

**Response of the British Bankers' Association, the International Swaps and Derivatives Association and the London Investment Banking Association to the Financial Services Authority CP 189: Report and first consultation on the implementation of the new Basel and EU Capital Adequacy Standards.**

**December 2003**

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## **1 Executive summary**

The implementation of the new Basel and EU Capital Adequacy Standards is a national project. Success will require co-operation and dialogue between the Financial Services Authority and the banking and investment firm industries.

CP189 is the fruit of an intensive effort already undertaken by the FSA. We would like to begin by expressing our appreciation to the FSA for extending the deadline for us to submit our comments. We are encouraged by the amount of work the FSA is putting into implementation and appreciate that delayed comment by the industry on CP 189 makes it difficult for the regulator to react.

Our aim is to continue to support the regulator's efforts with as much co-operation as possible as the implementation project develops. We are especially pleased that the FSA has decided to set up 2 new groups; a 'Credit Risk Standing Group' (CRSG) and an "Operational Risk Standing Group' (ORSG) in order to facilitate the discussion of implementation issues with the industry. We very much hope that these groups will assist the FSA in its efforts going forward and welcome the ability to contribute to these.

Therefore, we set out below our key messages and main recommendations following high-level discussions with our members on the tenor and direction of CP189.

Key messages and recommendations:-

- We believe that the new Accord and the proposed Risk Based Capital Directive (RBCD) are intended as frameworks within which firms demonstrate compliance and should not be treated as a detailed rulebook, with which firms comply. We would welcome FSA's viewpoint on this.
- The industry favours a principles-based approach to the implementation of the New Accord and RBCD. A principles-based approach should set out clear standards and the boundaries of acceptable and unacceptable practices.
- The industry favours a supervisory approach based on self-assessment but is concerned that basing this approach on the extensive use of regulatory scorecards will prove to be both more resource intensive and more prescriptive than expected.
- The industry is concerned that the FSA may not have the resource to enable a dialogue with firms or exercise judgement. A regulatory approach driven by resource constraints will fail to recognise diversity in practice and threatens to undermine and prevent the evolution of risk management practice over time.
- The industry would, in parallel to continuing technical work being undertaken at the level of the FSA rulebook, very much welcome a dialogue on the approach and process of supervision required by the new Accord and RBCD.

- We would encourage the FSA to “benchmark” their approach to the approach proposed by the other G10 regulators and, as required under the Lamfalussy approach, ensure convergence in practice.
- More consideration needs to be given to the efficient and effective ongoing operation of the new regime

We expand on a number of these themes below, they are reflected throughout the body of our comments.

### **FSA approach to implementation**

The Associations welcome the level of dialogue that has taken place, and is planned, between the industry and the FSA. This dialogue has rightly centred on interpretation of the Basel Accord and the standards it requires. The Associations believe that this dialogue on what the Accord means now needs to be combined with an equal and integrated dialogue on how it will be applied.

The Associations believe that the FSA and industry share a series of common objectives. We need to jointly develop an approach in which all can be assured of compliance with the Accord and RBCD standard, that is resource effective for the FSA and for firms and, critically, is able to accommodate the valid diversity of industry practice. We are not yet confident that this balance of objectives will be achieved by the current proposals.

In this context the Associations would highlight a number of concerns, as follows:

- **Resource:** the Associations are concerned that the FSA has seriously underestimated the volume and quality of required resource. This will impact both the degree of judgement that the FSA can exercise and the depth of dialogue in which it can engage with firms.
- **Supervisory approach:** the Associations support an approach based on self-assessment but are concerned that an attempt to realise this through extensive use of scorecards risks an over-standardisation of risk practice. This will result either in fitting practice to the FSA standard or an unexpected volume of exceptions.
- **Detail:** the Associations are concerned as to the level of detail set out in CP 189 and question the equivalence to Basel and the RBCD.

In summary concern exists that the potential for a negative cycle of implementation exists – too much detail, not enough dialogue, too little resource – the impact is cumulative and our concern is that the output could be a more rigid interpretation of the new Accord than is intended by the FSA.

Fundamentally we believe that the FSA approach is driven by its resource constraints and it has therefore adopted a modus operandi that attempts to accommodate diversity through standardisation. One of the unintended consequences of such an approach would be, not a fostering of enhanced risk management standards, but a process that will freeze such standards in time.

Therefore in parallel with continuing work on the PSB rules text the Associations would wish to engage in an urgent and in depth dialogue on how a more balanced approach might be achieved. This dialogue should unequivocally concentrate on the how the new Accord and RBCD might be applied.

We would start with an expression of principle with which we believe the FSA has considerable sympathy. In conception we believe that the new Basel Accord is intended as a framework within which firms demonstrate compliance. It should not be treated as a detailed rulebook, with which firms must comply. In particular it is fundamental that different means of meeting the same standard can and should be accommodated.

In working together to clarify the current proposals and develop an approach that meets our common core objectives we would propose that the following points be the basis for dialogue:

- **Resource:** the Associations would wish to discuss with the FSA the level and timing of FSA resource required and available.
- **Self-assessment** the Associations would wish to build on the FSA proposal for self-assessment but ensure a format that is flexible enough to accommodate legitimate diversity of practice.
- **Use test:** the Associations would urge the FSA to place the use test at the centre of the new regime. Currently external standards are being proposed for items where firms have every incentive to improve performance on their own account.
- **Dialogue** critically the Associations would wish to put centre stage a process of dialogue and challenge in which the FSA can exercise judgement in the assessment of standards.

The Associations would note and acknowledge the good intentions of the FSA. We have striven to respond in kind and very much hope that the FSA is open to our suggestion of dialogue and engagement on the matter of its approach to the supervision of the new Accord and RBCD.

### **Flexibility and evolution**

The Associations are concerned that the FSA approach to implementation of the new Accord and RBCD is, in the sum of its detail, too prescriptive. Either through interpretation, or in some instances addition, the FSA has extended the Basel framework to the point that it will constrain industry practice; have a material impact on the flexibility of the approvals process; have a material impact on the approvals prospects of firms and the capital required of UK banks and investment firms. The proposed stress test for pro-cyclicality is an excellent example of how the FSA has overly expanded the original mandate offered by Basel.

Increased detail in regulation does not, in fact, provide greater certainty. Frequently over-detailed regulation provides only opportunities for questioning how exact the language of

the regulation is intended to be and raises uncertainty on what the associated implementation standard must be.

We are furthered concerned that this “deepening” of the Basel framework is combined with a general reversal in the burden of proof, whereby firms have to prove that their approach, if different to the standard, is not wrong, an impossible proposition!

The FSA has asked for industry reaction on whether we seek prescription (sometimes described as “certainty”) or flexibility (often mis-characterised as “lack of certainty”). We believe that this is the wrong question. The industry seeks to understand the legitimate range of practice and diversity that the FSA will accept. This would avoid, in any case, the vexed need to define “best practice.” The industry questions whether it is appropriate for the FSA to decide on “best practice” and seriously questions the wisdom of defining new risk management orthodoxy in the process of writing the UK rules. We need to understand the boundaries within which we may act. Good practice and best practice rarely, if ever, require a single approach to be adopted.

The industry favours a principles-based approach to the transposition of the new Basel Accord and EU Regulatory Capital Directive that allows room for diversity, challenge and dialogue. The industry would wish to engage the FSA in a dialogue in consideration of a substantial re-orientation of approach. We press the FSA strongly to devote resource to defining the boundaries of unacceptable practice rather than defining in undue and unwieldy and unenforceable detail the content of the practices that firms should adopt when implementing Basel/RBCD.

The Associations would also wish to better understand the division the FSA intends between rules and guidance. This division will be material in helping focus our view on the flexibility of the FSA approach. We understand that the FSA is considering a rule text that is, in effect, a write across of the RBCD. We would support such an approach.

## **Groups**

It is not clear how the new requirements will be applied to either domestic or international groups. The industry approves of the High Level Principles for Cross-Border Supervision published by the Basel Committee and has supported proposals from the EU Commission for Lead Supervision. The time is now right to take this issue forward in practice. The industry would welcome a dialogue with the FSA on this issue and would be pleased to co-operate in working on practical proposals.

The Associations would note that many firms now operate a group risk management process and structure. The FSA has encouraged this approach. If existing group risk management structures cannot be accommodated then the consequence will be severe, either costly process re-engineering or cosmetic compliance. The FSA must be pragmatic and flexible if the proposals are to be risk sensitive and efficient. This should include a consideration of the level at which firms must demonstrate compliance, for example is the use test a portfolio level requirement or a group level test.

## **Equivalence and convergence**

The FSA is ahead of its peers in its interpretation of the new Basel Accord and is ahead of its peers in the development of a domestic rulebook. The Associations support these

efforts as a material contribution to the timely implementation of the RBCD. This support is tempered by a growing concern that the FSA may set a standard out of line with practice in other jurisdictions. FSA rules need to be benchmarked in practice to the approach of other G10 and EU supervisors.

The Associations would note the commitments that the FSA has under the Financial Services and Markets Act (2000) to give due regard to the competitive impact of its decisions on the UK banking and investment firm industries. We would further note that the RBCD will, once made, function within the new EU Lamfalussy arrangements. Convergence in EU supervisory practice is a core element in these arrangements.

In this context we would wish to ensure that the FSA is making every effort to ensure equivalence and convergence. In the body of our response (see response to Question 9) we have highlighted a number of items where we believe that the FSA is proposing a super-equivalent interpretation. Various international supervisory fora have been proposed and exist such as the Accord Implementation Group (AIG) and the EU Group de Contact (GdC); we would request that the FSA use these mechanisms as a forum for testing their own interpretation. Now, and in the future, we hope that the FSA will, where a case is proven, demonstrate a willingness to amend its own proposals.

### **Information and issue resolution**

The industry requires certainty on which to base planning. We note that the scale and timetable for implementation requires that firms make significant investment decisions now. We understand that this is difficult for the FSA to deliver given the lack of certainty at Basel and in Europe. We need, with the FSA, to explore how this gap in requirement and provision can be addressed. We believe that the FSA has a prudential and statutory responsibility to extend as much assistance to firms as is possible.

The Associations are keen to discuss with the FSA whether a process can be developed for industry level enquiries. Our objective would be to act as a clearing house for industry issues and then to forward those issues to the FSA. We very much hope that the FSA will feel able to respond to issues of common industry concern.

In the near term the Associations have consistently requested that the FSA publish a draft Application Pack. We repeat this request and also suggest that it might be accompanied by a parallel draft waiver. The Associations feel this would make a material contribution to the development of the new regime and to the quality of debate.

Please note that in responding the Associations have, as requested, answered the questions in CP 189 but that, in each chapter, these are preceded by more general comments and issues not raised by the FSA.

## **2 The Standardised Approach to Credit Risk**

*Q1: Do you agree with the choice of Option 2 for the risk-weighting of claims on financial institutions? If not, what arguments can be put forward in support of Option 1?*

The Associations have a strong preference for a single EU wide approach to the treatment of institutions under the Standardised Approach. National discretion on this option would be inconsistent with a Single European Market in Financial Services.

Our preference would be to adopt an amended Option 2 (Bank risk rating methodology). In line with our comments to the Basel Committee we would note that the risk weights for under single A rated banks under Option 2 of the SA are arbitrary, in particular that the scale of additional capital required for exposures to single A banks, relative to AA, is out of proportion to the difference in PD implied by the rating scale. We are concerned that under Option 2, the risk weight for single A rated banks or investment firms would lead to significant distortions relative to the current accord and to the proposed Option 1 SA and Internal Rating Based (IRB) approaches.

We do not think that either prudential risk based standards or competitive equity are served by the current proposals. The EU proposal for a permanent opt out from the IRB approach for banks and sovereigns increases our concerns (see European Commission, Review of Capital Requirements for Banks and Investment Firms, Working Document, Article 50.) We recommend that Option 2 be amended to ensure that A rated banks or investment firms receive the same treatment as AA or AAA firms, or that at the very least the current proposed risk weighting is revised.

Such an approach would reduce competitive distortions within the banking market both at domestic, EU and international levels. The scope of application to all EU credit institutions and investment firms, in our view, makes the resolution of this issue of specific relevance to the EU regime.

*Q2: Do you have any comments on the framework for the requirements on residential mortgages that we have outlined in paragraphs 3.8 and 3.9?*

The Associations support the FSA proposals subject to the proviso that they prove equivalent with the approach adopted by other Basel and EU supervisors. Reflecting this, our preference would be for these proposals to be reflected in the new Basel Accord.

*Q3: Is there interest from firms in the option to risk weight all corporate claims at 100%?*

The Associations view this option as a useful fallback approach for both firms and the FSA.

*Q4: Do you agree that firms using the standardised approach should hold additional capital if their Pillar 1 credit risk capital requirement is less than under IRB? How might the practical challenges be overcome?*

The Associations cannot support this proposal. It is reasonable to make adjustments under Pillar 2 where the Pillar 1 charge is inadequate. This is the case for both STA and IRB portfolio. It is not reasonable for there to be an automatic uplift in either instance.

The Associations would note that the STA is calibrated to be a conservative average, scaled to create an incentive for firms to adopt the IRB. To automatically lift portfolios that undershoot an IRB output without compensation elsewhere would skew this calibration. If this proposal stands it would bring into question the FSA's practical commitment to "no compulsion, no prohibition".

### **3 Operational Risk**

#### **Introduction**

We welcome the FSA's decision to include some further information in CP189 on how the forthcoming operational risk capital requirement will be implemented in the UK. In general we are happy with the FSA's proposals. However, given the high level nature of the discussion on operational risk in CP189 it is impossible for us to give very specific feedback at this stage. Therefore the FSA should view our response to the proposals in chapter 4 of CP189 as tentative.

#### **General comments on chapter 4**

We wish to commend the FSA for the good work that it is doing to consult with the industry on the operational risk components of the new Basel Accord and the EU's revised Capital Adequacy Standards. In particular we are very pleased that the FSA has decided to set up a new 'Operational Risk Standing Group' (ORSG) and so continue working on implementation issues with the industry. We believe that open dialogue such as this is vital if the new operational risk capital requirements are to be a success.

However, while we recognise that the Basel/EU proposals for operational risk are more fluid than for credit risk, we would have liked the FSA to include some more clarity on its proposals for operational risk in CP189. Unlike credit risk, there are no widely accepted methodologies for assessing/measuring operational risk. Therefore CP189 seems rather unbalanced, providing far more detail than is needed for credit risk, but far too little detail on operational risk.

Further clarity is of vital importance because many firms are already investing substantial resources in building new operational risk management frameworks and capital allocation models. Given the developing nature of the field many of these models and frameworks differ, often quite substantially, so it is important that the FSA takes action very soon to let these firms know that the sizeable development costs that they have incurred will not be in vain.

We therefore welcome the FSA's recent decision to circulate two AMA issues papers, along with some draft handbook text on the BIA, TSA and AMA approaches, to the members of the ORSG. The production of this material represents a useful step forward, however, there are still many issues that require a resolution and relatively little time to resolve them.

We particularly look forward to discussing the following with the FSA:

- The specific qualitative requirements that will be used to determine whether a firm can qualify for the standardised approach. In particular we note that the Basel consultation papers set down very challenging requirements, however the Commission's language on this issue is less robust. Therefore, we need to know how the FSA intends to approach this important issue.
- What a firm's AMA model could look like, or at least the minimum criteria required. Some more detailed questions on this are provided in appendix 1 below.

- The application of the AMA capital charge to a financial group and the use of capital allocation to legal entities.
- Whether it is planned for principles of the 'Use Test Scorecard' for credit risk to be rolled out to operational risk.
- An up to date roadmap on when further CPs will be issued and some more detail on the precise topics that these CPs will cover.
- The precise contents of the waiver pack that will be issued to firms that apply to use an AMA model for the calculation of their operational risk capital charge.
- The issue regarding the incorporation of correlation into an AMA and how firms can justify the correlation coefficients used.

### **Responses to the Questions in chapter 4 of CP189**

*Q5: Do you agree with our approach to the partial use of the AMA as described in paragraphs 4.9 to 4.15?*

Yes.

However, we note that there are still a number of issues on which further clarity is needed. For example, when talking about its approach to the gradual adoption of an AMA we are unsure as to what the FSA means when it refers to 'relatively tough' and 'less demanding' entry criteria. We would also like to know if the FSA would be prepared to allow trial runs of an AMA approach, where firms are given the option to revert back to the TSA if these trials are unsuccessful.

*Q6: Do you agree that partial use between the BIA and TSA should not be permitted on an intra-entity basis?*

Broadly, yes.

In general we agree that partial use between the BIA and TSA should not be permitted on an intra-entity basis (i.e. by business line) for the following reasons:

- Allowing this could lead to capital arbitrage; and
- The business lines in an entity are rarely run on a fully independent basis.

However we would urge the FSA to exercise a degree of flexibility on this issue, as we can envisage some circumstances where partial use between the BIA and TSA might be acceptable. For example, where a firm that has qualified for the TSA acquires a new business line that was previously using the BIA approach it may well be several years before it can raise the risk management standards of this line to a degree that is sufficient for it to qualify for the TSA.

*Q7: Do you agree that there is a case for partial use between the BIA and TSA on an intragroup basis?*

Yes. We agree that there may be good reasons for partial use between the BIA and TSA on an intra-group basis. For example, partial use may be appropriate where a group using the TSA acquires a new subsidiary that has historically been using the BIA.

*Q8: Do you agree to our proposed approach to the definition and threshold for recording and reporting operational losses?*

Yes. We welcome the approach outlined in the paper but are concerned that some FSA staff have made comments to contradict this by indicating the FSA has a threshold in mind and the onus is on firms to justify deviation from this. We believe it should be left to firms individually to determine an appropriate threshold level for loss data collection, based on their own understanding of the risks they face, and taking into account the significance and relevance to the operational risk capital requirement of losses below the threshold level. This level may differ from firm to firm but each firm should be prepared to justify the suitability of its internal threshold to the supervisor as necessary.

Moreover, if the FSA were to make any changes to its proposed approach it would need to give firms sufficient time to adapt their systems. We note the FSA intends to give further guidance on their expectations of what internal loss data should comprise. Most banks have already designed their loss databases and many will be advanced in building them. Any amendments to loss data parameters that would require changes to loss database specifications could have significant cost and timing implications for firms.

We disagree however with an approach that would allow for the definition of a loss to vary according to the type of business undertaken within a firm. To ensure accuracy, completeness and comparability of loss data, the definition of loss should remain consistent across all business lines.

### **Boundary issues**

In the course of preparing this response it became clear that the definition and treatment of the boundary between operational, market and credit risks requires further debate and analysis between industry and regulator.

We would therefore urge the FSA to recognise that firms may approach their boundary issues in different ways and to exercise a degree of flexibility when designing and interpreting any policy on this area. At a minimum, though, we would wish to see further dialogue on this topic.

Although some firms agree that improvements in the demarcation of operational, market and credit risks will help to improve the management of operational risk not all share this view. In addition some firms are concerned that it will not be cost effective for them to fully demarcate their credit/operational losses and market/operational losses in time for 2007 (although we note that others do feel that this is possible). A deeper understanding of the FSA's expectations regarding firms' behaviour in demarcating losses (large or small) is required.

We would also refer the FSA to our response to CP3 in which we set out our strong concerns regarding the inclusion of credit losses within the operational loss database. This is likely to give rise to a duplication of effort and on a worst case basis may result in double counting of loss amounts. The industry has already proposed an appropriate amendment to the wording of CP3 in this respect.

**Next steps**

We would like to re-emphasise our willingness to work with the FSA on designing and implementing its operational risk capital requirements. A successful result on this difficult issue will require us to all work in partnership so that we can establish a workable and cost-effective policy.

## 4 Internal ratings based approach to credit risk (IRB)

### Comments on the general approach

The internal ratings based approach to credit risk (IRB) is at the core of the new Basel Accord. Successful implementation of the IRB is therefore central to the delivery of the new capital adequacy regime, central to the achievement of ongoing financial stability, central to the cost-benefit of these proposals and central to the competitiveness of the UK financial services industry. The weight of our comments reflects this.

### Answers to the questions in Chapter 5: Internal ratings based approach to credit risk (IRB)

*Q9: Which issues should we cover in the next stage of the work and what priority should we give them?*

The Associations wish to comment on the general subject of dialogue with the FSA and then propose specific subjects for further discussion.

There is growing concern in the industry as to the level of guidance that can be expected from the FSA during the period up to 31 December 2006. The industry requires certainty on which to base planning. We note that the scale and timetable for implementation requires that firms make investment decisions now. We understand that this is difficult for the FSA to deliver given the lack of certainty at Basel and in Europe. We need, with the FSA, to explore how this gap in requirement and provision can be addressed.

The Associations see a solution in three parts:

1. **Resource and dialogue** consistent with their general position the Associations believe that expanded FSA resource would enable a closer dialogue between firms and the FSA.
2. **Industry guidance:** the Associations are prepared to act as clearers for common enquiries to the FSA and to assist in the distribution of common guidance. We understand that this guidance would be indicative and non-binding.
3. **Supervisory flexibility:** The FSA is aware that systems infrastructure changes have to be made now in preparation for approval in 2006. We would welcome a clear statement from the FSA signalling flexibility in the recognition of standards based upon a best efforts interpretation of the current rules.

We believe that the FSA has a prudential and statutory responsibility to extend much assistance to firms as is possible. We look forward to discussing these proposals with the FSA in the near term.

In setting the agenda for future work the Associations provide two lists. The first list highlights issues where the FSA has made proposals that we believe are super-equivalent to the Basel and RBCD requirements. To establish whether this is the case, we would request that, as a matter of urgency, the FSA forward these items for discussion at the AIG and GdC. We would hope that these discussions will either provide confidence in the equivalence of the FSA proposals or the basis for a review of the current proposals.

The second list highlights issues that have not yet been covered in discussion with the FSA but which are vital to resolve.

### **Super-equivalent issues**

- Pro-cyclicality
- Conservatism in LGD
- Assessment horizon
- All available and relevant information
- Materiality threshold for default

### **New issues**

- IRB for low default portfolios
- Validation of expert judgement models
- Pillar 1 stress testing of PD, LGD and EAD
- Counterparty risk in the trading book
- Treatment of SME in retail (segmentation and homogeneity)
- EAD requirements
- Securitisation
- Credit risk mitigation

*Q10: Is our general approach – setting out our detailed interpretation of the requirements in the revised Accord/RBCD – helpful? Have we given enough – or too much – detail? Will self-assessment be possible in practice?*

### **Level of detail**

The Associations have a general concern as to the level of detail and interpretation proposed by the FSA (see detail below). We understand and appreciate the FSA desire to supply as full a set of information to firms as possible, but must emphasise that detail does not of itself provide certainty. A fine line exists between helpful guidance and binding interpretation. Crucial to forming our view on this issue will be FSA plans for incorporating the CP 189 proposals into the FSA Prudential Sourcebook and the division in text between rules and guidance.

The Associations very much support a direct transposition of the RBCD into FSA rules. We understand that this is also the FSA position. The Associations therefore presume that much of CP 189 will become supporting guidance. The Associations support the separation of guidance from the rules text to underline the informative nature of the guidance, rather than implying that it is part of a set of mandatory requirements.

### **Self-assessment and scorecards.**

The Associations support in principle the FSA proposals for self-assessment and believe that this approach holds considerable potential if well realised. We regard self-assessment as the primary vehicle through which firms can deliver structured information on their IRB approach and compliance to the FSA. This information can then be the basis for an informed dialogue between firms and their supervisor. The primary benefits of this

approach are increased consistency and efficiency of supervision. The primary costs are an inadvertent standardisation of practice and the risks thereby of a very high volume of exceptions. The Associations wish to engage in a dialogue with the FSA in which the benefits of this approach can be maximised and the costs minimised. The balance between flexibility and consistency is key.

The Associations have concerns (see below for detail) that the current proposed scorecards lack the necessary flexibility to operate across firms and across the range of practice evidenced across asset classes – retail, mortgages, cards, SMEs, mid-corporates, large corporates, sovereigns, banks, specialised lending, securitisations and trading book. The use of scorecards designed to be completed for each exposure type will create a mountain of paper work for both firms and the regulator. The costs of processing this work and assessing the scorecards for approval, in terms of time and resources will greatly outweigh the perceived benefits of the standardisation in supervisory reporting.

There of course has to be a structure to the way in which information is submitted but that structure should be flexible and then used as the basis for dialogue. Scorecards may be appropriate for some firms and for some uses but should not be used as the only method of gathering information on a firm. The Associations would, in the main, prefer scorecards to be re-cast as a means of information provision and consistency rather than as a decision tool.

*Q11: Do you agree that firms using the standardised approach for some of their portfolios should hold additional capital if their Pillar 1 credit risk capital requirement is less than under IRB?*

No. Please see our response to Question 4.

*Q12: Have we covered the appropriate subjects? Do you have any general comments on our approach or on issues relating to more than one of the subjects covered in the annex? Have we developed a consistent and balanced approach to requirements on how firms take into account the effects of potential economic downturn?*

Please see the first part of our response to Question 9.

## **Answers to the questions in Annex 3: IRB detailed proposals**

### **Qualifying criteria**

#### **Partial use of the IRB approach**

*Q18: Is our proposed approach to phased roll-out described, including the use of Pillar 2 sufficiently clear? Do you support this approach?*

The proposed approach to roll-out is clear. The Associations would note that the CP 189 proposals on partial use were written in the context of a more restrictive set of Basel proposals. Basel itself has now moved forward and the FSA proposals need to reflect this new flexibility.

As noted above (see Question 4) we are concerned with the proposal to use Pillar 2 in a mechanistic fashion to make adjustments to the capital required of firms operating the

STA. We therefore support the sentiment expressed in paragraph 3.13 which suggests a more risk based approach will be developed based on the characteristics of the actual portfolio. This sentiment needs to be balanced by concern as to the standard implied in the requirement for firms to make a “fit for purpose” risk estimation.

*Q19: Do you support the proposed permanent exemption treatment for Sovereign, Bank and investment firm exposures?*

We support the proposed exemption but would welcome some further dialogue on the interpretation of "limited numbers". We would note continuing concerns on the incentives for moving to FIRB produced under the current calibration.

*Q20: Are the 15% materiality and other permanent exemptions sufficiently clear? Do you support adopting the EU treatment for Specialised Lending?*

The Associations support a 15% materiality boundary as guidance not as a hard standard. The FSA should understand that the decision to place portfolio into STA, FIRB and AIRB is a practical one and not driven solely by attempts to cherry-pick. It is right that the FSA should challenge firms but sufficient flexibility needs to be retained to accommodate the evolution of firms internal ratings systems, particularly in relation to the quantity and quality of data and also to allow for legitimate business decisions, for example in relation to mergers or acquisitions.

*Q21: Is the approach to roll-out described, including the roll-out period, sufficiently clear? Who should publish roll-out plans?*

The Associations support a three year roll-out period as guidance not as a hard standard.

We are concerned as to how the 15% requirement, the three year roll-out and the AIRB rule (3.18) will inter-act. Our reading is that any firm taking a portfolio onto AIRB will need to ensure that 85% of nonretail portfolios are on AIRB within three years. This requirement seems unnecessarily harsh, especially as identification of gaming should be relatively easy for portfolio left on FIRB. We would propose that AIRB and FIRB are treated as a single option for the purposes of roll-out plans.

The Associations believe that roll-out plans are a competitive issue between firms and therefore should not be published by the FSA. Market discipline and enhanced disclosure under Pillar 3 will itself force firms to respond to market expectations. The FSA should not mandate public disclosure over and above the level described there. The FSA might however usefully consider the publication of aggregate statistics.

### **Requirements for the use of internal ratings**

*Q22: Do you agree with the proposed approach, including the distinction between ‘core’ and ‘broader’ activities? Have we distinguished appropriately between ‘core’ activities and ‘broader’ activities? Do you have any suggestions as to the type of documentary evidence that firms may be able to provide in support of the proposed scorecard?*

The Associations broadly support the distinction between “core” and “broader” activities proposed. We would note however note some concern as to the functioning of the

proposed scorecards across the breadth of business and asset class, for example retail or specialised lending. We would also note that it is not current practice to base provisioning on forward looking stressed values of PD, LGD and EAD. In addition provisioning is not conducted in a traditional sense for marked to market exposures so consequently for the use of IRB for trading book assets provisioning should not be a core item.

In general the Associations are sceptical as to whether the use test is adaptable to the use of scorecards at all. Rather we would suggest that assessment of compliance with the use test be a function of the supervisory process.

*Q23: Do you think our approach is sufficiently clear and detailed at this stage? Could we be more specific about our approach?*

The Associations are not clear as to the objective of the experience requirement, how it is meant to operate or what firms are intended to demonstrate. Further clarity of expectation would be welcome.

*Q24: Do you agree with our proposed adoption of national discretions for all exposures other than Corporate, Bank and Sovereign portfolios on Advanced IRB? What evidence do you feel firms will be able to provide that supports an application for IRB approval for portfolios where they are not using the rating system at the time of application?*

We welcome the proposed adoption of the national discretions.

*Q25: Are the parallel running requirements sufficiently clear to enable firms to set their implementation timetable?*

The Associations welcome the clarification of the proposed parallel running requirements. Clarity would be further improved if the FSA confirmed that this is a calibration rather than infrastructure or systems test.

The Associations would question whether and why it is necessary to include in this exercise portfolio that will not move onto IRB until end 2009? The original Basel proposals suggest operation one year in advance of adoption.

### **Data accuracy**

*Q26: Do you support a mix of mandatory, regulator set targets and optional, firm set targets that can be shaped to reflect a firm's operations?*

The Associations agree that the FSA should review data accuracy and recognise the importance of the subject. We would note however that the current FSA proposals represent a considerable expansion of the more minimal Basel requirements. Therefore, whilst the Associations support a review, we believe that this review should be based on internal targets. Only if these targets were considered inadequate should the FSA intervene at the level of the firm.

*Q27: Do you feel there are key areas missing from the draft scorecard, or are there target areas that you feel should not be included?*

The Associations question the practicality of developing any standard data accuracy measure or value. We doubt that any such measures could be made meaningful.

### **Validation**

*Q28: Do you have any comments on the proposed validation standards; and on the draft self-assessment scorecard appended to this annex?*

The BBA and ISDA are joint sponsors, with RMA, of a recent “Internal Ratings Validation Study”. The study recorded validation practice amongst 26 internationally active banks. The key messages of the study were that banks legitimately employ a wide range of practice, that practice varies by asset class and that judgement still plays a critical role in all institutions and all environments. Industry standards have not yet emerged. We hope that this study can inform the approach adopted by the FSA to IRB validation.

The Associations have reviewed the FSA proposals on validation carefully and our concern would be how it proposes to accommodate the range of approach operated across all asset class and all internal ratings approaches in practice. Mirroring industry practice the Associations believe that, in the context of common standards, judgement needs to be exercised. Critically we think there needs to be considerable further thinking as to validation for models other than statistical ratings models set in a data risk environment. In particular there needs to be a dialogue on how to accommodate low default portfolios and expert judgement models.

The Associations would note that no firm within our membership has developed a validation scorecard, as proposed, even for internal use.

*Q29: Do you agree that a differentiated approach to credit risk model validation is appropriate?*

The Associations believe that a differentiated approach is critical but that this needs to be delivered through the quality of supervision not the development of further scorecards.

*Q30: Can you propose specific quantitative tests for assessing the accuracy of PD estimates for any, or all, portfolio types?*

The Associations do not favour mandatory quantitative tests or hurdle rates. Industry uses such information as part of a tool set within which informed expert judgement is key. This position is informed by a recent survey carried out by the BBA, ISDA and the Risk Management Association: Internal Ratings Validation Study. The BBA and ISDA have discussed the findings of this report with the AIG and would be pleased to do so with the FSA.

*Q31: Can you propose specific quantitative tests for assessing the discriminative power of rating systems for any, or all, portfolio types?*

See question 30.

## **Borrower rating criteria**

*Q32: Do you agree that the areas outlined in Annex 3.127 should constitute the key aspects of any future standard?*

We do not understand the need for expanding upon the meaning of the Basel requirement. The Associations would suggest that if firms pass the use test then they will themselves be making every effort to improve their borrower rating criteria. FSA standards in this area would, at best, be an unnecessary distraction.

## **Use of external models and external data**

*Q33: Is our proposal detailed in Annex 3.135 to 3.140 and how it would work sufficiently clear? Do you support it?*

The FSA proposals are clear and we support the FSA in its preliminary work with external vendors. However the Associations note that this work was not carried out with the co-operation of other regulators and has not to our knowledge been shared with members of the AIG. Our concern at this stage is that other regulators develop different approaches which impose different standards on the use of very similar if not the same external resources (data and models). This would lead to confusion amongst internationally active banks whose use of external models and data crosses jurisdictional borders, and we would therefore strongly encourage the FSA to only further develop this work as part of an international effort to impose minimum standards.

*Q34: Do you agree with our proposals on external data (Annex 3.141 and 3.142)? What do you think are key items of data? Are there some pieces of data that should be mandatory?*

The Associations believe it is right for the FSA to test whether firms understand and document their use of external data. We would resist strongly any attempt to make certain pieces of data mandatory. We also would strongly state that firms are in the best position to decide on the relevance of data and are continually seeking to improve competence. FSA standards would not be helpful.

*Q35: Do you agree with this assessment of the role of the firm (Annex 3.143)? Would you like to propose what measures might be appropriate to demonstrate understanding?*

The Associations generally agree with the roles for firms as proposed in this section. Usefully the FSA indicates what firms should be doing rather than how. It should then be for firms to evidence this to the FSA.

*Q36: Do you believe what is described in Annex 3.144 to 3.149 to be an appropriate process for firms to adopt?*

In principle the Associations support the approach suggested but would propose that the full requirements only apply where the external data source is a primary input into the IRB process.

*Q37: Do you agree with the provisions described in Annex 3.150 to 3.152? Are there mitigating circumstances that should be considered?*

The Associations support these proposals.

*Q38: Would you find it helpful if we published information on the range and type of external data available and used by 'good practice' firms? Do you have any suggestions as to what data should be included?*

The Associations would support this proposal, members have indicated that the information might be useful as a guide.

*Q39: Are there any areas that have not been addressed in the draft vendor information pack that it would be useful to include?*

No comment.

### **Segmentation and homogeneity**

*Q40: Do you agree with our proposed approach outlined in Annex 3.162-3.166? Are there circumstances whereby an alternative approach might be justified?*

The Associations would note that the use of credit scoring models is not always possible or always the best answer. The FSA should be able to recognise valid but alternative approach that provides robust risk measures, for example application score based PD estimates or vintage analysis studies.

A group of UK banks submitted a paper to the FSA on 17 November detailing concerns in respect of SME segmentation and homogeneity. The Associations support this paper.

*Q41: Do you feel that our 'scorecard' approach adequately addresses the issues?*

The Associations do not feel that a scorecard approach is relevant in this area. The information requested will vary greatly in form and value from portfolio to portfolio. [Need assistance in expanding this section.]

*Q42: Do you have any suggestions for how we might allocate 'scores' to the individual parts of the above template in order to facilitate self-assessment?*

The Associations do not support the use of a scorecard in this area. The actual allocation of scores may very well seriously mislead or misrepresent performance. This is an excellent example of where inappropriate use of a scorecard will create more work for both firm and supervisor.

### **Technical clarification**

#### **Definition of default**

*Q43: Are there mitigating circumstances where default information in one product area should not be considered relevant or available information? If so, what are these? If this includes cost/benefit considerations we would like to see supporting evidence to better understand the position.*

The Associations welcome an approach to retail PD based upon obligation not obligor.

We would wish to clarify in this context that SME portfolio, which qualify for the retail approach, this will also be rated on the basis of an obligation approach. We would also underline the importance of a practical interpretation of the requirement to use “all available and relevant information”. In particular the integration of portfolio information across business would be prohibitively expensive.

*Q44: Have we made the relationship between indicators of unlikelihood to pay and the existence of risk mitigants clear?*

Yes.

*Q45: Do you have any evidence that suggests a lower number of days (than 180) might be a better measure?*

The Associations support the use of 180 days as a maximum and would ask the FSA to confirm that this is its intent.

*Q46: What alternative approaches not identified in Annex 3.198 to 3.203 should be considered?*

The Associations are content with the approach proposed by the FSA but would note that counting from billing date for revolving credit facilities is common, not universal, practice. A number of member firms indicated that they currently count from due date. Given that this difference will be picked up in the calculation of LGD, and that the costs are substantial, the Associations would propose that the FSA exercise some flexibility in the timetable under which firms will comply.

*Q47: Are there mitigating circumstances that firms would like to propose that could be applied without adding undue complexity?*

The Associations do not support the removal of the materiality threshold for default proposed in the new Basel Accord. A zero threshold would have the potential for perverse outcome, for example putting an entire group into default because of a non-material payment delay in a non-material subsidiary.

The Associations would also note that many bank systems simply do not report de minimus breaches. The costs of addressing this situation would be out of scale to any conceivable prudential gain.

The Associations would propose the setting of a materiality threshold. We would recommend a simple limit of 5% relative to the facility limit.

*Q48: Do you support the approach outlined in Annex 3.210 to 3.212? If not, what would be an alternative approach?*

The Associations do not consider the proposed approach practical. In particular we do not understand how firms would demonstrate compliance. We would also note that terms and conditions vary between firms even for “standard” transactions.

*Q49: Do you agree that an earlier number of days and/or additional/stricter indicators of unlikely to pay may be used as a measure of default where this can be justified, despite the consistency implications?*

The Associations would value further clarity around the “acceleration” criteria. We would note that this item has been dropped from the reference definition of default for Credit Default Swaps produced by ISDA [ISDA to expand].

We would also note that ECAI definition of sovereign default are relevant only to bonds.

### **Exposure boundaries**

*Q50: Can you suggest ways in which non-conventional products could be included in QRE, other than by explicit approval, in a way which guards against regulatory arbitrage?*

The Associations are aware that following the October meeting of the Basel Committee in Madrid further work is being undertaken on QRE. We will reserve comment until the Basel proposals are clear. In the past the Associations have favoured a product neutral definition of QRE that referenced only portfolio volatility.

*Q51: Are the approaches to setting exposure boundaries detailed in Annex 3.218 to 3.235 appropriate? Are there other issues we should address?*

A number of member firms are currently working on this issue and will revert directly to the FSA.

### **Assessment horizons for borrower ratings and estimation of PD**

*Q52: Do you support our proposed approach on the allowable assessment horizons of rating systems?*

The Associations do not find this discussion of the relative strength and weakness of point in time (PiT) and through the cycle (TTC) ratings either helpful or informative. The text of this section demonstrates an obvious belief on the part of the FSA that TTC is best practice toward which the industry is moving, whilst PiT is just “acceptable”. The key points table (p. 62) states that PiT will be allowed for the transitional period, suggesting that they may be removed later! It is not clear on what evidence this preference is based. Further the FSA does not produce an acceptable or practical definition of either concept.

As stated in our work on the CRIAG, assessment horizons and historical data pools vary across ratings, and appropriate controls, documentation, and senior management oversight ensure that firms take account of all the relevant inputs. Generally, firm’s analysis is done over a period of time (including at least one economic cycle), using a conservative approach, with due weight on the downside. Analysis uses qualitative factors that are “point-in-time” (e.g. a share price might be considered “point-in-time”, as the only share price that matters is the share price now) combined with expectations

for the future and is therefore neither “point-in-time” or “through the cycle”. The Associations therefore recommend that the FSA puts in place a broad framework that does not specify the time horizons firms employ in their internal ratings systems.

*Q53: Do you support our proposal set out in Annex 3.248 to 3.250? If not, can you suggest other ways in which some or all of the pro-cyclicality impact might be addressed in Pillar 1, rather than Pillar 2, of the revised Accord/RBCD?*

The Associations cannot support this proposal and believe that it is entirely super-equivalent to the Basel proposals. Further the Associations do not understand what counter-cyclical value this proposal would have. The only consequence of this requirement would be that firms are required to hold more capital. This in itself has no benefit, only cost. We would note, and support, the approach the US authorities have indicated they will take on this issue. This approach is based on an understanding that conservatism should not be layered into the Pillar 1 calculation without consideration for the consequence for the integrity of internal rating approaches. Not least the willingness, or capacity, of firms to then meet the use test. Rather conservatism should be an adjustment applied by firms, under Pillar 2, to the output of the IRB process.

*Q54: Do you support adoption of the national discretion on data requirements (Annex 3.254 to 3.255), which also covers LGD, EAD and EL for Retail exposures?*

We support these proposals.

### **Loss given default**

*Q55: Is it sufficiently clear why the approach described in Annex 3.266 to 3.269 has been chosen? Do you have any suggestions for when/how ‘outlier years’ can be identified?*

The Associations cannot support this proposal. We are extremely concerned that the FSA is taking an approach to the calculation of LGD which will prove materially more conservative than that adopted by other supervisors. The FSA proposal is that firms must always use worst case LGD data, or where it does not have this data an estimation of worst case, unless it can prove that an extreme set of results represents an outlier year.

The Associations understand that the FSA would wish to be conservative but this proposal goes beyond what is reasonable. For example in an economic upturn is it reasonable to assume worst case LGD? As above we would note a preference for preserving the integrity of the internal rating process and making adjustments under Pillar 2.

*Q56: Is our proposed approach to zero LGDs sufficiently clear? Do you have any insights into how a minimum floor may be set?*

The Associations would propose that zero LGDs be allowed where firms are able to support this with robust data. For example zero LGD could be a reality in the instance of very high quality loan portfolios such as 10% LTV. The requirement for non zero LGDs could create a disincentive to hold such assets or an incentive to game the rules.

*Q57: Do you agree with this approach to the selection of appropriate discount factors? If not, how would an alternative discount rate be arrived at?*

The Associations would note that the IASB requires the use of effective interest rate. It would be helpful if the FSA requirement were aligned.

*Q58: Is this approach to the considerations for defaulted assets sufficiently clear? Are there circumstances where defaulted assets could be considered 'risk free'?*

The Associations note the theoretical justification for the approach taken by the FSA. We note however that other supervisors have taken a more practical route, for example the US agencies have proposed a charge of 8% of the balance.

### **Exposure at default**

*Q59: Do you agree that development of EAD models, and associated stress tests, should be a matter for firms in the first instance?*

The Associations are aware that following the October meeting of the Basel Committee in Madrid further work is being undertaken on the requirements on retail EAD. Therefore we will reserve comment until those proposals are clear.

### **Pro-cyclicality and stress testing**

*Q60: Do you feel that guidance on the interpretation and application of the stress tests, where used as an input into the Pillar 2 capital assessment, would be helpful? Do you have any recommendations on where it is most important to have guidelines, and what these could include?*

The Associations participated in an FSA Working Group on this subject. That Working Group reached a clear conclusion that there is no value in the FSA interpretation of the Basel requirement to conduct Pillar 2 stress tests. The Associations would value further dialogue on this issue and will shortly publish a paper recording the conclusions of the Pro-cyclicality Working Party.

## **5 Governance issues**

*Q13: Is our approach to governance issues clear? How do you envisage boards and senior management in practice meeting their responsibilities in respect of the use by firms of advanced approaches that meet our minimum requirements?*

The Associations generally welcome this section and note amendments made following discussions with industry earlier this year.

We would note that the FSA needs to be aware that in larger firms, and in the instance of international groups, much authority is delegated to specialist or national Committees. This necessarily has an impact on the level of understanding at Board level. The FSA therefore needs to be pragmatic and ensure the proper functioning of the senior management structure.

## **6. The application process**

*Q14: Do you have any feedback on any of the issues raised in this chapter?*

The new Basel Accord represents a considerable challenge for firms, it also represents a considerable challenge for supervisors. This chapter sets out how the FSA is intending to meet that challenge. Whether the FSA is successful is as important to each of our member firms as their own preparations.

As noted above, the Associations welcome the level of dialogue that has taken place, and is planned, between the industry and the FSA on the PSB rules. This dialogue has rightly centred on interpretation of the Basel Accord and the standards it requires. The Associations believe that this dialogue on what the Accord means now needs to be combined with an equal and integrated dialogue on how it will be applied.

The Associations would raise the following issues for dialogue and attention:

### **1. Implementation timetable and sequencing: the sequencing of interaction between firms and FSA between now and 2006.**

The scale of the Basel project means that a roadmap is an essential tool for both industry and regulator to plan and allocate resource most effectively. Although industry is deep into its implementation projects, firms are at very different stages. Industry does not yet have a clear view of the point at which its achievements will be held up to scrutiny by the FSA, in what way the scrutiny will be carried out or to what standards.

The FSA might take the view that a firm operating to reasonable standards would be likely to be able to answer regulatory questions and demonstrate compliance, even if the questions were only formulated at a late stage. However, we do not believe that this is a realistic proposition.

To illustrate our concern, we note that in practice much of the systems development and associated standards is being carried out by the industry working on a “best guess” of what the FSA will demand. This leaves industry open to a number of uncertainties, including the uncertainty that:

- Basel or the EU will amend the standards in a way neither industry nor regulator currently expect;
- The FSA may interpret standards in a way that is not anticipated by industry based on their current understanding of the FSA’s thinking.

It is clearly unreasonable for the industry to expect definitive answers from the FSA on such questions either immediately or in the very near future. Instead, we would ask the FSA to develop and make transparent its policy for interacting with firms who have based their implementation projects on assumptions that become outdated or invalid over the course of the next few years before the Accord and Directive are finalised. If a firm has acted in good faith, and can demonstrate this, it should not be penalised later when regulatory thinking and the legislative template have had time to crystallise. However, both industry and regulator can benefit from an agreement on how to react when the FSA is assessing work that was carried out on the basis of “old” information

before “new” information became available. We believe that transitional arrangements should be possible to be formulated.

**2. Supervisory process and the use of scorecards: the FSA supervisory approach and in particular the FSA use of scorecards.**

As our response makes clear, we do not believe that the scorecard approach is completely feasible as currently proposed. We do however agree that a wide use of self assessment is desirable and that the FSA needs to be able to fashion an approach that is a “self standing structure.” We need therefore to discuss how such a structure can be created without giving rise to the overwhelming burdens that the scorecard would achieve. We believe we can only make progress if we discuss at an early stage with the FSA what would and would not be practicable.

**3. Approval process and waivers: the form and scope of approvals to use the advanced methodologies.**

It is our understanding that the FSA is likely to adopt a waiver approach for advanced methodologies, although self certification may be the route taken for the Standardised Approach for Operational Risk. We understand that in making such decisions the FSA will need to have regard to the volume of applications that it might receive. We would like to see an early draft of a “jumbo” waiver that the FSA might be considering. In our response to Discussion Paper 13 we highlighted a number of concerns with the operability of a waiver system, and its potential for inflexibility, as well as the cliff effect that a firm dropping from an advanced to standardised approach would experience. Equally we would not wish a waiver process to act as a disincentive for the natural continued evolution of models and standards that we have seen in the context of market risk models. In view of such concerns, the FSA will understand our desire to have an early detailed understanding of the waiver process that is envisaged.

**4. Handbook structure: how and where the division between rules and guidance will be struck.**

We welcome the FSA’s assurance that work on an application pack is well under way. We look forward anxiously to having more concrete feedback. Decisions on the use of waiver or self certification, as the FSA has acknowledged will have a significant bearing on what aspects of the Integrated Prudential Sourcebook will be rules and what will be guidance. We recognise these issues are not purely process, as they entail a consideration of whether the FSA would have the legal latitude to offer self certification as well as issues of whether the FSA believes self certification would be appropriate on conceptual terms. Nevertheless, the process implications of these decisions are considerable and we would ask the FSA as a matter of priority to establish a working model on what it intends to do.

**5. Application to domestic and international groups: how the new Accord will be applied to domestic and international groups.**

We appreciate that the FSA is fully aware of the complexity of this issue. The task of determining who will be responsible, within a major international group, for setting approval standards and processes for review is immense. As a basic presumption, the industry favours a Home state model, and lead supervisory structures. Nevertheless there

are a myriad of legal and practical complexities on which the industry needs a much closer dialogue with the regulator to ensure that, in the continuing international regulatory debates, FSA understand the practical constraints within which the industry is operating.

**6. Ongoing system and requirements: what the ongoing system and reporting requirements on firms will be.**

The present focus on how to implement the new framework cannot be carried out in isolation from meaningful thinking on how the Basel system will be operated moving forward. The type and frequency of reporting, the review/breach of waivers, the frequency of specialist/generalist review of a firm by FSA or third party consultants have to be factored into the thinking now, so that the appropriate systems decisions can be taken by firms. Unfortunately we do not think that questions on the care and maintenance regime can be deferred until later.

**7. FSA resource: FSA specialist and line supervision resources necessary to meet industry expectations.**

The work leading up to and beyond the implementation of the new capital adequacy framework implies a significant burden on the FSA personnel, whether in policy articulation, line side application or specialist review teams. How the FSA will allocate responsibilities and how this will be resourced is not solely a question that affects the regulator itself. We recognise that the decisions the FSA makes on the basis of industry input will have real resource implications. We would like to discuss this matter with you at an early opportunity.

This dialogue needs to take place as a matter of urgency. The Associations very much welcome indications from the FSA that it would be prepared to engage in such a dialogue.

In the near term the Associations have consistently requested that the FSA publish a draft Application Pack. We repeat this request and also suggest that it might be accompanied by a parallel draft waiver. The Associations feel this would make a material contribution to the development of the new regime and to the quality of debate.

Finally the Associations would note a specific concern in respect of the use of external experts. The FSA intent on this issue is very unclear. Paragraph 6.13 suggests that firms may choose to obtain such opinions but that they are not required. It is not clear what weight the FSA will give to such opinions. The Associations are sure that the FSA understands industry sensitivity on this subject and would request additional clarity on intent and status.

## 7 Cost-benefit issues

*Q15: What are the main drivers of cost in implementing the revised Accord/RBCD? What are the main drivers of the expected IT changes? Is it an increase in capacity or is it a different system that you require? What is the role of the operational risk requirements in such a change? Are there any decisions that we can make on the substance or timing of our implementation that would lead to lower costs across all or a large part of the industry?*

HM Treasury recently published a consultation on the new Capital Adequacy Directive: CAD 3. The Associations will respond in depth to that paper and the issues it raises. The Associations have noted the overlap between that document and the cost-benefit chapter of CP 189 and because of this we have decided not comment on this section at this time.

*Q16: What effects do you think the revised Accord/RBCD may have on competition in UK and international financial services markets? Have you identified potential impacts on the wider economy?*

See Question 15.

*Q17: What benefits do you see in practice in the implementation of the revised Accord/RBCD? Do you expect firms to see these proposals as a catalyst for improved risk management? Do you expect firms to switch their decision systems to the new calibrations or to run a parallel system - one for regulatory purposes and the other for their internal business purposes? By what order of magnitude will the alignment of regulatory and business requirements reduce compliance costs for firms? If you are a firm considering adoption of an advanced approach, how are you assessing the benefits, e.g. when preparing project plans? How do you assess the NPV of your project?*

See Question 15.

## **Appendix One: Questions to the FSA about their expectations regarding the design of an AMA**

### ***Data collection***

1. How much freedom will a firm have to determine its own loss collection threshold? For example, will it be permissible to have a very large threshold and if so what will a firm need to do to justify this?
2. What are the FSA's expectations regarding data validation and security?

### **Expected losses**

3. Will a firm be able to remove its expected losses from its capital calculations where it does not include these losses in its pricing decisions and budget plans or where it does not make specific provisions for them?
4. How should a bank demonstrate the inclusion of EL in its pricing and budget plans?

### **Boundary issues**

5. If required, at what level of granularity will firms be expected to demarcate their market/operational losses?

### **Risk mitigation**

6. How much detail will firms need to provide to the FSA about their insurance recoveries in order to reduce their regulatory capital charge?

### **The ingredients of an AMA**

7. What are the minimum ingredients of an AMA? Will it be possible to base an AMA simply on scenario analysis or will firms have to collect and analyse actual historical loss data?
8. What will firms have to do to justify their choice of key risk indicators?
9. Can scenario analysis be done at the group level or will individual business units be required to undertake their own scenario analyses?
10. What are the FSA expectations regarding how to incorporate BE&ICEs into a capital model?
11. Does the FSA really expect firms to use a 99.9% confidence interval? In CP190 the confidence interval for insurers that develop their own internal capital models was specified at only 99.5%, why is this so different?

### **Diversification**

12. How, e.g. based on what principles, will firms be expected to justify the diversification/correlation effects that they include in their models?

### **Outsourcing**

13. How will firms be expected to treat activities that they have outsourced?

### **Qualification for TSA and AMA**

14. Regarding qualification for the TSA, what does the FSA mean when it talks about 'qualitative criteria'?
15. When will firms be able to start applying for a waiver to use an AMA?
16. How long will it take to get approval for using an AMA? Also will a firm's AMA be approved before it starts its parallel run, during this run or afterwards?
17. What issues will a firm need to look at when performing its self-assessment?
18. If a firm is compliant with PRU 6.1 (Operational risk prudential systems and controls) will it automatically qualify for the TSA?

### **Governance**

19. We would appreciate guidance from the FSA on what they expect to be place (eg group wide policies etc) rather than how they expect this to be achieved.