Discussion Paper

13

Financial Services Authority

UK implementation of the new Basel and EU capital adequacy standards

July 2002

Contents

1	Executive summary	3
2	Introduction	6
3	Our approach to implementation	9
4	Timetable and consultation plans	21
5	Implementation issues in detail: credit risk	24
6	Implementation issues in detail: operational risk	29
7	Next steps	32
	Annex A: The three pillars of the new Capital Accord (an aide-memoire)	
	Annex B: Questionnaire on firms' approaches to implementation	

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The Financial Services Authority invites comments on this Discussion Paper. Please send your comments to reach us by 30 September 2002.

You can send your comments electronically using the form on the FSA's website (www.fsa.gov.uk/pubs/dp/dp13_response.html).

Alternatively, you can send comments in writing to:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

1 Executive summary

1.1 The work on the revision of the Basel Committee's Capital Accord is reaching its final stages. The revised Capital Accord and equivalent European legislation will have far reaching implications for the capital adequacy regulation of banks, building societies and investment firms covered by the Investment Services Directive. We have set up a new project team within the FSA to take forward implementation work.

1.2 This paper sets out our initial thinking on the implementation work programme, including the timetable. We are assuming an implementation date of 31 December 2006. This paper is not intended to be a detailed guide to the Capital Accord and European legislation. Some of the paper is relevant to all firms covered by the new requirements. But much of the paper focuses on the new advanced approaches to calculating credit and operational risk capital requirements, which only some firms will want to adopt. We welcome comments on all aspects of this discussion paper.

1.3 This paper does not raise any issues which directly affect retail consumers. However, consumers and consumer groups should note that the purpose of the existing and revised Capital Accord is to reduce the probability that consumers suffer loss or markets are disrupted as a result of prudential failure. It does so by seeking to ensure that the financial resources held by a firm are commensurate with the risk associated with the business profile and the systems and controls environment within the firm.

1.4 We expect to implement most of the new requirements by making rules and issuing guidance under the Financial Services and Markets Act 2000. These will form part of the *Prudential sourcebook* section of our *Handbook of Rules and Guidance*. We have already indicated in a recent consultation paper "Individual Capital Adequacy Standards" (CP 136, published in May 2002) where we think the Capital Accord will affect our approach to setting individual capital adequacy standards.

1.5 We plan to undertake the work in three phases. We are starting work now, with industry representatives and trade bodies, on the new advanced approaches to credit and operational risk with the aim of issuing a consultation paper next spring. At present we are planning to offer all the advanced approaches to all types of firm, regardless of the nature of our regulatory relationship. We start with no expectations about which firms or types of firm will apply for which approaches. These approaches have been designed to give incentives to firms to adopt advanced risk management techniques, a principle which we shall reflect in our implementation. Senior managers should decide themselves how to respond, taking into account the likely costs and benefits.

1.6 The entry criteria for the advanced approaches, although within the grasp of many firms before the end of 2006, are challenging. Firms considering the use of the Internal Ratings Based (IRB) approach for credit risk or the Advanced Measurement Approaches (AMA) for operational risk need to be considering the issues in this paper and preparing evaluations and projects plans now, if they are not already doing so.

1.7 In the second phase, we shall prepare and consult on draft rules and guidance covering all parts of the new Capital Accord and European legislation. We hope to do this in early 2004, after the expected publication of the final Capital Accord and to issue rules and guidance in early 2005. Finally, in the third phase, from early 2005 we shall begin to work with firms applying to use the more advanced approaches. Our approach will be informed by our overall risk-based framework and the principle of senior management responsibility. In particular, we shall aim to set out our requirements for approval fully and clearly to enable firms to make their own assessment of their readiness to comply in advance of discussions with us. Our proposed timetable is summarised in a table on page 23.

1.8 Our implementation project team comprises staff from prudential policy, supervision and risk management areas. This team will also be considering the implications of Basel implementation for our skills and resourcing requirements. One of the issues on which we are seeking responses to this paper (see paragraph 3.18) is whether we should charge specific fees to firms applying to use the more advanced approaches.

1.9 While turning the new Capital Accord and European legislation into national standards will raise different issues in each country, there will be a process of international co-ordination, at both Basel Committee and European levels. We are committed to playing a full role in these processes with the aim of ensuring that regulators as far as possible take the same broad interpretation of the new standards.

1.10 Chapter 2 of this paper is the Introduction which gives an overview of the implementation task, including which firms will be affected. Chapter 3 outlines our approach to implementation – explaining how it will relate to the *Prudential sourcebook* and Individual Capital Adequacy Standards as set out in CP 136, how we plan to implement the advanced approaches, our aspirations for the implementation of Pillar 3 and international aspects of implementation. It includes a table explaining how this work relates to some of our other key initiatives. Chapter 4 gives details of our implementation timetable and consultation plans. Chapter 5 discusses in more detail some of the issues arising from the implementation of the new standards for credit risk; focussing mainly on the IRB approach. Chapter 6 provides a brief outline of our proposed approach to the implementation of the operational risk requirements in the revised Capital Accord. Chapter 7 describes the next steps firms should consider taking. Annex A gives more information on the three pillars which make up the new Capital Accord. Annex B is a short questionnaire aimed at enabling firms to express their intention to apply for one of the advanced approaches. Firms are asked to complete and return it with any comments on this paper by 30 September 2002.

2 Introduction

2.1 The objective of this paper is to set out our initial plans for the implementation in the UK of the Basel Committee's new Capital Accord and the equivalent European legislation. The paper is not intended to be a detailed guide to the Capital Accord[1], not least as it is still some time until it will be finalised. Some background information on the Capital Accord can be found in Annex A.

2.2 We encourage all authorised firms whose business will be covered by the new standards (see paragraph 2.8) to read this paper. That said, not all aspects of implementation will be applicable to all firms subject to the new requirements. A major focus of this paper and of the initial work that we plan on implementation is the new, relatively advanced approaches to calculating credit and operational risk capital requirements that only some firms will want to adopt[2]. Other parts of this paper, including the material on the proposed timetable of our implementation work, are relevant to all firms.

2.3 Although we are not formally consulting on draft rules and guidance at this stage, we welcome comment on any part of this paper.

2.4 We are publishing this paper well ahead of when we expect the final version of the new Capital Accord to be issued, which is likely to be late in 2003. Publication of the final European directive (to be known as the Directive on Regulatory Capital) is not expected until some time after this. Nonetheless, we think that an early indication of our proposed approach and the likely timetable will be of use to firms as they take forward their own planning. A number of firms and trade bodies have asked for a statement from us. We also believe that enough progress has been made in Basel and Europe for us to start working with industry representatives on key implementation issues. We set out in this paper how we are tackling this work.

1 Throughout this paper we use the term 'Capital Accord' to refer to the revised Basel Capital Accord and related European legislation. In addition to our commitment to the implementation of the Basel Capital Accord we are of course obliged to set national standards that fully implement the equivalent EC directive.

2 Throughout this paper, we use the term "advanced approaches" to refer to the Internal Ratings Based approach (IRB) to credit risk capital and the Advanced Measurement Approaches (AMA) to operational risk.

2.5 The proposed timetable is set out in Chapter 4 of this paper. **We are working to an implementation date of 31 December 2006.** Although we hope to have completed much of the work well before this date, the implementation process will be lengthy and some of the details of our new approach may not be finalised until late on in the process when the European directive is published and we have completed our consultation requirements.

2.6 Information on the Capital Accord and the Directive on Regulatory Capital is available on the FSA's website (www.fsa.gov.uk/international/1_caf.html) or directly on the BIS website (www.bis.org/publ/bcbsca.htm) and European Commission website (www.europa.eu.int/comm/dgs/internal_market/index_en.htm). Annex A of this paper contains a brief summary of the three pillars of the new approach.

2.7 This is the first in a series of bulletins and consultation papers that we propose to issue on UK implementation.

Which types of firm will be affected?

2.8 The new capital standards will affect a wide range of firms. However, it is too early to say exactly what the scope will be. This will depend on both:

- the scope of the revised Investment Services Directive and new Directive on Regulatory Capital. Current European directives on regulatory capital apply to all credit institutions and most investment firms subject to the Investment Services Directive (ISD)[3]. But the scope of the new requirements is under discussion and may be different; and
- our approach to implementation. We may decide, after consultation, to apply the new standards, at least in part, more widely than the minimum required by EC legislation[4] – to ensure that firms undertaking the same business and posing similar risks to our objectives are subject to the same standards.

2.9 Insurance companies (Category 2 firms) will not be covered by the new standards nor will firms excluded from the scope of the Integrated Prudential sourcebook[5], such as incoming EEA firms (those using the EEA passport to undertake business in the UK).

Overview of the implementation task

2.10 The introduction of the revised Capital Accord has far-reaching implications for capital adequacy regulation in the UK. It will involve major change to existing standards and how we apply them at the level of each firm. These

3 For the purposes of the Integrated Prudential sourcebook, these are Categories 1 (deposit-takers, including building societies) and 3A (ISD investment firms that trade as principal) as well as Categories 4A (ISD firms that hold client money, 4C (other ISD firms subject to the Capital Adequacy Directive) and 5A (other ISD firms). See Consultation Paper 97, paragraphs 5.3 to 5.4.

4 That is to firms in Categories 3B and 4B in terms of Consultation Paper 97.

5 See Consultation Paper 97, paragraphs 2.10-2.13.

include new approaches to credit and operational risk capital requirements, changes to our systems and controls and risk management requirements and a new balance between setting standards (and monitoring compliance) ourselves and relying on senior management responsibilities and market discipline.

2.11 The new standards, although they have implications for business in firms' trading as well as banking books, do not directly affect the treatment of market risk (for example, the option for firms to make use of Value at Risk models to calculate regulatory capital requirements). We shall, however, be reviewing how we recognise market risk internal models at the same time as we consider how to implement the advanced approaches introduced by Basel. Our aim is to achieve consistency across all the relevant processes, whilst recognising the differences that exist between credit, market and operational risk.

2.12 We have set up a new project within the FSA to take forward the initial work on implementation. The project team comprises staff in prudential policy, including those involved in negotiating the new Capital Accord, staff in the supervision divisions with responsibility for firms subject to the new standards and risk management specialists in our Risk Review Department. Part of the project's brief is to consider the implications of the new Capital Accord for the FSA's skills and resourcing requirements, the ways in which those requirements may be met and the timetable for meeting them. One of the issues on which we are seeking responses to in this paper (see paragraph 3.18) is whether we should charge additional fees to firms applying to use the advanced approaches.

2.13 While turning the new Capital Accord into national standards will raise different issues in each country, there will be a process of international co-ordination, at both Basel Committee and European levels. We are committed to playing a full role in these processes. For example, the Basel Committee has set up an Accord Implementation Group under the chairmanship of Nicholas Le Pan, Superintendent of Financial Institutions in Canada. It will be considering aspects of the implementation task including national approaches to the implementation of the Pillar Two requirements (supervisory review) and the implications for institutions with operations in more than one country. We are represented on and actively contributing to this group.

2.14 We are also actively engaged in the work of the Groupe de Contact, the forum of EEA banking supervisors. This group has been examining practical ways to implement the requirements contained in Pillar Two, particularly the supervisory risk assessment processes and individual capital requirements. The Groupe de Contact is working with the Banking Advisory Committee, the formal grouping of European finance ministry and supervisory officials, to assist the European Commission in drafting the new European legislation.

3 Our approach to implementation

3.1 This Chapter outlines the main features of our implementation programme. Much is relevant to all firms subject to the new standards, even if they are not planning to use the advanced approaches. Even paragraphs 3.11 to 3.18, which deal at a high level with the advanced approaches, may be of wide interest. A timetable for the work is in Chapter 4.

Our main instruments for implementing the new standards

3.2 We shall of course be implementing the new standards within the framework of the Financial Services and Markets Act 2000 ("the Act"). While it is for the Government to decide whether implementation requires any changes in UK statute, we expect these to be few, if any. The drafting of the Act took account of the need for future European legislation to be implemented using the FSA's rule-making powers. We therefore expect to implement the new requirements by:

- making rules and issuing guidance under the Act. These will form part of the (Integrated) *Prudential sourcebook* (PSB) section of the *Handbook of Rules and Guidance* and will be the subject of consultation in the normal way; and
- embedding the new standards in our risk assessment frameworks and regulatory processes.

3.3 Although we shall consult on all the proposed rules and guidance, the main focus of the consultation, and of the Cost Benefit Analysis which will accompany it, will be on:

- areas of the new standards reserved for national discretion – usually where there is provision for national regulators to choose between prescribed alternative approaches (for example to the capital requirements applying to exposures to banks in the standardised approach). We shall consider the pros and cons of each alternative and set out our reasons for the proposed choice[6].

6 A list indicating the treatment to be adopted for the purposes of the third Basel Committee Quantitative Impact Study (QIS3) will be made available to UK firms participating in the study and will be on the BIS website.

- issues where we think it necessary to set out how the new Capital Accord should be interpreted by firms subject to the FSA's regulation (for example, validation standards where firms use the IRB approach, i.e. the data firms should use and the approaches they should take to ensure that models accurately predict borrower default and credit loss); and
- areas, if any, where we propose to set our own standards higher than those in the Capital Accord (see paragraph 3.8 below).

3.4 Implementation will occur within the context of our new risk assessment framework. We have described the framework and processes in various publications[7], including how we assess individual firms to evaluate the risks posed to our statutory objectives and how these may be mitigated. Overall, the new Capital Accord, because it is more risk sensitive (in the areas of credit and operational risk) than existing approaches, should be consistent with and support the new framework. For example, where a firm applies to use one of the new advanced approaches, we expect that the work we undertake before we allow it to do so will contribute significantly to the risk assessment of the firm in the relevant area. This will help to minimise duplication.

3.5 We discuss below (see paragraph 3.17) how we think our new risk-based framework will affect approvals of firms' applications for optional approaches.

Link to the continuing Integrated Prudential Sourcebook work

3.6 The rules and guidance implementing the Capital Accord will form part of the PSB. We consulted last year, in Consultation Paper 97 "The Integrated Prudential Sourcebook", on the draft text of the PSB. We then consulted[8] separately on to what extent should the PSB be brought into effect before the implementation of the new Capital Accord, which will require further development of the material consulted on in CP97. We shall shortly publish in a policy statement our latest thinking on the PSB, including the timetable, in the light of these consultations. While the PSB will be implemented in a number of steps, this statement will say that we plan to implement most of the capital standards for banks, building societies and investment firms, reflecting both the material consulted on in CP97 and the new Capital Accord, in late 2006.

3.7 The box at the end of this chapter lists the main FSA and international initiatives in the prudential field and their associated timetables.

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7 See the publications "New Regulator for the New Millennium", January 2000, and the update publications "Building the New Regulator", December 2000 and February 2002. Our regulatory processes are set out in the Authorisation, Supervision and Enforcement manuals, part of the FSA Handbook.

8 See Consultation Paper 115, "Integrated Prudential Sourcebook: timetable for implementation", published in November 2001.

3.8 In developing the draft rules and guidance to implement the Capital Accord, we shall follow the broad principles set out in CP97[9], taking into account responses to the consultation on that paper. In particular, we shall follow the approach outlined there to "superequivalence" (i.e. areas where we set our own requirements at higher level than the EC or Basel minimum). We stated there that we would set standards above the international minimum only "where there is a material risk of the standards otherwise being too low to help meet our regulatory objectives"[10]. We refer in this paper to areas of the new Capital Accord where we may choose to set standards higher than the Basel minimum. Final proposals, supported by Cost Benefit Analysis, will be published with our formal consultation next year.

Link to our new proposals for Individual Capital Adequacy Standards (ICAS) – and the Pillar Two requirements

3.9 We have set out in Consultation Paper 136[11] a new framework for determining the individual capital standards that firms will have to meet. This will replace the existing approaches to individual capital standards for banks, building societies and investment firms from the end of 2006. As explained in that paper (see paragraph 2.16), this new framework and the sections of the Handbook to which it relates will form a major part of the implementation of the capital adequacy elements of the Pillar Two proposals in the new Capital Accord. That paper also includes discussion (see Chapter 4) of how we might address individual elements of Pillar Two (including concentration of exposures risk, "procyclicality", interest rate risk in the banking book and residual risk including documentary risk) within the ICAS framework. Implementation of significant elements of Pillar Two will therefore be taken forward through the further work programme set out in that paper. Other aspects (such as the supervisory review of firms' risk assessment processes) are already addressed in our new risk assessment framework for firms. This paper focuses mainly on the work programme covering Pillars One (minimum standards) and Three (disclosure).

3.10 As we noted in Consultation Paper 136 (see paragraph 3.20), the implementation of Pillar One may lead to significant reductions in required capital for some firms. While the effect of Pillar Two may be to add significantly to the Pillar One requirement (e.g. through the charges for "procyclicality" and residual risk), we have no intention of using Pillar Two routinely to reverse the Pillar One regulatory capital savings resulting from the new Capital Accord.

9 Consultation Paper 97, Chapter 3.

10 Consultation Paper 97, paragraph 3.7

11 "Individual Capital Adequacy Standards", published in May 2002.

Implementing the optional advanced approaches

3.11 The new Capital Accord will greatly extend the range of advanced options available to firms for calculating the minimum capital requirements – i.e. approaches which rely on the use of relatively sophisticated internal risk management methodologies. At present, these options are confined to the market risk area. In future, the full list of optional approaches firms available to firms will be:

- IRB to the calculation of capital for: retail credit exposures; corporate, sovereign and bank credit exposures – a choice of foundation and advanced IRB approaches; and equity and specialised lending;
- internal approaches to the calculation of capital on collateralised corporate, sovereign and bank credit exposures – either own estimates of collateral haircuts or a Value at Risk approach for use with repo style transactions;
- AMA for the calculation of operational risk capital; there will also be a choice of simpler approaches (standardised and basic indicator); and
- internal models based approaches, including a Value at Risk approach, to the capital for market risk – already available under the existing Capital Accord and EC legislation.

All are available only where firms meet certain minimum requirements and subject to the approval of the national supervisor.

3.12 We plan to allow any firm to apply to use any or all of the advanced approaches. This is consistent with our obligation under the Act to have regard to the desirability of facilitating competition between regulated firms. We shall not expect any particular type of firm (or group of firms) to apply for the advanced approaches – that must be the decision of senior managers, informed by their own assessment of the costs and benefits, including competitive considerations. The Basel Committee has developed the new advanced approaches in co-operation with firms so as to give them incentives to adopt advanced risk management techniques. We believe that these approaches, like the existing advanced approach to market risk, embody good practice in risk management – because they enable firms to improve their measurement of risk and to hold capital in proportion.

3.13 It is, however, for each firm, where it is likely to meet the minimum requirements, to decide whether to adopt any of these approaches. Each will need to take into account the likely impact on its regulatory capital requirements, including Pillar Two requirements, and the investments in advanced risk management capabilities, data collection, IT support and other areas that may be necessary. We shall of course want to ensure that where a firm chooses not to adopt an advanced approach mainly because it may lead to capital requirements higher than the standardised approaches (i.e. the

incentive in this case is not to adopt better risk management practice), this is taken into account through increased capital requirements under Pillar Two. Over time, we expect the number of UK firms adopting the advanced approaches to increase.

3.14 There will be no general requirement on firms, once they have adopted an advanced approach in one of the main areas listed above, to adopt it in all or any others. So, for example, a firm may use the IRB approach to credit risk while choosing the basic indicator or standardised approach for operational risk. We refer in paragraph 5.2 of this paper to the requirements for implementation of the IRB approach across all activities of the firm. And a firm may use a Value at Risk approach for just its collateralised credit transactions without also using it for market risk.

3.15 The entry criteria for the advanced approaches are likely to be challenging for many firms. We give some indications in Chapters 5 and 6 of this paper of what firms might be doing now in order to prepare for adoption of the advanced approaches, if this is what they want. We recognise that final decisions on whether to apply for an advanced approach will depend on the details of the final Capital Accord. However, firms contemplating the use of an IRB approach or the AMA for operational risk from 31 December 2006 need to start preparing evaluations and project plans now, if they have not already done so. Firms wishing to use IRB from that date will need to commence measurement and reporting of capital requirements on an IRB basis from January 2006 ("parallel running"). They will not, however, be required to be in full compliance with the relevant IRB standards over this period, during which their formal capital requirements will continue to be based on the existing rules.

3.16 The Capital Accord is likely to require us to have in place mechanisms to ensure that a firm does not adopt an advanced approach unless we are satisfied that it meets certain conditions. We shall work over the coming year on the detail of these mechanisms. Our initial thinking is as follows.

- We are likely to adopt a waiver process to applications for the advanced approaches. Firms which wish to adopt an advanced approach will need to apply for a waiver from the rules that would otherwise apply (for example in the standardised approach). The processes for waiver applications are set out in Chapter 8 of the Supervision manual. We refer in paragraph 3.18 to the possibility that we shall charge a fee for such waiver applications.
- We shall set out our requirements for firms wishing to apply for such a waiver as fully and clearly as possible to enable firms to make their own assessment of their compliance.
- We may then ask firms to submit evidence of their compliance (i.e. self-certification), which may be supported by independent expert opinion, as

part of their application. This would be consistent with the principle of senior management responsibility as well as enabling us to focus on those applications where significant issues arise.

3.17 In determining what are the significant issues on which we should focus, we are likely to take some account of the impact and probability of the risks a firm poses to our statutory objectives crystallising. This may mean simply spending more time on firms which we regard as high risk or focussing on fewer issues for low risk firms, taking into account for example the extent to which the waiver applied for would reduce their regulatory capital requirements. Equally, there may be areas of the new standards, such as the advanced IRB approach and AMA, where we shall want to look in depth at all applications with less regard for the firm risk category.

3.18 We recognise the need for appropriate expert resources to support the handling of all applications. As mentioned in paragraph 2.12, we shall be considering the implications for our resource needs, including the fees that we charge to authorised firms, later this year. One approach, which would be consistent with ideas we have raised before as part of our consultation on fees, would be to charge "demand led fees"[12] to support waiver applications. The benefit of work on the advanced approaches will accrue primarily to the firm which has applied for the waiver. At first sight therefore it appears that this is a case where we ought to charge a demand led fee. It might be appropriate to charge a minimum fee for all applications for the advanced approaches for credit and operational risk, with any additional costs incurred during the work to be paid by the firm at the end of the work. The granting of the relevant waiver would be contingent on the firm both meeting our minimum requirements and the payment of the fee. We would welcome views on charging for processing waivers in this way. The way in which we actually recover the cost to us of undertaking these activities will, however, depend on the outcome of our planned wider consultation on "demand led fees".

Pillar Three (disclosure)

3.19 We regard disclosure by firms as a key element of the new Capital Accord. We have therefore been giving early consideration to how we should implement Pillar Three, our attitude to compliance with and enforcement of the new requirements and where the work on disclosure overlaps with other FSA and wider initiatives.

3.20 The most efficient outcome would be for the high level requirements for disclosure specified in accounting standards and with those in the new Capital Accord to be consistent. Firms complying with the Pillar Three requirements would then automatically be complying with the accounting standards and vice

12 See CP 111 "The FSA's post-N2 fees raising arrangements" and CP 125 "Fees 2002/03". Demand-led fees are charges to meet the cost of activities resulting from a request from a fee-payer for us to undertake a specific regulatory activity on its behalf, where the benefit of such activities would primarily accrue to it rather than firms or consumers generally or to the wider UK economy.

versa. This approach would minimise the costs for firms. Whether we can achieve this outcome depends not only on the final shape of the Pillar Three requirements but also on developments in the accounting standards field. From 2005, listed companies will have to comply with International Accounting Standards (IASs) when preparing their consolidated financial statements. As we expect Pillar Three also to apply at the consolidated level, for some firms we would look to IASs as the main means of implementing the high level Pillar Three requirements. The International Accounting Standards Board is currently reviewing its standards on financial instruments and financial activities.

3.21 For unlisted firms, there are two possible outcomes. IASs could be applied to unlisted as well as listed companies. We expect the DTI to consult later this year on how widely IASs should be applied in the UK. Alternatively, we could look to UK accounting standards for the high level implementation of Pillar Three for unlisted companies. The UK Accounting Standards Board has begun a programme of bringing UK standards into line with IASs where they believe that is appropriate.

3.22 It will therefore be some time before we are in a position to decide whether or not the accounting framework will provide the high level implementation mechanism for Pillar Three that we want. If it becomes clear that accounting standards (and therefore published financial statements) are unlikely to deliver the broad Pillar Three requirements, we will need to consider alternative approaches. Whatever the outcome of the accounting debate, we shall need to introduce rules to give effect to Pillar Three. For instance, we shall probably need to specify some disclosures in more detail than will be given by the relevant accounting standards.

3.23 We do not expect the new Capital Accord to prescribe where disclosures must be made. Our recent Discussion Paper on regulatory reporting[13] sets out some thinking about the role that publication of regulatory reports might have in market discipline. As for frequency of disclosure, we shall need to co-ordinate our thinking with our review of the Listing Rules and with European developments such as the Regular Reporting Directive.

3.24 As with other elements of our regulation of firms, we shall take a risk-based approach to monitoring and enforcing firms' compliance with Pillar Three requirements. Although a key element of the new Capital Accord, disclosure is not an end in itself. Its purpose is to facilitate market discipline[14]. The market itself should therefore play a key role in monitoring and enforcing compliance. We would expect this to happen in several forms:

13 Discussion Paper 12: The New Regulatory Reporting Environment, issued in May 2002

14 Our Discussion Paper on harnessing market forces will discuss various aspects of the relationship between regulation and market discipline.

- to the extent that failure to comply with a Pillar Three requirement also represented non-compliance with an accounting standard, through existing enforcement mechanisms operated by the Financial Reporting Review Panel;
- market pressure, either directly or via the press; and
- peer group pressure.

3.25 This suggests that we should focus resources on equipping market participants to understand what disclosures they can expect from firms and how to respond to their absence. We could even encourage market participants to notify us of significant failures to comply with the Pillar Three requirements. However, this does not mean that we would never actively monitor or enforce compliance with our own rules that give effect to the Pillar Three requirements. In particular, those disclosures that are pre-conditions to a firm's eligibility for particular advanced approach under Pillar One may require a different approach. As noted in paragraph 3.16 above, firms may be asked to self-certify that they have met the relevant minimum conditions. This will include the associated disclosure requirements.

Reporting requirements

3.26 The implementation of the new Capital Accord is one of a number of changes requiring us to review our approach to the collection of data from firms on a regular basis – that is the type of reporting currently covered in Chapter 16 of the Supervision manual in the Handbook. We have started work in this area and initial thinking on reporting is included in Discussion Paper 12. Further consultation papers will be issued.

3.27 The work we are undertaking now on the advanced approaches introduced by the new Capital Accord will cover associated reporting requirements.

International implementation issues

3.28 As mentioned in paragraph 2.13 above, we shall be participating in the international co-ordination of implementation work. While implementation will be primarily a process for national regulators and there will be differences of approach in areas reserved for national discretion, our efforts in the international work will focus on encouraging regulators to take the same broad interpretation of the new standards. This will be particularly important for issues (such as data and validation requirements for IRB approaches) where scope will be left for interpretation of the final international standards (see paragraph 3.3). Wide differences in approach could compromise one of the objectives of the Capital Accord, to create a "more level playing field". This would also affect our own need to have regard to the international competitive position of the UK as well as adding to the implementation costs

for firms and groups that have to meet national standards in the various countries where they operate.

3.29 One of the potential sources of such costs will be the need for firms to obtain recognition for the use of advanced approaches from each national regulator and from the lead regulator for the purposes of consolidated supervision. In many cases, the approach used in different countries, for example IRB for corporate portfolios, will be the same or similar (allowing for different local data needs and control infrastructures).

3.30 We shall be working with other regulators to consider possible frameworks for co-operation and/or mutual reliance on each other's work in order to minimise such duplication. An obvious starting point is for the lead regulator of an internationally active group to take responsibility for at least co-ordinating recognition work, as it does already in other areas of supervisory work. In the case of groups based in the UK, for which the FSA is the lead regulator, this would mean that we would take the lead in the recognition work. For groups based overseas, we would expect to take into account, as far as possible, the work undertaken by the overseas lead regulator. We shall, however, be giving further consideration to this and other possible options.

Initiative	Current position
New Basel Capital Accord (“Basel2”/Directive on Regulatory Capital)	The Basel Committee on Banking Supervision (‘BCBS’) is developing a revised Capital Accord (also referred to as “Basel 2”). A parallel process in Europe is developing new capital adequacy directive requirements (the ‘Directive on Regulatory Capital’). These initiatives propose a three pillar approach (see Annex A to this paper). This Discussion Paper sets out our overall approach to the implementation of Basel2/Directive on Regulatory Capital. The BCBS and the EU expect to publish their third (and final) consultation papers in the first half of 2003. As outlined in this Discussion Paper, we shall issue a series of CPs, including a consultation on the PSB rules and guidance, during 2003-4. We aim to implement these requirements in line with the common Basel/EU implementation timetable by end-2006.
Integrated Prudential Sourcebook (PSB)	We published CP97 (Integrated Prudential Sourcebook) in June 2001. This set out the benefits of, and our approach to, an integrated PSB. It also included (in CP97a) draft text of much of the proposed PSB. In November 2001 we published CP 115 (Integrated Prudential Sourcebook – Timetable for implementation) which set out proposals for the timetable for PSB implementation in the light of changes to the Basel Accord and related EU directive timetable. In March 2002 we published CP 128 (Liquidity risk systems and controls). In July 2002 we are publishing: • a feedback Policy Statement on the non-insurance elements of CP 97 (non-insurance) and on CP 115. This sets out our response to comments and our revised plan for implementation; • feedback on the insurance elements of CP97 and reconsultation on certain insurance issues; • a CP on operational risk systems and controls, with expanded and revised PSB text. We plan to publish in Q4 2002/Q1 2003 further PSB-related insurance CPs, covering: • financial engineering; • enhanced Pillar 1, Individual Capital Adequacy Standards, stress and scenario testing; • regulatory reporting; • transitionals, permitted links.

	We also plan to publish during this period: • a CP on innovative tier 1 capital; • revised PSB text on systems and controls and other matters for the initial implementation stage; • feedback statements on liquidity risk and operational risk.
Individual capital adequacy standards ('ICAS')	CP 136, Individual Capital Adequacy Standards (May 2002), proposes an outline framework through which we can extend the setting of risk-based individual capital standards to a wider range of firms. We plan to implement this framework for insurers in 2004 and to consult on the detailed framework for other sectors in line with the full implementation of the PSB.
Regulatory reporting	Discussion Paper 12, "The new regulatory reporting environment" published in May 2002, examines how we might improve the broader regulatory reporting environment. As part of this discussion, we examine the wider aspects of the information that we shall need to meet our objectives and how best we can satisfy these needs on a cross-sector basis. The second part of the paper examines the current regulatory reporting framework for insurers and puts forward various options that could be developed in constructing a new reporting environment. This Discussion Paper will be followed by a Consultation Paper in late 2002 that will propose a framework for insurance firms' regulatory reporting. Wider reporting needs for other sectors will be developed during the course of this year.
Harnessing Market Forces	We are currently undertaking a project that is examining ways in which we can harness market forces to help us to achieve our statutory objectives. Amongst other things, this project is looking at the potential use of market signals to focus on possible risks to our objectives and at possible disclosures by us of information to enhance transparency and thereby help the operation of market forces.
International Accounting Standards (IAS)	In the EU, it is proposed that International Financial Reporting Standards (IFRS) will become mandatory for all listed firms by 2005. However, some key insurance aspects are under review, in particular the measurement of insurance liabilities, the fair value concept for insurance contracts, and other accounting issues relating to investments and reinsurance. The existence of such a standard may help insurance supervisors in their efforts to approach certain aspects of insurance regulation in ways that are consistent both between countries and with the regulation of the banking and securities sectors.

EU developments	Within the above policy development projects, we shall continue to incorporate other recent and prospective EU developments, which include: **UCITS Directive** - adopted December 2001, must be implemented by February 2004; **Insurance Mediation Directive** - expected to be adopted in summer 2002, for implementation by 2004; **Financial Conglomerates Directive** - expected to be adopted in summer 2002, for implementation by 2004/5; and **Investment Services Directive:** further EU Commission proposals published in March 2002.

4 Timetable and consultation plans

4.1 As mentioned in Chapter 2, we are assuming an implementation target date of 31 December 2006, consistent with statements of the Basel Committee and the European Commission. This target date will of course be kept under review.

4.2 We set out in the table below the milestones that we think that we and the industry need to work to if we are to complete implementation by end-2006. There are three elements to our work programme, each on different timetables.

- Our plans for the recognition of the advanced credit and operational risk approaches: we think that because of the long lead times, it is important to start work on these now. We have established and have had initial meetings of two joint FSA/industry working groups to take this work forward; trade bodies are represented on these groups as well as individual firms. This work will cover the minimum requirements for recognition of a firm's use of an advanced approach; the recognition process; and associated reporting requirements[15].
- Preparation of the draft rules and guidance across all the areas of the PSB affected by the new international standards: this work will fall mainly into next year. The later start reflects the need for greater certainty about the final Capital Accord before this work can begin and the priority we are giving to completion of the PSB work for implementation in 2004. Industry working groups ("PSB standing groups") will be involved in pre-consultation on the draft text during the course of next year as they were in the preparation of CP97.
- Discussions with individual firms on their formal applications to use the advanced approaches. This formal work cannot start until early 2005, i.e. after we have consulted on the draft rules and guidance that will implement the Capital Accord in the PSB.

4.3 Not fully reflected in the table are the implications of a possible late publication of the final EC directive. As mentioned in paragraph 2.4, this will be some time after the publication of the final Basel Committee Capital Accord. Although we

15 Details of the membership and terms of reference of these groups are available on the FSA's website (http://www.fsa.gov.uk/international/1_caf.html) or from Katy Martin, Prudential Standards Division.

can and should aim to make significant progress on implementation issues well before the final EC directive is published, we shall need to keep developments in Europe under review. We shall of course reflect provisions in the directive that differ from the final Basel Committee Capital Accord in our implementation. At present we are assuming that the directive will be published in late 2005.

Consultation with the industry

4.4 We intend to work closely with firms affected by the Capital Accord throughout the implementation process. In addition to the industry groups mentioned in paragraph 4.2, we are planning the following publications:

- a Consultation Paper, to be published as soon as possible after the issue of the European Commission's Third Consultative Document, setting out in detail our proposed approach to IRB and the AMA – both the standards and the process of assessing compliance; and
- a further Consultation Paper in early 2004 focussing mainly on the draft rules and guidance for inclusion in the PSB but also giving feedback on our CP on the advanced approaches and updating firms generally on implementation issues.

We also aim to publish occasional implementation bulletins. All publications will be available on the FSA website (www.fsa.gov.uk) in the normal way.

4.5 We are of course prepared to discuss with individual firms at any time their own approaches to implementation – i.e ahead of formal applications. Moreover, we are asking firms to let us know now which of the advanced approaches they are thinking of adopting (see Chapter 7). However, we shall not be able to begin formal discussions with firms with a view to recognising their individual approaches until 2005.

Other Publications

4.6 We also think it appropriate that we publish clear and timely information on the results of our implementation. We are considering both the level and the format for disclosure of our decisions, taking into account the nature and timing of the disclosures that firms are required to make under Pillar Three. The focus will again be on the more advanced approaches. The objective will be to enable market participants to evaluate the impact of our implementation, including the consistency with which we are implementing the new approach. For example, we could publish detailed breakdowns of the probabilities of default (PDs) by portfolios, estimated by firms calculating credit risk capital under the IRB approach. Depending on what other regulators disclose, it will also make possible comparisons with implementation in other countries. We may also publish information which will set out the time taken to deal with applications for particular advanced approaches. Views on what else we might publish and with what frequency would be welcome.

Summary of implementation timetable

Date	Basel and European timetables[16]	FSA timetable
July to October 2002		Firms to complete questionnaire on current intentions to apply for optional approaches and return to FSA by 30 September 2002 (Annex B).
October 2002	Start of third Basel Committee Quantitative Impact Study (QIS3). Publication of a European Commission Progress Document.	
Early 2003	Target date for publication of Basel Committee's Third Consultative Paper ("CP3") and EU's Third Consultative Document on the Review of Regulatory Capital for Credit Institutions and Investment Firms.	Publication of Consultation Paper focussing on our approach to the advanced approaches and updating on our timetable and other implementation plans.
Late 2003	Target date for publication of the final Capital Accord.	
Early 2004	Publication of the Commission draft Directive on Regulatory Capital.	Publication of Consultation Paper focussing on our draft rules and guidance for inclusion in the PSB, providing feedback on our approach to the advanced approaches and updating on our timetable and other implementation plans.
Early 2005		Start of discussions with firms on formal applications for advanced approaches they wish to adopt. Publication of capital standards in the PSB, including those implementing Capital Accord and draft Directive on Regulatory Capital, subject to any changes necessary to implement the final Directive.
31 December 2005	Final Directive on Regulatory Capital to be published – allowing one year for national transposition.	
January 2006		Parallel running begins for firms wishing to adopt an IRB approach on implementation date (see paragraph 3.15).
June 2006		Target date for final decisions on advanced approaches that firms may use from end-2006.
31 December 2006	Earliest date firms may adopt the new Capital Accord/Directive on Regulatory Capital.	Capital standards in the PSB, including those implementing the new Accord, take effect.

16 The European timetable is based on our assumptions of the required timetable if the directive and the Capital Accord are both to be implemented on the same date. We will be keeping this timetable under review during the implementation process.

5 Implementation issues in detail: credit risk

5.1 This chapter discusses in more detail some of the issues arising from implementation of the new Capital Accord. The chapter is of relevance mainly to firms interested in using the IRB approaches. The credit risk framework for the Standardised Approach is similar in structure to that of the 1988 Capital Accord. The use of assessments produced by External Credit Assessment Institutions (ECAIs) to determine credit risk is the major change. A list of recognised ECAIs will be included in the PSB.

IRB: overview

5.2 The use of firms' own assessments of credit risk is one of the most significant changes from the 1988 Capital Accord. IRB is one of the major implementation challenges for both regulators and firms who wish to use the approach. A key objective is to create incentives for firms to achieve and maintain high standards of credit risk management. As mentioned in paragraph 3.12, we shall make IRB available to all those firms that meet the entry criteria. We shall not expect any particular type of firm (or group of firms) to apply. The Basel Committee's Second Consultative Paper ("CP2", published in January 2001) contained restrictive rules on how the IRB approach had to be implemented across all the activities of a firm. Responses to the consultation were critical. Groups operating in many different countries were particularly concerned. The final Capital Accord will respond to these criticisms by allowing greater flexibility to firms in rolling out IRB, across both countries and exposure classes. We intend to reflect this new flexibility in our implementation of the new Capital Accord.

5.3 However, the standards to qualify for the IRB approach will be high. They will represent a composite of best practice as observed by the Basel Committee in its development of the approach. Even those firms which consider themselves to have a high level of expertise in credit risk management need to look carefully at, for example, whether they meet the requirements for independence of the staff designing, using and controlling the ratings system from those

originating business. In this and other areas, firms may need to enhance their current approaches if they are to be able to use IRB.

5.4 There will also be a clear requirement on firms that the internal ratings system play an essential role in their operations – in such areas as credit approval and internal capital allocation. It cannot merely be a methodology for calculating regulatory capital. Moreover, and consistent with the principle of senior management responsibility, it is important that a firm's directors and senior management have a thorough understanding of its IRB system and ensure that it is operating properly. Firms must be able to estimate the various parameters that are input into their capital calculations in a consistent, reliable and valid fashion. However, we recognise that the relative scarcity of appropriate data means that credit risk related measures can rarely be estimated with the same statistical robustness, and validated with the same tools with the same degree of confidence, as is the case with market risk.

5.5 The Basel and European IRB frameworks will address this data issue by requiring firms to meet rigorous minimum requirements in order to be able to use the IRB approaches, including:

- the requirement that a ratings system has been used by a firm for a sufficient period (see paragraph 5.9) before it is approved for use for regulatory capital purposes;
- the need for robust systems for validation, by firms, of the accuracy and consistency of their ratings systems, processes and the estimates produced;
- the use of conservatism where there are doubts over the adequacy of firms' estimates, for example where these are based on a small number of observations, where they derive from judgmental consideration, or where they cover only a limited part of the economic cycle; and
- requirements for minimum periods of data observations.

5.6 We are aware that the underlying issues have been considered by firms which have already adopted internal ratings (or similar quantitative approaches to measuring credit risk) for internal purposes unconnected to regulatory capital requirements. In particular, firms will have addressed these points in deciding their validation requirements. So we shall be drawing on the experience of the industry as well as other interested third parties. As noted in paragraph 4.2 of this paper, we have set up an industry working group to work with us on these issues. However, we would welcome input from other interested parties directly in response to this paper or via the membership of the group (see footnote 15). These are also among the main issues we shall be discussing with other supervisors, including in the Basel Accord Implementation Group (see paragraph 2.13).

IRB: data and validation issues

5.7 As mentioned in paragraph 3.3, there are areas of the IRB proposals where the final Capital Accord will leave scope for national interpretation. The issues which we are considering include:

- the validation techniques and standards used by firms in deciding the acceptability of their methods for quantifying credit risk. Because ratings assignment methodologies differ, validation techniques also differ – both between and within firms. We are open-minded on the use of particular techniques. We would therefore recommend that firms both examine the published literature on validation techniques and are prepared to discuss their own validation techniques in industry working groups and elsewhere;
- in the estimation of PDs (and, as relevant, other inputs), what size of confidence intervals around the estimated parameters are acceptable in order for a firm to be able to use the IRB approaches;
- the practical steps firms might take to enable them to use the IRB approaches where the quantitative evidence available to a firm does not provide support for its estimates within the acceptable statistical confidence intervals. In discussing PD estimation, CP2 suggested that firms should combine the various sources of data available (their own data, external data sets, statistical models), using judgement in doing so and applying that judgement in a conservative fashion. We shall want to see that judgement exercised in a way that is considered, defensible and transparent as well as conservative. Such an approach seems most likely to be appropriate for portfolios and /or individual credits where there is little experience of default and/or loss;
- information on how firms manage performance of rating systems in practice. In addition to the tolerance levels set for actual outcomes against expectations, this would include what action is taken when actual performance falls outside these parameters and particularly the circumstances in which the divergence is considered so great that the estimates of risk may no longer be considered reliable;
- the standards which firms should meet for ensuring the quality of the data they input into their IRB systems, and for storing it thereafter.

5.8 We are also looking at the particular challenges associated with using each of mapping to external data, pooled data, and third party models as measures of risk. These techniques are useful in allowing a firm to supplement the often low level of observations of default etc derived from its own experience. However, to varying degrees they raise additional questions over the comparability of a firm's own portfolio to those from which the measures were derived, and the firm's knowledge of and control over these systems. There are also technical complications such as the consistency of the definitions of default between the various measures and that

mandated for use in IRB. We are keen to work with firms to address these issues. Many firms are likely to lack sufficient internal data, at least in the early years, to support reliable estimates of default probability and other IRB parameters. Resolving the issues associated with use of external data will therefore be critical to enabling them to move to an IRB approach at the end of 2006.

5.9 There are also various areas of the IRB framework reserved to national regulators' discretion. These include provisions in which certain IRB approvals can be supported by shorter runs of data during transitional periods, with an absolute minimum of two years. We are likely to adopt these transitional provisions in our implementation. Nonetheless, we believe that where data are scarce, firms and supervisors can gain confidence from longer runs. The following simple example illustrates the point. Two firms A and B may each seek IRB recognition. Firm A's portfolio incurs 1000 losses each year; the 2000 observations produced by two years data may prove sufficient to gain IRB recognition. However, Firm B has a portfolio which typically incurs only 10 losses a year. Here the two years minimum will produce only 20 losses and the firm may not be able to use an IRB approach for this portfolio because the confidence interval around its PD estimate is unacceptably wide or it may do so only with an upwards adjustment to its own PD estimates. In such circumstances a firm would benefit from having a longer run of data than the two years minimum in the Capital Accord.

Transitional arrangements for IRB

For IRB there are transitional arrangements for some of the minimum requirements for approval. These will be in place for the first 3 years after implementation of the Capital Accord and subject to national discretion. The table below sets out these arrangements as described in CP2.

Item	Requirement	Transitional arrangement
Observation period for corporate, bank and sovereign foundation approach (PD)	At least 5 years	2 years at implementation, increasing by 1 year for each subsequent year of transition (i.e. to reach 5 years by end – 2009)
Observation period for corporate, bank and sovereign advanced approach (PD)	At least 5 years	No transition period
Observation period for corporate, bank and sovereign advanced approach (LGD, EAD)	At least 7 years	No transition period
Observation period for retail exposures (PD, LGD, EAD)	At least 5 years	2 years at implementation, increasing by 1 year for each subsequent year of transition (i.e. to reach 5 years by 2009)
Use of ratings system	At least 3 years	Transition period to 2009

5.10 Similarly, although there are also transitional provisions that reduce the minimum requirement for an IRB system to have been in use for three years, we shall have more confidence in an approach that has met the test of operation in practice – i.e. we are more likely to approve use of IRB approaches in such circumstances. This may be a particular issue with estimates of Loss Given Default (LGD) under the Advanced IRB approach, the dynamics of which seem likely to be insufficiently understood by a firm until it has been using these data for its own purposes for several years. So in this case we shall be considering carefully whether to adopt the transitional provision. Use of the transitionals will be discussed with the industry working group and our proposals set out in the consultation paper planned for next year.

5.11 A related consideration is to what extent the data issues outlined above reduce or remove the potential to enable firms to assess for themselves their compliance with the conditions for use of IRB (see paragraphs 3.16 and 3.17 for our general approach in this area). For example, a firm may not have sufficient confidence to be able to decide whether or not its rating system met the quantitative requirements for IRB approval, and if so what estimates it should input for PD.

IRB: consistency issues

5.12 The flexibility implicit in the IRB framework will result in different firms estimating different PDs (and other parameters, where relevant) for the same borrower, even if they are using the same IRB approach (e.g. Foundation). We are keen to learn whether firms or other interested parties consider such divergence at the individual borrower level to be acceptable, and if not whether we should attempt to ensure that firms apply similar PDs to individual borrowers. If this is the case, what degree of divergence would such parties consider acceptable, and how would such an objective be achieved?

5.13 One option would be to seek to ensure that firms apply similar PDs to portfolios. We shall need to consider the degree of divergence that should be acceptable here and the methods we should use to achieve this objective. For example, should we collect – either routinely or on a sample basis – information on firms' ratings of individual borrowers to identify differences within portfolios? And, if so, what information should be fed back to firms using the IRB approaches, and/or made more widely available? We would welcome comments on these issues.

6 Implementation issues in detail: operational risk

6.1 This chapter provides a brief outline of our proposed approach to the operational risk requirements of the new Capital Accord, focussing on the choice of approaches available to firms. It is aimed at all firms subject to the Capital Accord.

6.2 The measurement of operational risk in the calculation of a firm's capital requirements is one of the newest areas of the Capital Accord, both for firms and regulators. While the issues are less familiar than those raised by credit risk, the measurement and mitigation of operational risk by firms is an essential part of sound risk management practice. Techniques for the management of operational risk, though in some respects well-established, are of course still evolving. We want to encourage this evolution. We have already proposed introducing requirements on operational risk systems and controls in the PSB, to be implemented in 2004. Revised draft material will be issued for consultation this summer (see the table in Chapter 3 of this paper).

Overview of the Capital Accord proposals

6.3 The new proposals in the Capital Accord are based on three approaches with AMA being the most sophisticated. The intent is to create an evolutionary path for operational risk management. This first approach, the basic indicator approach, is simple. The capital requirement is based on a simple percentage of an operational risk indicator. This affects the whole firm. The second approach, the standardised approach, is similar but divides a firm along certain generic business lines, each with an operational risk indicator and a percentage charge. For calibration purposes, the only difference between the two approaches is that the percentage figures for the different business lines will differ. At least at present, the risk indicator is proposed to be the same for both approaches, that is 'gross income'[17].

17 Gross Income is defined as Net Interest Income plus Net Non-Interest Income (comprising (i) fees and commissions receivable less fees and commissions payable, (ii) the net result on financial operations and (iii) other income. This excludes extraordinary or irregular items.) It is intended that this measure should reflect income *before* deduction of operational losses.

Availability of the approaches

6.4 We propose to offer all three approaches to all firms. The regulatory capital requirement should in principle be higher the less advanced the approach adopted, thereby providing the incentives for better risk management. But this will depend on the final Capital Accord. We accept that a large, internationally active firm could be on the basic indicator approach. Equally, we see no reason why a smaller firm with sophisticated risk management systems should not use an AMA, although in practice there may be cost-benefit limits here for smaller firms.

6.5 All firms on the basic indicator and standardised approaches will have to meet simple quantitative requirements. They will have to be able to define for each year their gross income, either in aggregate or for the business lines. These figures will be open to validation by us and will have to meet high standards of accuracy and integrity. For the standardised approach, firms will have to be able to demonstrate the reasons behind their mapping of income streams or products to a business line. This will need to be documented.

6.6 In order to qualify for the standardised approach, firms will also need to satisfy certain qualitative criteria. We expect these criteria to be set out soon in a new Basel Committee paper. The objective is to make the qualitative criteria challenging but realistic. For example, a firm adopting the standardised approach will need to identify its operational risk across the firm and be able to assess in broad terms the potential impact of operational risk on solvency. It will have to have effective reporting on operational risk to senior management, who will have to have explicitly defined their appetite for operational risk. However, a firm on the standardised approach will not be required to devote the same scale of resources to measuring operational risk as a firm on an AMA. For instance, systematic and detailed loss data collection would not be required of a firm using the standardised approach; nor would any kind of modelling.

6.7 Some firms may see the standardised approach as a stepping stone to adoption of an AMA. They will be able to choose to put some business lines in the standardised approach and others in an AMA. The extent to which this will be possible and any pre-conditions will be discussed with our industry working group and our conclusions set out in the consultation paper planned for next year.

The Advanced Measurement Approaches – an overview

6.8 The proposals for the AMA are one of the most innovative parts of the new Capital Accord. The AMA are intended to allow firms with a sophisticated risk management system to use their internal loss data in the estimation of required capital. The AMA provide incentives to mitigate operational risk to a certain tolerance level. Although the definition of the AMA is still evolving in

the discussions on the new Capital Accord, there are elements that we think firms who are planning to adopt an AMA will need to consider now. These are set out below.

6.9 In September 2001 the Basel Committee published a Working Paper on Operational Risk. Annex 1 of that document set out the draft qualifying criteria for the AMA[18]. To help firms supplement internal data, the Committee has published a loss data matrix to facilitate the collection of loss data on common lines[19]. Those wishing to adopt the AMA should consider this material, bearing in mind that these criteria may still change. We also encourage firms to refer to the Committee's draft Sound Practices for the Management and Supervision of Operational Risk, Part 2, published in December 2001[20].

6.10 Two of the 2001 criteria are, we think, especially important:

- the need to have an internal risk measurement system that is closely integrated in the day-to-day risk management processes of the firm. In other words, the measurement system must have an impact on senior management's view of the profile of operational risk in the firm; and
- the internal risk measurement system must capture the impact of infrequent, but potentially severe, operational risk events. In other words, the estimate should go beyond frequent, but low impact losses.

We would expect firms wishing to adopt an AMA to have considered how they would meet these criteria.

18 See the BIS website: www.bis.org/bcbs/publ.htm

19 www.bis.org/bcbs/publ.htm

20 www.bis.org/publ/bcbs86.htm

7 Next steps

7.1 The range of firms covered by the new standards and the options available to them make it impossible to prescribe a course of action applicable to all. Some firms' planning is already proceeding while others are waiting for a clearer indication of the outcome of the negotiations in the Basel Committee and Europe. Much will depend on which approach firms choose to follow for credit and operational risk. Given that these approaches are challenging, firms that wish to adopt any of them in 2006 should consider now how they will set about demonstrating that they meet the requirements.

7.2 To assist firms in their planning and to help us to assess the number and type of firms interested in applying for the advanced approaches, we are asking firms to inform us now of their broad intentions. We attach a questionnaire – see Annex B. We would be grateful if firms could complete and return this to Katy Martin, Financial Services Authority, 25 The North Colonnade, Canary Wharf, London, E14 5HS or by e-mail to dp13@fsa.gov.uk by 30 September 2002. Some firms may have already been asked by us to complete a similar questionnaire; we would be grateful if those firms could notify us if there has been any change in their views since responding to the previous questionnaire.

7.3 We welcome comments and questions on any part of this paper. The second page of the paper sets out details on where to address these.

Annex A

The three pillars of the new Capital accord (an aide-memoire)

A.1 The proposed new Capital Accord consists of three mutually reinforcing pillars. These are expected also to be reflected in the European Directive on Regulatory Capital.

Pillar One

A.2 The first pillar sets out the minimum capital requirement. The current definition of capital, the minimum requirements of 8% of capital relative to risk weighted assets and the measurement methods for market risk all remain unchanged. The main difference is in the measurement of credit risk and in the introduction of a measure for operational risk.

A.3 For both credit and operational risk a menu of approaches to the measurement of risk is available to firms. For credit risk there are two principal options: the standardised approach, where risk weights will be defined by reference to a rating provided by an external credit assessment institution; and the internal ratings based (IRB) approach where firms will be allowed to use their internal estimates of borrower creditworthiness to assess credit risk. For some exposure classes, there are two variants of IRB – the foundation and advanced. For operational risk there are three different approaches: the basic indicator, standardised and advanced measurement approaches. The basic indicator approach uses one measure of operational risk for a bank's total activity. The standardised approach specifies different indicators for different business lines. The advanced measurement approaches require firms to use their internal loss data in the estimation of required capital.

Pillar Two

A.4 The second pillar sets out the supervisory review process. This part of the Capital Accord is based around a set of principles designed to ensure that firms have adequate capital beyond the mechanics of Pillar One. There are cases where the risk assessment models developed for the advanced approaches

might not result in a Pillar One capital requirement which captures all the risks the firm faces. Under those circumstances, institutions should themselves consider the implications of this, and set themselves capital targets commensurate with their overall risk profile. Supervisors should then be able to evaluate the risks of the institution and the process used to set the capital target. Where there appears to be a capital deficiency, supervisors should take action to raise capital to a level commensurate with the risk profile.

A.5 The principles which underpin this approach are that:

- firms should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels;
- supervisors should review and evaluate firms' internal capital adequacy assessments and strategies as well as their ability to monitor and ensure their compliance with regulatory capital ratios.
- supervisors should take appropriate supervisory action if they are not satisfied with the result of this process;
- supervisors should expect firms to operate above the minimum regulatory capital ratios and should have the ability to require firms to hold capital in excess of the minimum;
- supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Pillar Three

A.6 The third pillar refers to the use of enhanced disclosure by firms in order to bolster market discipline. The framework for Pillar Three sets out disclosure requirements for firms in several areas, including a firm’s approaches to risk management, its risk exposures and the capital required to support them. A core set of requirements will apply to all firms subject the new regime, with more detailed requirements for those firms which are using the more advanced approaches under Pillar One.

Questionnaire on firms' approaches to implementation

In order to help with our planning for implementation – we would be grateful if affected firms could complete the questionnaire below and return to Katy Martin, Financial Services Authority, 25 The North Colonnade, Canary Wharf, London, E14 5HS or by e-mail to dp13@fsa.gov.uk by 30 September 2002.

Some firms may have already been asked by us to complete a similar questionnaire; we would be grateful if those firms could notify us if there has been any change in their views since responding to the previous questionnaire.

You should note that we will regard the answers given to the questionnaire as an indication of firms' current thinking and not as a commitment by firms to adopt any of the approaches they indicate they are likely to use.

Credit risk

1. What is the likelihood of your wanting to use IRB approaches from commencement of the new capital framework ('Day 1')?

a) Zero

b) Unlikely

c) Likely

d) Certain

Firms answering 'zero' to this question should proceed to question 4.

2. Assuming that you are on IRB at Day 1 what is the likelihood of your wishing to use the Advanced, as opposed to Foundation methodologies, for those exposure classes where this distinction exists?

a) Zero

b) Unlikely

c) Likely

d) Certain

3. Assuming that you are on IRB at Day 1, please estimate how many separate portfolios would require approval under each exposure class.

a) Corporate

b) Bank

c) Sovereign

d) Retail

e) Equity

f) Specialised Lending

g) Securitisations

In the case of entities subject to consolidated supervision by the FSA, this should cover all of the relevant group or sub-group which is subject to capital requirements set by the FSA.

It would be useful to us if you could provide (very brief) descriptions of the various portfolios. However please consider this to be optional additional information, which can be provided at a later date if that would be more convenient.

4. If you are not on IRB at Day 1, what is the likelihood of your wishing to commence use of the IRB approaches at a later date? For the purpose of answering this question please interpret 'a later date' as being by the end of 2008.

a) Zero

b) Unlikely

c) Likely

d) Certain

5. If it is more than likely that you will want to use IRB approaches at a later date, can you provide an estimate of the later date(s) you have in mind?

6. What are the main factors that might make you more or less likely to pursue IRB recognition?

Operational Risk

1. What is the likelihood of your wanting to use either the standardised or advanced measurement approaches from commencement of the new capital framework ('Day 1')?

a) Zero

b) Unlikely

c) Likely

d) Certain

Firms answering 'zero' to this question should proceed to question 4.

2. Assuming that you are using either the standardised or the advanced measurement approaches at Day 1 what is the likelihood of your wishing to use the advanced measurement approaches, rather than the standardised approach?

a) Zero

b) Unlikely

c) Likely

d) Certain

3. If partial use of the advanced measurement approaches were permitted, how likely is that you would take advantage of this arrangement?

a) Zero

b) Unlikely

c) Likely

d) Certain

In the case of entities subject to consolidated supervision by the FSA, this should cover all of the relevant group or sub-group which is subject to capital requirements set by the FSA.

It would be useful to us if you could indicate which business lines you would intend to have on the advanced measurement approaches and which on the standardised approach.

4. If you are not on either the standardised or advanced measurement approaches at Day 1, what is the likelihood of your wishing to commence use of the one of these approaches at a later date? For the purpose of answering this question please interpret 'a later date' as being by the end of 2008.

a) Zero

b) Unlikely

c) Likely

d) Certain

5. If it is more than likely that you will want to use either the standardised or advanced measurement approaches at a later date, which approach is it more likely to be?

6. If it is more than likely that you will want to use either the standardised or advanced measurement approaches at a later date, can you provide an estimate of the later date(s) you have in mind?

7. What are the main factors that might make you more or less likely to wish to adopt the standardised or advanced measurement approaches?

Other

8. Please provide any other information that you feel may be relevant to the FSA in interpreting your answers to these questions.

9. Please provide a contact point for future questions of this kind.

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