

## BASEL & IPSB IMPLEMENTATION: ACTION REQUIRED NOW!

August 2002

**UK firms need to move to action mode on Basel now. The FSA requires that affected firms should give a non-binding indication of their preferred approach to credit and operational risk by 30 September this year.**

The FSA is also unambiguously calling for firms, especially those that have any pretension to using internal ratings based approaches for credit risk or the advanced measurement approach for operational risk, to begin implementation work as soon as possible.

The FSA's suggested approach to data quality and to the transitional provisions will also benefit firms that make early progress.

Firms should also note that FSA is considering applying demand-led fees for approving requests to use the more sophisticated approaches, and soliciting practitioners' views on the issue. The paper does not, however, consider corollary issues such as demand-led timetables if the FSA are taking additional fees for the task.

The FSA has given its first indication of how it proposes to implement Basel II and the EU legislation that will give it effect through the Prudential Sourcebook (DP 13 – *UK Implementation of the new Basel and EU capital adequacy standards*). It focuses mainly on capital requirements and the more sophisticated approaches to calculating regulatory capital, namely the Foundation and Advanced Internal Ratings Based (IRB) approaches to credit risk, and the Advanced Measurement Approaches to operational risk.

Some issues related to disclosure are also broached. The FSA's first thoughts on the implementation of supervisory review are set out in CP 136 (*Individual Capital Adequacy Standards*) and are not discussed in the latest document.

Together with the agreement reached on 10 July by the Basel Committee on the remaining contentious areas of the Accord and the circulation of draft information requirements for the next quantitative impact study (QIS 3) on 19 July, this fires the starting gun for the race for implementation.

**The FSA gives an assumed implementation date of 31 December 2006**, although firms that intend to transition to an internal ratings based approach or use an advanced measurement approach for operational risk will need to be ready to start parallel running from January 2006. The FSA will implement Basel through the Integrated Prudential Sourcebook (PSB). The FSA issued a revised timetable for the PSB on 30 July.

Firms are required to give an indication to the FSA of their likely transitional approach to credit and operational risks by **30 September 2002**. This choice is non-binding and for FSA planning purposes. A final selection will not have to be made until June 2006. Firms that transition to simple approaches will be able to apply to use more sophisticated ones at a later date.

The FSA paper is an unambiguous call to action for any firm that wants to use the more sophisticated approaches available from implementation date.

"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 [DP 13] and preparing evaluations and project plans now if they are not already doing so”

The FSA has set out a three-phase programme. Firms will want to engage both with the policy department and with their line supervisors about the supervisor’s expectations and the nature of the process that the FSA will follow in reviewing firms’ chosen approaches.

Timeframe	Activity	Outputs
Now – Spring 2003	Fleshing out content of the IRB and AMA approaches	Consultative Paper on advanced approaches Spring 2003 with update of FSA implementation plans
Spring 2003 – 2004	Preparation of and consultation on draft rules and guidance for inclusion in the PSB	Consultation Paper on rules in early 2004, feedback on advanced approaches and further update on implementation plans.
Early 2005 – 2006	Working with firms that are adopting advanced approaches	Publication of capital standards in PSB in early 2005. Start of parallel running in 2006

**Some Facilitation of the roll out Process through Transitional Provisions...**

All the approaches offered by Basel – both for credit and operational risk – are open to all firms capable of meeting the entry criteria. Boutiques may apply to use the sophisticated approaches, and large institutions may use the simple ones. There will be much greater flexibility than seemed likely from CP2 for firms to roll out the more sophisticated approaches to credit risk across both countries and exposure classes. This should facilitate implementation for large, diversified and especially international institutions.

The FSA will take advantage of the transitional arrangements that allow firms to use the Foundation and Retail IRB approaches for credit risk even if they do not have the five years of data that are otherwise required. However, the FSA is concerned about data quality and the steps that firms might take where the internal quantitative evidence does not support sufficiently reliable estimates of default probability and other IRB parameters. Where data are scarce, firms will need to be able to use external data or appropriately conservative estimation techniques, or the FSA is likely to insist on longer runs of data than Basel minima. **Data availability, and resolving the issues associated with the use of external data will be critical for firms looking to move to an IRB approach at the end of 2006.**

Basel also contains transitional provisions that suspend the requirement for the IRB system to have been in use for three years. However, the FSA appears to be in two minds about whether to apply these provisions. This is an obvious lobbying point arising from DP 13. Irrespective of the position that it ultimately takes on this, the FSA will certainly have more confidence in systems that have any sort of track record, especially if a firm is applying to use the Advanced IRB approach. Again, **firms that begin early and can show**

that they have an understanding of the dynamics of their system and their estimated parameters will have an advantage.

There are no transitional arrangements for firms looking to use the Advanced IRB. Although Basel's second consultative paper does not distinguish between the Foundation and Advanced IRB approaches in this area, FSA's interpretation is that no transition period is available. Firms may wish to lobby on this, but as currently proposed, firms will need five years of probability of default data and seven years of data on loss given default and exposure at default.

### ...but High Hurdles for Sophisticated Approaches

FSA will facilitate the roll out process to some extent, but the standards to qualify for the advanced approaches will be high. The FSA explicitly reserves the right to apply standards higher than those specified by the Basel Accord. Even current market leaders may find themselves struggling to meet the criteria that the FSA stress, and this may provide another area where firms both individually and collectively should consider lobbying.

For **credit risk**, firms will need to ensure that they focus on:

- **Independence:** the staff designing and controlling the ratings system must be independent from those originating business;
- **The use test:** the internal ratings system must play an essential role in day-to-day operations;
- **Senior management responsibility:** the Board and senior management must have a "thorough understanding" of the IRB system; and
- **Validation:** firms must be able to estimate the various parameters that are input into their capital calculations in a consistent, reliable and valid fashion.

For **operational risk**, firms using the Standardised (Business Lines) Approach will need to be able to:

- **Map** income streams to the standardised business lines;
- **Identify** operational risk across the firm and assess the broad impact of operational risk on solvency;
- **Report** operational risk to senior management; and
- **Define** its appetite for operational risk

There is no requirement for such firms to engage in systematic and detailed loss data collection or any kind of modelling of the sort that will be required of firms using the AMA.

FSA gives little clue as to its approach to AMA, aside from referencing existing material published by the Basel Committee. However, it stresses that any AMA approach must satisfy the following:

- **The use test:** the risk measurement systems must be closely integrated into the day-to-day risk management processes of the firm; and
- **Capturing high impact events:** the system must be able to capture the impact of low frequency, high impact operational risk events.

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### Pillar 3 – Market Discipline

Given the state of play on the development of accounting standards, the FSA is not yet in a position to decide whether the accounting framework can provide the high level implementation mechanism for Pillar 3, although it agrees that this would be the most efficient outcome. That said, the FSA states that it will need to specify some disclosures in greater detail than provided in accounting standards.

The proposed approach to the enforcement of Pillar 3 is possibly the most radical element of the document. The FSA suggests that, as Pillar 3 is about empowering the market, the FSA should focus on educating the market about the disclosures to expect and how to respond to their absence – although this does not mean that the FSA will not set rules in this area and enforce compliance with them.

### Fees

The FSA document poses the question whether the approval of Basel approaches should be an area where demand-led fees are levied to recover the cost of the expert resources that the FSA will need to deploy. As the use of advanced approaches will benefit the firm seeking a waiver from the standard approaches, the FSA believes that an argument for demand-led fees could be made. The issue of what firms might expect for their money by way of demand-led timetables, or a duty of care in respect of work done, is not considered. A consultation on the general issue of levying demand-led fees is promised for later in the year.

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