

Basel 2/Capital Requirements Directive

Background

The original Basel Accord was agreed in 1988 by the Basel Committee on Banking Supervision. The 1988 Accord, now referred to as Basel 1, helped to strengthen the soundness and stability of the international banking system as a result of the higher capital ratios that it required.

Basel 2 is a revision of the existing framework, which aims to make the framework more risk sensitive and representative of modern banks' risk management practices. There are four main components to the new framework:

- i) It is more sensitive to the risks that firms face: the new framework includes an explicit measure for operational risk and includes more risk sensitive risk weightings against credit risk.
- ii) It reflects improvements in firms' risk management practices, for example by the introduction of the internal ratings based approach (IRB) that allows firms to rely to a certain extent on their own estimates of credit risk.
- iii) It provides incentives for firms to improve their risk management practices, with more sensitive risk weights as firms adopt more sophisticated approaches to risk management and
- iv) The new framework aims to leave the overall level of capital held by banks collectively broadly unchanged.

This revised capital adequacy framework aims to further reduce the probability of consumer loss or market disruption as a result of prudential failure. It is also seeking to ensure that the financial resources held by a firm are commensurate with the risks associated with the business profile and the control environment within the firm. The new Basel Accord will be implemented in the Europe Union via the Capital Requirements Directive (CRD). It will directly affect banks and building societies and certain types of investment firms.

This is where the problems start and where the industry had significant issues. The Basel Accord was designed to strengthen the soundness and stability of the international banking system. So why has this Accord be forced on to investment firms. There is a simple explanation. Banks in Europe undertake investment management and securities activities. Therefore all European Investment Managers are tarred with the same brush as Banks. All legislation that comes from Brussels is written with Banks in mind. A heavy German influence.

I spent the last 18 months of my time at AMVESCAP courting the European Commission, HM Treasury, FSA, MP's, MEP's, Trade Associations and the European asset management industry in order to get some realism and understanding of the different risk profiles between the pure asset management industry and Banks. I am pleased to say that there has been some success. I will touch on this later.

The Basel Accord has a new framework. **The new framework** consists of three 'pillars' which in brief are as follows:

- Pillar 1** sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk.
- Pillar 2** firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar 1 and must take action accordingly.

Pillar 3 is to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.

I will come back to this in more detail later.

FSA is working with the Basel Committee, the European Union and the industry to develop its policies for implementing the new capital adequacy framework via the Capital Requirements Directive.

FSA implementation work so far

In Discussion Paper 13 FSA outlined how and why they were starting work on an implementation of the Basel Committee's revised Capital Accord and the Risk Based Capital Directive (RBCD). FSA felt that an indication of their proposed approach in key areas was necessary to help firms with their planning. This reflects the scale of the changes that the revised Accord/RBCD envisage and the lead times both for firms and the FSA.

The objective of DP13 was to explain how FSA planned to implement some of the new requirements of the revised Accord and RBCD and to consult on their proposed approach to the implementation of key aspects of the requirements for the advanced approaches offered under the revised Accord/RBCD.

The main focus of their paper was on the Pillar 1 requirements; FSA were not consulting on the implementation of the requirements covered by Pillar 2 or Pillar 3 of the revised Accord/RBCD.

FSA's proposal was based mainly on the Basel Committee's third consultation paper (CP34) as it is the Risk Based Capital Directive that FSA must implement. However, the timing of the publication of the European Commission Services' third consultation paper (CD34) meant that FSA had not been able to reflect that paper fully in their CP. Therefore, FSA consultation was subject to the finalisation of both the Accord and the Risk Based Capital Directive. The FSA rules will also be subject to any developments in international implementation, e.g. at the Basel Committee's Accord Implementation Group (AIG).

The revised Accord/RBCD represents a major change in the supervision of capital adequacy. FSA will need to make extensive changes to their existing standards and how they apply them at the level of each firm. These include new approaches to credit and operational risk capital requirements and a new balance between setting standards and relying on market discipline.

Since the publication of Discussion Paper 13, FSA have been working with two industry groups: the Credit Risk Implementation Advisory Group (CRIAG) and the Operational Risk Implementation Advisory Group (ORIAG). Each group comprises trade body and industry representatives. The membership lists, terms of reference for the groups and minutes of their meetings can be found on the FSA website.

Broad Principles

At the start of FSA's work on the implementation of the revised Accord/Risk Based Capital Directive they set out some broad principles. These are based on the FSMA principles of good regulation, such as:

a risk-based approach and emphasis on senior management responsibility. This will mean focussing on key risk areas when reviewing applications for advanced approaches,

looking to firms to undertake self-assessments of compliance with FSA's criteria and ensuring a fit between implementation work and the ARROW risk assessment work.

firms to decide for themselves, taking into account costs and benefits, whether to apply to adopt an advanced approach. This principle is often referred to as 'no compulsion, no prohibition'. However, where a firm chooses not to adopt an advanced approach because it may lead to higher capital requirements, FSA will take this into account under Pillar 2.

'super equivalent' only where there is a material risk to FSA's regulatory objectives and as justified by cost benefit analysis. Any standard is super equivalent if it is higher than the European minimum.

flexibility in interpreting and applying the new standards subject to an objective of applying them consistently. Firms will be able to adopt different approaches in areas such as statistical validation of rating systems.

transparent in setting out requirements as fully as possible in the FSA Handbook and disclosing which firms are on which approach and –on an anonymous basis – what firms have done to meet requirements in particular areas.

international consistency of implementation. Taking account of the UK timetable including full consultation, with achieving international convergence on the broad interpretation of the new standards. Working with regulators, mainly in the Basel Accord Implementation Group (AIG) and Europe.

promote a lead supervision principle for co-ordinating international regulators' approaches to groups

FSA have also been working with other regulators on the co-ordination of implementation. For instance, FSA have been working with the Accord Implementation Group on a range of issues including the implementation of Pillar 2. The Accord Implementation Group has also considered how to ensure that work on approval of the adoption of an advanced approach by international groups is undertaken in the most effective and efficient manner.

Within Europe, FSA have also been working with the Groupe de Contact, the forum of supervisors from the European Economic Area, on the practical implication of the implementation of Pillar 2.

Overview of the new Accord/RBCD

Briefly the structure of the new requirements proposed in the revised Accord/Risk Based Capital Directive consists of the three 'pillars', as mentioned earlier:

Pillar 1: Minimum capital requirements

These requirements are based on the measurement of the amount of credit, market and operational risk to which a firm is exposed. In the past, firms were required to measure their exposure to credit and market risk only. Therefore this only applied to credit institutions and companies trading as principles. Now Firm's will have to measure operational risk as well.

A key innovation of the new Accord/RBCD is to allow firms to use internal risk systems to measure their credit risk and operational risk. In the case of credit risk this will be the Internal

Ratings Based (IRB) approach. For operational risk, firms will be able to use their own models (the Advanced Measurement Approach).

FSA will have to approve the use of Internal Ratings Based and Advanced Measurement Approaches by a firm.

Firms are already able to use internal risk systems, including Value at Risk (VaR) models for market risk capital requirements. FSA have approved the use of VaR models for a number of groups in the UK and will build on this experience in the market risk area in preparing for the new Basel/RBCD standards.

Pillar 2: Supervisory review

Supervisors have to take a view on what additional capital, if any, firms should hold against risks that are not covered in Pillar 1. Firms will be required to have a process for assessing their overall capital adequacy in relation to their risk profile, and a strategy for maintaining the appropriate capital levels. FSA will review these assessments and strategies and other information received in the course of their supervision, and take appropriate action if they are not satisfied with the result of these processes.

Pillar 3: Market discipline

Firms will have to publish certain details of their credit/market/operational risks, levels of capital and risk management processes. The aim here is for firms to make available information that will strengthen market discipline.

Impact of the new requirements on small firms

In FSA's implementation work, and in keeping with the principle of 'no compulsion, no prohibition', they have been mindful of the impact of the new requirements on the whole range of firms that will be subject to these requirements. There is a concern that the new requirements will disadvantage smaller firms, in particular small deposit-takers.

However, Internal Ratings Based and Advanced Measurement Approaches apply more widely than simply to the largest, most complex firms. Indeed, it may be easier for less complex firms with fewer portfolios or business lines to adopt an Internal Ratings Based approach or an Advanced Measurement Approach. The responses received to DP13 indicated that there were several small firms considering adopting an advanced approach. However, FSA also recognise that many small firms will not choose to adopt an advanced approach.

So what does this mean in practical terms for regulated companies??

There has been a mixed signal from the FSA to the industry as a whole. However the insurance industry has completed an analytical document on operational risk at the request of the FSA. Maybe we could discuss this at question; including the approaches adopted by some companies.

There was a build up of steam for the investment firms towards introducing operational risk systems. However this has halted due to the expected Consultation Document on Operational Risk due out this month. This will be a very important document for the whole industry.

The introduction of an Operational Charge for Investment Companies may be substantial depending on the approach senior management have taken towards systems and control. I see this charge as the stick and the introduction of good operational controls as the carrot. This being another emphasis on the Senior Management Arrangements, Systems and Controls requirements.

Capture of Cost Data relating to operational risks

CALCULATION OF OPERATIONAL RISK

I mentioned earlier that certain criteria will be taken into account when calculating the operational risk charge. The Operational Risk Implementation Advisory Group (“ORIAG”), chaired by The Financial Services Authority, have taken account of a number of FSA papers:

Working Document of the Commission Services on Capital requirements for credit institutions and investment firms;

Discussion Paper 13 UK implementation of the new Basel and EU capital adequacy standards;
Consultation Paper 142 Operational Risk Systems and Controls;
Consultation Paper 136 Individual Capital Adequacy Standards; and another paper on
Sound Practices for the Management and Supervision of Operational Risk

These papers were used to determine how Firms should calculate the Operational Risk charge. There may be some of you in the audience who have already applied these papers to determine an operational charge for your business. It would be very useful if this could be discussed during question time.

As you are aware there are the three approaches to determining the calculation:

- The Basic Indicator approach
- The Standard Approach
- The Advanced Measurement Approach

The governance and management framework within companies will have an impact on the ability to use the different approaches. The Standard and Advanced Measurement Approach is highly dependent on the size, complexity, and organisational structure of the firm. The Advisory group concluded that whilst there is a need for an independent Operational Risk management process for a TSA firm, this did not necessarily require an independent risk management function.

However, there was recognition that a clear definition of the roles and responsibilities of different functions was an integral part of the Operational Risk management framework (such as directors, senior management, risk functions, internal audit, financial and operational control, and line management). Furthermore, there was a need for the Operational Risk governance framework to be an integral part of the wider corporate governance framework.

The role of Internal Audit (where it existed) in Operational Risk management was specifically considered. Whilst the Advisory Group felt that there should be no requirement for TSA institution to have an Internal Audit function, it was recognised that for many firms (and in particular smaller firms), Internal Audit was an integral part of their Operational Risk management strategy. However, it was recognised that Internal Audit should not be involved in devising policy on Operational Risk management or in everyday risk management tasks, both of which were a matter for management. It was important that Internal Audit maintained their independence and

objectivity, and that there was a clear demarcation of responsibilities. Operational risk belongs to senior management and they are responsible for its implementation.

The Advisory Group also noted that the entry criteria to TSA or AMA require a firm to collate appropriate Management Information to enable it to identify and assess its Operational Risk exposures, including the systematic tracking of relevant Operational Risk data. This would require the firm to establish processes to enable it to analyse data on internal and external Operational Risk events that provide a more objective but historical assessment of Operational Risk exposures, and business environment and internal control factors that provided a relative but current assessment of exposure.

The Advisory Group recognised that internal data should be used by the firm to identify and assess the potential likelihood and impact of Operational Risk exposures;

to assess its internal control environment;

to enhance the internal control environment through root cause analysis or other investigations; and to validate the effectiveness of its Operational Risk management framework.

A key feature highlighted was that whilst a firm might be subject to a number of Operational Risk events, only a few of these would result in actual losses. From an Operational Risk management perspective, in addition to monitoring their actual losses firms should also be interested in understanding the causes and possible consequences of all Operational Risk events.

The Advisory Group considered that at a minimum, a firm should establish a monitoring and escalation process that enabled changes in the firm's Operational Risk profile to be escalated to the appropriate level of management. This would require the firm to outline formal escalation parameters and/or thresholds and those to whom responsibility for assessing and monitoring Management Information lay.

Furthermore, the firm should ensure that the monitoring and escalation process adequately covered all Operational Risk exposures at both a business activity and firm-wide level.

The Advisory Group also noted that there was an explicit requirement for routine validation of a firm's compliance with the entry criteria. Five main mechanisms for validation were identified:

- *business management certification* – line management self certify their compliance. This could also include independent risk model assessment by a specialist department outside (or inside) the business line;
- *internal audit certification* – internal audit provide an independent review of both qualitative attributes as well as compliance to quantitative data standards;
- *external audit certification* – this might be necessary to the extent disclosures or capital calculations form part the annual Financial Accounts upon which the external auditor opines;
- *third party certification* – this might or could include certification by independent consultancies (other than external auditors); and
- *supervisory certification* – regulatory review through the use of specialist technical resource within the regulator or third party examiners.

Risk profile. Secondary requirement

The FSA will inspect as part of their next ARROW review an assessment of operational risk policies and procedures. It may be that FSA will require a firm to include in its secondary requirement an amount specified as a requirement to cover an unusual risk profile. An amount required to cover the inadequate management of operational risk to which a firm is exposed will be seen as “like a penalty” for the CEO and senior management. It will also be a cost of doing business in the UK.

In setting a secondary requirement, the FSA may take into account:

- (a) the existence of standard operating procedures laid down by management and adhered to by staff governing the way in which businesses are performed, who may commit the firm, the methods for recording and processing transactions and the production of management information;
- (b) how frequently these operating procedures are reviewed to ensure that they continue to address the activities of the firm;
- (c) the existence of risk management systems which, based on the nature, size and complexity of the business, measure the risks incurred in all their activities including market, credit, operational and legal risks and include control mechanisms to alert management where risks become unacceptably high e.g. exception reports/KPI's or KRI's
- (d) whether staff are sufficient in number, have appropriate experience, skill levels and specialised knowledge to manage the risks of processing, reporting and controlling the business undertaken.
- (e) the existence of management information which allows management to determine whether the firm is meeting its strategic plans, budget, forecasts etc.
- (f) the degree of centralisation of control procedures and systems;
- (g) the firm's commitment to staff training;
- (h) where appropriate, the effective use of an internal audit function;
- (i) the existence of an independent review procedure to assess the risks arising from new and on going business activities;
- (j) the frequency of external verification of data held relating to, for example prices, debtors, creditors, balances with depositories and clearing houses;
- (k) the existence of documented systems specifications;
- (l) the existence of adequate and tested back-up facilities and disaster recovery plans;
- (m) the availability of maintenance and programming expertise;
- (n) the age, degree of automation and integration of a firm's systems and the ability of a firm's systems to process additional data;

- (o) the existence of insurance cover appropriate to the firm's activities. and
- (p) the procedures to manage its current and future cash flows and capital requirements and planned routes to obtain additional capital.

Therefore it is very desirable for regulated entities to get their operational risk policies and procedures in good shape before the next FSA Arrow inspection visit.

SCOPE OF CONSOLIDATION

To finish up with I would also like to discuss the Risk Based Capital Directive. I referred to this piece of European legislation at the start of this presentation that kept me occupied for some 18 months. It is, or it can be, very difficult to understand. The Directive started life with a different title and with thirteen States wanting different results and placing different priorities on different requirements. No different to any other Directive I suppose.

The Directive was Bank lead and there was no initial understanding by those implementing the Directive in Brussels or at Canary Wharf of the different risk profiles between a Bank, Securities House or an Asset Management company. After many hours of discussion the rules are now not bad for asset management companies at least.

I do not want to get bogged down in all the legislation and have chosen only two points to talk about.

Who is caught and how you obtain a waiver.

Who is caught

A firm's group means the firm and:

- (a) any EEA parent in the group which is a financial holding company, a credit institution, or an investment firm;
- (b) any credit institution, investment firm or financial institution which is a subsidiary of the firm or of the firm's EEA parent; and
- (c) any credit institution, investment firm or financial institution in which the firm or one of the entities in (a) or (b) holds a participation.

I'm sure that is clear. If a group exists, the firm must also include in the scope of consolidation any ancillary investment services undertaking in the group.

A firm's parent is a financial holding company if it carries out mainly listed activities or if its main business is to acquire holdings in companies undertaking these activities. The FSA interprets the phrases 'mainly' or 'main business' to mean where the balance of business is over 50% of the relevant group or sub-group's balance sheet (measured on the basis of total assets) or profit and loss statement (measured on the basis of gross income).

So, basically if you are an authorised firm and you have a parent company in Europe you must consolidate to that level and calculate a financial resources statement based on the consolidated balance sheet.

This does, surprisingly enough cause some companies financial resource deficits and problems in interpretation.

The waiver clause

However there is light at the end of the tunnel for some companies. Basically pure asset management companies.

The Capital Adequacy Directive provides that the FSA may waive consolidated supervision provided certain conditions are met. These conditions are mainly derived from the Capital Requirements Directive.

A firm need not meet the Consolidated Supervision requirements if:

- (a) there is no credit institution in the group;
- (b) no firm in the group deals in investments as principal, except where it is an operator of a collective investment scheme dealing solely as a result of its activity of operating a collective investment scheme or where the firm's positions fulfil the CAD Article 3 exempting criteria;
- (c) each member of the group which is a CAD firm:
 - (i) is subject either to a liquid capital requirement or to an equivalent capital regime;
 - (ii) complies with its financial resources requirement and the large exposures requirements, or with the equivalent rules of its regulator; and
 - (iii) has systems and controls to monitor and control the sources of capital and funding of all other financial institutions within the group;
- (d) the firm notifies the FSA of any serious risk that could undermine the financial stability of the group as soon as it becomes aware of that risk;
- (e) the firm reports to the FSA all group large exposures as at, and within four months of, the end of each quarter;
- (f) the firm meets certain conditions noted below*; and
- (g) the firm has first notified the FSA in writing that it intends to rely on this rule.

*If the firm notifies the FSA that it will not apply the rules in this section, it must:

- (a) submit to FSA a consolidated supervision return within the specified time, together with a consolidated profit and loss account;
- (b) ensure that each firm in the group deducts from its solo financial resources any quantifiable contingent liability in respect of other group entities;
- (c) ensure that the solo financial resources requirement of each firm in the group incorporates the full value of the expenditure of the firm wherever it is incurred on behalf of the firm; and
- (d) make a note in its audited financial statements that it is not subject to regulatory consolidated capital requirements.

I hope that this brief run through the Basel/ Risk Based Capital Directive has drawn a few issues for you to consider.