.11.15		Add guidance on super senior tranches, see 16.28.
9.12.4	Clarify treatment where both IAA and SFA are available.	We will amend the guidance in line with 16.21.
9.14	Move section 9.14 to follow section 9.9.	We will make this change.
Glossary	Add definition of 'securitised exposures'.	We agree that this will add clarity and we will add this term.

17 Pillar 3: rules of disclosure

Introduction

17.1 We confirm our long-standing intention, supported by the industry, to implement the Pillar 3 requirements as 'copy-out' rules with no additional guidance. The rules can be found in BIPRU 11. In summary:

- Respondents welcomed our risk-based approach to monitor and enforce firms' compliance with the disclosure requirements.
- Some respondents highlighted the need for additional guidance to explain the interaction of the Pillar 3 requirements with accounting standards.
- Some respondents requested further information on whether the Pillar 3 disclosure requirements would still be applicable if the information required for disclosure is not relevant or applicable to the firm.
- Others sought clarification on whether the concepts of materiality and proprietary or confidential information are applicable to all types of firms.

Response to individual questions

Q78: Do you agree that the Handbook text should be a straight copy-out of the CRD with no additional guidance provided?

17.2 Respondents broadly supported a straight copy-out of the CRD. However, some requested further clarifications in specific areas, including on the similarities and differences between Pillar 3 and accounting disclosure requirements.

17.3 **Our response:**

Interaction with accounting standards

In our view, there are two key arguments why we should not issue any formal guidelines on the similarities or differences between Pillar 3 requirements and accounting disclosure requirements such as IFRS 7 Financial Instruments: Disclosure.

First, Pillar 3 disclosure requirements are intended to inform prudential reporting, but IFRS 7 requirements are intended to provide disclosures for users of financial statements. Although we expect the greatest overlap to occur for qualitative disclosures, quantitative disclosures are likely to differ on a case-by-case basis. The guiding principle of Pillar 3 disclosure requirements should be 'through the eyes of senior management' as they are best-placed to decide whether a disclosure requirement is equivalent to IFRS 7.

One of the main objectives of Pillar 3 is to allow market participants to see the nature and extent of risks referred to in the prudential framework as seen and assessed by management.

Second, IFRS 7 requirements are principles based and so have elements of discretion, whereas Pillar 3 disclosure requirements are more prescriptive. A comparison between the two sets of requirements will inevitably require an interpretation of the accounting standard requirements and could limit the options inherent in IFRS 7.

Application of disclosure requirements: materiality

The aim of Pillar 3 is to provide market participants with key pieces of information on firms' risk exposures and their risk assessment processes. The directive permits firms to omit certain disclosures on the basis that the information is not material.

Under BIPRU 11.3.5R, the disclosures required under BIPRU 11.5 may be omitted if the information provided is not regarded as material. Firms must regard information as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions.

However, in the case of BIPRU 11.6, the disclosure requirements will be applicable only if the firm is using a particular instrument or methodology such as the internal ratings based (IRB) approach, credit risk mitigation techniques or the advanced measurement approach for operational risk.

Since we are adopting a copy-out approach, it is not possible to specify which disclosure requirements apply to each type of firm. Senior management must determine whether the information required by Pillar 3 is applicable or material to the firm.

Application of disclosure requirements: confidential and proprietary

Generally, firms may omit any item of information required to be disclosed under Pillar 3 if the item includes information which is proprietary or confidential.

Information is confidential if there are obligations to customers or other counterparty relationships binding the firm to confidentiality. Information is proprietary if sharing that information with the public would undermine a firm's competitive position. Proprietary information may include information on products or systems which, if shared with competitors, could undermine the value of the firms' investments.

When firms do not disclose information because it is proprietary or confidential, they need to state that specific confidential or proprietary information has not been disclosed, the reasons for the omission, and some more general information except where that would also be classified as proprietary or confidential. This requirement is only applicable if firms are withholding disclosures on confidentiality/proprietary grounds.

Q79: Firms will apply IFRS 7 Financial Instruments: Disclosure for annual periods beginning on or after 1 January 2007. Do you agree with our proposal to require firms implementing the standardised approach to make Pillar 3 disclosures for annual periods at the same time?

17.4 Respondents agreed with our approach on the timing of disclosure. However, some raised the issue of firms that will not apply IFRS 7.

17.5 **Our response:** We will align the timing of the reporting dates for Pillar 3 and IFRS 7 disclosure requirements for firms applying IFRS 7. However, all firms must publish their Pillar 3 requirements on at least an annual basis and as soon as practicable. We expect firms to make Pillar 3 disclosures at least once during the calendar year 2007 if they are using the standardised and foundation approaches. For firms using the advanced approach, the disclosures should be made at least once during the calendar year 2008. It is up to the firm's senior management to decide where and how they will disclose information.

BIPRU 11 changes

Reference	Comments	Response
11.2.6	This section allows firms with non-EEA parents to apply for waivers as long as comparable information is disclosed by the parent. However, the cross reference is to waiving the requirements in 11.2.4 and 11.2.5, and these provisions relate to EEA parent financial holding companies. It would seem to be more straightforward if the cross-reference were to section 11.3.	Agreed. The section will be amended.
11.5.4 (1) & 11.5.7 (1)	These sections refer to 'internal capital.' We note that this term is taken from the directive, but is defined neither in the directive nor in the Handbook. There is a diversity of views within our membership in respect of whether there would be benefit to firms in guidance or definition being provided by the FSA. Although a significant proportion of our membership wishes to exercise firm level discretion in defining this term, firms are conscious that this might lead to significant diversity of approach. Additionally, the FSA should be aware that some firms would welcome guidance and may wish at a minimum to pursue this topic in the context of discussions held as a part of their supervisory relationship with the FSA.	The main objective of using a copy-out approach is to avoid any unintentional gold-plating. Hence, we think the best approach is to allow firms to use their own discretion regarding the definition of 'internal capital'.
11.5.8 (3)	This section refers to the total amount of exposures after accounting offsets. The comment 'accounting offsets' requires further definition. We understand the comment 'without taking into account the effects of credit risk mitigation' as excluding on-balance sheet netting, but including individual impairment allowance offsets against exposures (i.e. specific provision). Consequently, this disclosure will only apply to the Standardised Approach given that the individual impairment allowance offset is not a valid option under the two IRB Approaches where calculations will be made using gross exposures not including the impairment allowance offset.	As stated above only BIPRU 11.6 disclosure requirements specify the context (instruments or methodologies) in which the disclosure requirements are applicable. Requirements in BIPRU 11.5 are applicable in all circumstances unless the information required is not material. BIPRU 11.5.8 (3) relates to net exposures, without taking into account credit risk mitigation, irrespective of the methodologies the firm is using.

Reference	Comments	Response
11.5.8(3)-(6)	We believe there is some confusion with regard to the four disclosures requesting breakdowns by exposure classes. In particular, BIPRU 11.5.8 (5) asks for distributions of exposures by counterparty type e.g., Sovereigns, Banks, Corporates, etc, and then asks for these to be broken down by 'exposure class'. Within BIPRU 4.3.2, exposure classes have been defined as claims on central governments and central banks, institutions, corporates, etc., a similar analysis to counterparty type. However, the Basel Accord called for breakdowns of counterparty type by major types of credit exposure, e.g., loans, commitments, other non-derivative off balance sheet exposures, etc. which presents a logical matrix structure. Therefore we take the FSA use of exposure class in BIPRU 11.5.8 (3-6) to mean the same as type of credit exposure in the Accord and ask for confirmation that this suggested treatment is correct.	BIPRU 11.5.8 (3-6) requires exposures to be broken down by exposure classes. BIPRU 11.5.8 (4-6) also requires further detail if appropriate. Firms may use the Basel Accord methodology to break down the exposures further but are not required to use this approach. An example where further breakdown can be meaningful is when a firm has a significant proportion of its relevant exposures in one exposure class.

18 Approvals process for IRB, AMA and CCR IMM waiver applications

Introduction

18.1 In CP06/3, we consulted on the approvals process for IRB, AMA and CCR IMM waiver applications. While we did not receive any specific suggestions to amend the material covered, we did receive some general comments. Some respondents noted that the content of this chapter was very much in line with the CP05/3 proposals, which have remained largely unchanged since their publication in January 2005.

Further feedback

Fees

18.2 We outlined our initial proposal on fees for 2006-07 in CP06/3. Chapter 6 of CP06/2[1] (Regulatory fees and levies 2006/07) provides an update of our proposal to charge for the work to implement the CRD. Respondents noted that we would be considering new periodic fees to be charged to firms that have successfully applied for an IRB, AMA and CCR IMM waiver. They will respond to this suggestion formally at the time of the next annual fee consultation, in the first quarter of 2007.

Decision-making process

18.3 CP06/3 stated an FSA committee would oversee IRB, AMA and CCR IMM waiver decisions. Some respondents expressed concerns about a firm's waiver application being rejected by this committee at the final stage of the process. They hoped this would be a rare event and that FSA staff would have discussed potential shortcomings with the firm well in advance of the formal decision being taken. In their view, this would allow the firm to take remedial action in a timely fashion.

1 http://www.fsa.gov.uk/pubs/cp/cp06_02.pdf.

18.4 **Our response:** We reiterate there will be open communication between the applying firm, its FSA relationship manager who has the principal responsibility for reviewing the application and other FSA staff involved in the process. This should mean that these staff can identify and communicate significant shortcomings to the firm at an early stage. The committee will reach a decision after considering the FSA staff recommendation.

If the committee turns down an application, we will explain why we have come to that decision. We have also discussed with the industry a note on our attitude to shortcomings in firms' waiver applications[2]. This note should help applicants understand better the possible conditions that could be attached to a waiver decision.

18.5 The joint-industry response asked us to adopt a pragmatic and flexible approach to the waiver approvals process. In their view, this latitude was necessary as it was not possible for the industry to conduct a line-by-line assessment of the Handbook in preparing their waiver application given that the final text and minimum requirements were not yet clear.

18.6 **Our response:** We have already demonstrated a pragmatic approach for those wanting to submit applications before we have finalised the Handbook text. We asked firms to complete a self-assessment against the BIPRU text consulted on in CP05/3. To those firms which did apply, we provided individual guidance on updating their self-assessment after CP06/3 was published. Self-assessment is an essential part of the application process. Firms seeking approval for one of the advanced approaches are responsible for providing us with evidence that they meet the minimum standards for their chosen approach. The self-assessment process is one component in demonstrating compliance. In CP06/3 we said that we would deem valid the preparatory work undertaken in good faith by any firm in anticipation of the final text of the directive, provided that firms:

- comply with our policy baseline articulated for that purpose and, with effect from the publication of CP06/3, the complete set of draft rules; and
- discuss with us an appropriate, individual timetable for making changes required by the final CRD text and our final Handbook rules.

This commitment remains and we believe it provides for an appropriately flexible and pragmatic approach to the waiver process as we finalise the Handbook text.

2 http://www.fsa.gov.uk/pubs/international/bag.pdf.

19 Governance of IRB and AMA

Introduction

19.1 In the draft Handbook text (BIPRU 4) that accompanied CP06/3, we:

- copied out the CRD requirements for governance and senior executives' understanding of internal ratings based (IRB) rating systems;
- provided additional guidance on governance of advanced measurement approaches (AMA) to operational risk; and
- included a definition of the 'designated committee' used to approve IRB rating systems and AMA models.

19.2 We explained that we considered it necessary for a 'designated committee' to include at least one member of the firm's governing body. This was to ensure that adequate review and challenge of rating systems occurred at a sufficiently senior level. We also indicated in CP06/3 that the BIPRU requirements for approval and understanding of rating systems[1] would apply at the level of the firm and, where relevant, the UK consolidation group or non-EEA sub-group[2].

19.3 This chapter summarises the responses to the question raised, and explains how our thinking on the subject has developed.

Response to individual question

> Q80: Are the proposed governance requirements for IRB and AMA sufficiently clear and proportionate?

19.4 We received three responses on the proposed definition of 'designated committee', including the joint-industry response. Each was opposed to the proposed designated committee definition, asserting that it was disproportionate and overly-prescriptive. The respondents argued that firms should have the freedom to define risk management governance arrangements for themselves. They felt such approval would be more appropriately handled by lower-level, specialist committees, with regular reporting and updates received by the governing body.

1 BIPRU 4.3.9R – 4.3.12R

2 Please see BIPRU 8.10.4R.

19.5 In addition, the joint-industry response:

- suggested that the proposed definition was superequivalent to the CRD's requirements;
- in the case of UK subsidiaries of overseas firms using global rating systems, called for us not to apply, at the UK subsidiary-level, approval requirements that would duplicate unnecessarily those applied at the global level, but to rely where possible on home regulators' oversight and approval processes;
- welcomed the suggestion that approval arrangements at the group-level might be capable of satisfying simultaneously those at the authorised firm level; and
- considered the additional guidance relating to AMA governance also to be superequivalent and disproportionate.

19.6 **Our response:**

Designated committee definition and approval of IRB rating systems

We have reviewed the comments received on Chapter 19 of CP06/3 and continue to consider it appropriate to define 'designated committee' such that it must include at least one member of the firm's governing body. Our view is that the proposed definition is not superequivalent, but an explicit requirement of the CRD[3]. In addition, we continue to believe that the definition is necessary to ensure effective review and challenge of firms' IRB rating systems.

We acknowledge the practical difficulties identified by respondents, and recognise that we must strike an appropriate balance between meeting the CRD's IRB governance requirements and industry concerns about proportionality. Accordingly, we propose to require the governing body or designated committee to approve only the firm's 'material' IRB rating systems and 'material' changes to those systems. A firm should determine for itself:

- what 'material' should mean in this context[4]; and
- the governance arrangements that should apply to non-material rating systems.

In line with the CRD requirement for understanding of rating systems (see below) and the need for proper challenge, we will expect the governing body or designated committee's approval of a material rating system to go beyond considering the operational processes in place to ensure the rating system's adequacy. It should involve high-level consideration of the adequacy of the rating system itself. This could include, for example:

- the overall capital impact of using the rating system;
- its key strengths and weaknesses;
- the overall extent, and adequacy, of conservatism applied; and
- the adequacy of the rating system's performance.

3 Paragraph 124, Section 5.1, Part 4, Annex VII.

4 It should be noted that in a large group with a large number of rating systems the number of rating systems considered to be material could potentially be relatively small.

It would be reasonable for a governing body or designated committee to take into account in its review reports, recommendations or sign-off from lower levels.

In addition to approving material rating systems (and material changes to those), we propose to require a governing body or designated committee to approve a policy statement defining its overall approach to material aspects of rating and estimation processes for all rating systems, including non-material rating systems. This is intended to ensure adequate senior approval in situations in which non-material rating systems could be, in aggregate, as significant or more significant, than material rating systems.

Definition of governing body and senior management

In FS05/1 and CP06/3, we explained that we would also use our current Handbook definitions of 'governing body' and 'senior manager' to define the parties to which the IRB governance requirements apply. Firms should continue to refer to the Handbook Glossary for the definition of 'governing body'. We intend to leave 'senior management' undefined in the BIPRU Glossary. In identifying the parties to which the IRB requirements on 'senior management' apply, firms should have regard to the Handbook definition of 'senior manager'.

Understanding of IRB rating systems

The CRD requires a firm's:

- governing body and designated committee to have a general understanding of the firm's rating systems[5];
- senior management to have a good understanding of rating systems' design and operations; and
- governing body, designated committee and senior management to have a detailed comprehension of the management reports associated with the rating system.

The joint-industry response identified our expectations of senior executives' understanding of IRB rating systems and AMA as the industry's principal governance concern. In FS05/1, we recognised that it would be neither appropriate nor proportionate to expect senior executives to have the same detailed understanding of rating systems as the specialists within the firm responsible for designing and maintaining those systems. This remains our view. In addition, we continue to believe that it would be inappropriate at this stage to include in BIPRU additional guidance on what 'general understanding' and 'good understanding' of rating systems might mean in practice.

Group-level requirements for approval and understanding of IRB rating systems

In CP06/3, we suggested that the CRD requirements for approval of rating systems apply at both the level of the firm and, where relevant, the level of the UK consolidation group or non-EEA sub-group. This remains our view.

5 It should be noted that the BIPRU 4.3.9R requirement for 'general understanding' of the rating system applies to the governing body irrespective of whether or not a designated committee is used to approve rating systems. As stated in FS05/1, we would expect the 'general understanding' requirement to fall within the overall competence of the governing body as a whole, and the designated committee as a whole, rather than to each of its individual members.

The CRD requirement for group-level approval was emphasised by BIPRU 8.10.4R. Responses to CP06/3 stated that BIPRU 8.10 was not sufficiently clear. As a result, we plan to clarify in BIPRU 8 the way in which the IRB governance requirements apply at the group-level. Our intention is that:

- rating systems that are material in the context of the UK consolidation group or non-EEA sub-group must be approved by either the governing body or a designated committee of a UK consolidation group or non–EEA sub-group; and
- where such a designated committee is used, its members must include at least one member of the governing body of the UK consolidation group or non-EEA sub-group.

We suggested in CP06/3[6] that it could be possible for group-level approval arrangements simultaneously to meet the approval requirements at the authorised firm level. We proposed that one potential way in which this might be achieved could be by the authorised firm identifying as its designated committee the designated committee of the UK consolidation group or non-EEA sub-group. After further analysis, our view is that there are two principal ways in which this could be achieved:

1. *Where IRB is used within an EEA group on a unified basis*

   Where an EEA parent credit institution and its subsidiaries, or an EEA parent financial holding company and its subsidiaries use the IRB approach 'on a unified basis'[7], we will consider the parent and its subsidiaries together in deciding whether the rating system approval requirements have been met. In respect of IRB applications subject to Article 129, we will consider this issue in consultation with other relevant EEA regulators. The key conditions that must be met in order for approval to be given on a group-wide basis in these circumstances comprise:

   - the authorised subsidiaries within the group have delegated the approval of rating systems to the governing body or designated committee of the EEA parent credit institution or EEA parent financial holding company;
   - the designated committee (where one is used) of the EEA parent credit institution or EEA parent financial holding company complies with the BIPRU definition of 'designated committee'; and
   - the governing body or designated committee of the EEA parent credit institution or EEA parent financial holding company approves either:
     - all rating systems in the group (and material changes to them); or
     - rating systems that are material in the context of the group (and material changes to them), and a policy statement defining the overall approach to material aspects of rating and estimation processes for all rating systems, including non-material rating systems.

6 Please see paragraphs 19.10-19.13 of CP06/3 for further details.

7 BIPRU 4.2.3R and CRD article 84(2) refer. The BIPRU Glossary includes the relevant definitions.

2. *Where the governing body or designated committee of the UK consolidation group or non-EEA sub-group includes a member of the governing body of the relevant firm*

   We recognise that this approach may be challenging, particularly in the case of larger groups, but would be happy to discuss with groups the circumstances in which such an approach could meet the CRD's approval requirements.

   In situations other than 1 or 2 above, rating systems that are material for a particular firm must be approved at two levels:

   - by the governing body or designated committee of that firm; and
   - where also material in the context of the UK consolidation group or non-EEA sub-group, by the governing body or designated committee of the UK consolidation group or non-EEA sub-group.

   We will discuss approval arrangements in particular cases as part of our continuing dialogue with groups on their implementation of IRB approaches.

   In CP06/3, we also highlighted the understanding requirements that apply at the level of the group. It remains our view that:

   - the governing body and designated committee of the UK consolidation group or non-EEA sub-group must have a 'general understanding' of rating systems[8];
   - the senior management of the UK consolidation group or non-EEA sub-group must have a 'good understanding' of rating systems' design and operations; and
   - the governing body, designated committee and senior management of the UK consolidation group or non-EEA sub-group must have a detailed comprehension of the management reports relating to the rating systems within the group.

FSA's review of IRB governance arrangements

Consideration of governance will be a fundamental part of our review of an IRB waiver application. In assessing the arrangements in place at the level of the firm and, where relevant, the UK consolidation group or non-EEA sub-group, we will consider:

- compliance with the BIPRU Glossary definition of designated committee;
- the nature of the rating system approval process, including:
  - the governing body or designated committee's key areas of focus and challenge in reviewing and approving rating systems (including, where appropriate, the use of reports, recommendations or sign-off from lower levels);
  - the evidence available to demonstrate the level of challenge that has taken place at the governing body or designated committee – for example, the documents reviewed and minutes of relevant meetings;

8 In line with our approach set out in footnote 5, the BIPRU 4.3.9R requirement for 'general understanding' of the rating system applies to the governing body irrespective of whether or not a designated committee is used to approve rating systems. As stated in FS05/1, we would expect the 'general understanding' requirement to fall within the overall competence of the governing body as a whole, and the designated committee as a whole, rather than to each of its individual members.

- where relevant, the policy statement approved by the governing body or designated committee defining the overall approach to material aspects of rating and estimation processes for all rating systems;
- what the governing body and designated committee's 'general understanding' and senior management's 'good understanding' of rating systems is considered to mean in practice; and
- the approach to satisfying the requirement for management reporting on the rating system to the governing body, designated committee and senior management.

AMA governance

We continue to believe the 'designated committee' definition proposed in CP06/3 to be appropriate also for AMA and that the governance requirements that apply to IRB should also apply to AMA. This is to ensure that adequate review and challenge of AMA models occurs at a sufficiently senior level. Other regulators are taking the line that a firm's designated committee or governing body should review its AMA. The importance of this is amplified by the fact that the AMA is not yet as embedded in industry practice as credit risk approaches. We consider that our proposals will help to ensure the integrity of the use test by involving directly a firm's governing body or designated committee.

As with our IRB governance requirements, we acknowledge respondents' concerns about the need to take a practical and proportionate approach. We propose to require a firm's governing body or designated committee to approve only 'material' aspects of a firm's AMA model, and material changes to that model. A firm should determine for itself what 'material' should mean in this context, and the governance arrangements that should apply to approval of non-material AMA aspects.

We will expect the governing body or designated committee also to approve a policy statement defining its overall approach to modelling operational risk.

The governance requirements for AMA model approvals apply at the level of the firm and, where relevant, the level of the UK consolidation group or non-EEA sub-group. We intend that:

- AMA models that are material in the context of the UK consolidation group or non-EEA sub-group must be approved by either the governing body or a designated committee of a UK consolidation group or non-EEA sub-group; and
- where such a designated committee is used, its members must include at least one member of the governing body of the UK consolidation group or non-EEA sub-group.

We intend to specify two main ways in which group-level approval arrangements would be capable of meeting simultaneously the governance requirements at the level of the firm.

1. *Where AMA is used within an EEA group on a unified basis.*

   Where an EEA parent credit institution and its subsidiaries, or an EEA parent financial holding company and its subsidiaries use the AMA 'on a unified basis', we will consider the parent and its subsidiaries together in deciding whether our AMA approval requirements have been met. In respect of AMA applications subject to Article 129, we will consider this issue in consultation with other relevant EEA

regulators. The key conditions that we intend to apply in order for approval to be given on a group-wide basis in these circumstances comprise:

- the authorised subsidiaries within the group have delegated to the governing body or designated committee of the EEA parent credit institution or EEA parent financial holding company responsibility for approval of AMA;
- the designated committee (where one is used) of the EEA parent credit institution or EEA parent financial holding company complies with the BIPRU definition of 'designated committee'; and
- the governing body or designated committee of the EEA parent credit institution or EEA parent financial holding company approves either:
  - all aspects of the AMA (and material changes to them); or
  - aspects of the AMA that are material in the context of the group (and material changes to them), and a policy statement defining its overall approach to modelling operational risk.

2. *Where the governing body or designated committee of the UK consolidation group or non-EEA sub-group includes a member of the governing body of the relevant firm.*

We recognise that this approach may be challenging, especially in the case of larger groups, but would be happy to discuss with groups the circumstances in which it could meet our approval requirements in respect of AMA.

In situations other than 1 or 2 above, aspects of AMA that are material for a particular firm must be approved at two levels:

- by the governing body or designated committee of that firm; and
- where also material in the context of the UK consolidation group or non-EEA sub-group, by the governing body or designated committee of the UK consolidation group or non-EEA sub-group.

As with the IRB approach, we plan to discuss approval arrangements in particular cases as part of our continuing dialogue with groups on their implementation of AMA.

In respect of understanding of AMA:

- the firm's governing body and designated committee should have a 'general understanding' of the AMA model, and its senior management should have a 'good understanding' of the AMA model's design and operations; and
- the governing body and designated committee of the UK consolidation group or non-EEA sub-group should have a 'general understanding' of the AMA model, and its senior management should have a 'good understanding' of the AMA model's design and operations.

Governance will be a fundamental part of our review of an AMA model application.

BIPRU 4 and BIPRU 8 changes

Reference	Comments	Response
4.3.9R	Respondents suggested the proposed 'designated committee' definition was impractical and superequivalent and that approval could reasonably be given by lower level committees or senior management.	We consider the definition to be required by the CRD. Therefore, we plan to continue to use the definition in the BIPRU glossary.
8.10.4R	Respondents were keen that group-level approval structures could be capable of also meeting firm-level rating system approval requirements.	We intend to clarify in BIPRU the circumstances in which this would be possible.
	Respondents requested that, in respect of the approval by UK subsidiaries of overseas firms of global rating systems, the FSA rely where possible on home regulators' oversight and approval processes.	The CRD constrains our ability to do so. We intend to clarify in the BIPRU the requirements for approval at the level of the firm and the group.

20 Covered bonds regime

Introduction

20.1 The joint-industry response fully supported the implementation of a covered bonds regime that meets the legal requirements of the UCITS[1] Directive and the CRD. Ongoing dialogue through the Standing Group process was encouraged as was full consultation on the detail of the Handbook text.

20.2 Since CP06/3 was published, the responsibility for implementing an EU-compliant covered bonds regime has moved to the Treasury[2]. This was necessary as the Treasury has the wider rule-making powers required to implement the regime.

Response to individual questions

Cost-benefit analysis

Q81: What are your views on the benefits and costs of implementing an EU-recognised covered bonds regime?

20.3 The joint-industry response detailed a number of the costs and benefits. Costs included IT systems and independent reporting. The benefits included the preferential risk weights and a positive impact on the retail mortgage market. Increased liquidity was another key benefit highlighted.

20.4 The response also highlighted the beneficial impact of having a regime that allowed market-led initiatives. It noted that under the standardised approach the benefits were limited by the fact that the risk weighting was linked to the rating of the issuer and not the issue.

20.5 **Our response:** The implementation of an EU-recognised covered bonds regime is supported by this analysis of costs and benefits. Further analysis will be conducted as part of developing the Treasury's proposals for consultation.

1 Undertaking for the collective investments in transferable securities.

2 A written Ministerial Statement appeared in Hansard on Thursday 29 June: http://www.publications.parliament.uk/pa/cm/cmhansrd.htm

Supervision of issuers

Q82: What are your views on the proposed supervisory notification thresholds?

20.6 The joint-industry response accepted and understood the need for supervisory notification thresholds. There was a request for ongoing dialogue and an opportunity to comment further in developing the detailed requirements.

20.7 **Our response:** We welcome the industry's input and will continue the dialogue as part of developing the detailed requirements.

Special public supervision

Q83: What are your views on the proposed approach to 'special public supervision'?

20.8 The joint-industry response generally supported the proposed approach to 'special public supervision'. However, further dialogue was requested in particular around the independent verification of compliance with the rules at inception and on an ongoing basis.

20.9 **Our response:** We welcome the industry's input and will continue the dialogue as part of developing the detailed requirements.

Handbook changes

20.10 Implementing the CRD is one of the elements required to set up a covered bonds regime in the UK. The Handbook text covering the risk weighting of covered bonds in the standardised and internal ratings based (IRB) approaches are unchanged in the final rules for BIPRU 3.4.97-98 and BIPRU4.4.35 respectively. The UK regime, enabling firms to issue covered bonds, which will qualify under these rules, will come into effect once the Treasury completes its works and implements Article 22(4) of the UCITS Directive. Further Handbook text will be introduced at that time.

21 Feedback on cost-benefit analysis

Introduction

21.1 This chapter responds to the comments we received on the cost-benefit analysis (CBA) contained in Chapter 21 and Annexes 2 and 3 of CP06/3.

General feedback

21.2 The joint-industry response contained extensive commentary on the CBA. In response to the overarching comments, we acknowledge that we could have been clearer in the way that way we presented our findings. In particular, we would like to clarify that:

- In assessing the costs and benefits of superequivalent measures, we used the directive minimum as the baseline for estimating costs and analysing benefits.
- The point estimates of compliance costs we used are, of course, subject to significant uncertainty, though we are not convinced we would add value to those estimates by putting a range around them.
- We did consider regulatory failure and other unintended consequences[1]. We acknowledge that the uncertainty surrounding such impacts is – because of their unintended nature – greater than for intended consequences. Going forward, we would welcome input from those consulted about how we could improve our understanding of unintended consequences. As the joint-industry response noted in respect of procyclicality, the quoted benefits can also be unclear.

1 See for example the discussion in paragraph 74 of Annex 2 in CP06/3.

Detailed feedback

Net present value

21.3 We did not set out in our analysis a net present value as it would clearly be positive for banks and building societies given our estimates of reductions in regulatory capital. We note here that the £24 billion per year reduction in regulatory capital requirements is an estimate and may not translate into a corresponding reduction in actual capital held[2]. While it is our preferred estimate, we acknowledge that the actual outturn may be significantly different.

Non-capital compliance costs

21.4 PricewaterhouseCoopers (PwC) produced independent estimates of one-off and ongoing non-capital compliance costs. The one-off cost estimate was, to the extent figures are comparable, in line with those estimated in previous studies[3]. There were no obvious comparators for the ongoing cost estimate. Ongoing costs are expected to be low relative to one-off costs (particularly for larger firms) as much of the ongoing compliance work is not expected to be over and above what firms would do as normal business practice. We acknowledge that, as firms begin to comply, the actual ongoing costs may differ from those we have estimated.

21.5 We are not grandfathering existing arrangements and respondents raised this as a potentially significant driver of costs. PwC did not estimate the costs of this separately from other costs so we expect at least some of these costs will be included in the overall cost estimates presented by PwC to the extent that firms were aware of the lack of grandfathering at the time the interviews took place (late 2005). As we have explained elsewhere in this Policy Statement, the significant changes made to most of the rules means in most cases there is nothing to grandfather.

Reduction in capital requirements

21.6 Our estimate of the reduction in capital requirements for banks and building societies of £24 billion is subject to uncertainty. The eventual capital savings may be less. This estimate was based on the best information available to us at the time, including:

- background from previous studies in this area;
- preliminary results for UK Group 2 institutions from the fifth Quantitative Impact Study (QIS5);
- discussions with a number of trade associations; and
- data from regulatory returns to perform a desk-based analysis.

21.7 The results from QIS5 for Group 1 banks in the UK suggest the reductions in capital requirements may be less than we predicted, though these QIS5 estimates are themselves subject to uncertainty.

2 This is discussed at length in Annex 2 of CP06/3.

3 Section 3.3 of the PwC report published as Annex 3 of CP06/3 discusses this.

21.8 We did not take into account the impact of the floors on capital reductions for firms on the advanced approaches during the first three years following implementation of the CRD. Rather, we focused on the estimated capital impacts of applying the new rules. However, we could usefully have acknowledged in CP06/3 that the capital floors will delay the estimated capital reductions for firms on the advanced approaches.

Weighted average cost of capital

21.9 The 'weighted average cost of capital' (WACC) we used would be better described as the 'weighted average cost of funding'. This is because – as the joint-industry response noted – it is the weighted average of a firm's cost of equity capital and cost of debt. (As an aside, the joint-industry response estimated the cost of regulatory capital for banks as 6.9%. Based on the proportions of tier 1, 2 and 3 capital in regulatory returns, we would estimate it to be closer to 7.8% for banks and building societies.) We use the WACC (as defined above) rather than the cost of regulatory capital in our CBA because:

- Short-term debt is an important and permanent source of financing for credit institutions. As it is not just an incidental source of financing (i.e. it is used to finance long-term assets) it is good practice to include short-term debt in the WACC calculation[4].
- We assume that following a change in regulatory capital, the balance sheet 'size' remains unchanged. This means any change in the regulatory capital is offset by changes in the 'other debt' funding component. So, for example, if regulatory capital increases, other debt will decrease to maintain the overall size of the liabilities side of the balance sheet. While there will be more of the balance sheet remunerated at 7.8%, there will be less of the balance sheet remunerated at 4.5% (our estimate of the cost of other debt for banks and building societies). It is this net impact on costs that is relevant for CBA purposes. It assumes changes in the levels of regulatory capital held are quickly offset by changes in other debt. In practice, there may be a transitional period, where this adjustment takes place. During this period it would be appropriate to use the cost of equity capital (7.8%) as the relevant metric. Using this higher cost metric would increase the costs of complying with requirements, such as on procyclicality, by more than doubling them. But we contend it is more appropriate to use the WACC (the cost of funding).

21.10 We acknowledge that firms may reasonably have different views about the appropriate cost of capital. For example, they may view our estimate of 7.8% for the cost of tier 1, 2 and 3 capital as more appropriate. In that case, the cost estimates of extra capital set out in CP06/3 (e.g. for economic cycle stress tests) would be more than doubled.

Capital calculations for investment firms

21.11 We need to clarify our CBA capital calculations for investment firms. The joint-industry response noted that our description of pre-CRD capital requirements for investment firms may be misleading. We described our calculation as being the sum of credit risk,

4 For example, R Brealey & S Myers, Principles of corporate finance, McGraw-Hill, 2003.

market risk and the expenditure requirement, which, according to the joint-industry response, is not the way that IPRU (Inv) Chapter 10 firms calculate their requirements. However, our calculations were in fact in line with the way these firms calculate their financial resources requirement. For our calculations, we used the sum of primary and secondary requirements reported directly by these firms in their regulatory returns.

Investments in subsidiaries and allocations and connected capital lending

21.12 The joint-industry response queried why we had taken into account only 18% of the deductions from capital for investments in subsidiaries and associates and connected capital lending. The main impact of these deductions is to constrain the distribution of capital between a firm and its affiliates. This may have opportunity costs which we cannot quantify. But there will be an absolute cost if the deduction policy increases the amount of capital that a firm is required to hold. Based on a sample of banks, accounting for around a quarter of the aggregate deduction, we estimate that 82% of the £90bn results in capital allocation constraints and only 18% leads to the holding of additional capital.

Systems and IT costs

21.13 Systems/IT costs were the main component of non-capital compliance costs as detailed in Annex 3 to CP06/3.

Pillar 2

21.14 We used a single Pillar 2 scenario in line with our fit-for-purpose approach to this CBA and to avoid multiple scenarios that would have added little in terms of understanding actual outturns.

Private equity firms

21.15 One respondent noted that capital requirements for private equity firms that are part of a larger group subject to the CRD could be subject to consolidated supervision for the first time and, as a result, could see their capital requirements increase. This change differs from the general expectation of an overall decline in capital requirements for limited licence investment firms under the CRD. The respondent also suggested this may mean some private equity firms may need to restructure to satisfy the consolidated capital requirements and that the costs of doing this could be above the average non-capital compliance cost estimate produced by PwC. As part of our desk-based analysis, we were able to identify investment firms, including private equity firms, which were part of groups, and estimated consolidated capital requirements under the CRD. However, we acknowledge there may be cases where the capital requirements for private equity firms could increase. Year-end 2004 regulatory returns data for most of these firms suggest they hold capital well above the regulatory minimum, with surpluses in more than half these entities 30 times higher than the own funds requirement.

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