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Does the latest Basel consultation paper from the FSA take businesses any nearer to compliance?

The latest Basel guidelines

by **Rebecca Lucas**

It is almost six years since the Basel Committee proposed a new capital framework. This was finalised last June; the first draft of the European Union (EU) directive, based on the framework, was released shortly after – with ECOFIN revisions published in December – and various Basel implementation groups have been advising on how the directive should be implemented by EU member states.

As the Financial Services Authority (FSA) has considerable discretion in various areas of Basel implementation, the industry has been eagerly awaiting its response to the draft directive – this arrived in the form of a consultation paper (CP 05/3) released in January of this year.

The first CP on Basel to be published by the FSA since CP189 in July 2003, it represents the best indication we have of the regulatory capital rules to be implemented in the UK.

Overall CP impact

So how much closer does the paper take us to understanding how to achieve IRB compliance?

The FSA makes it clear the guidance provided has had to be balanced against possible changes to the directive before it is finalised in mid 2005, as well as against the expected results of the various workstreams the Committee of European Banking Supervisors (CEBS) is running to give more guidance on Basel implementation.

As well as limiting the amount of guidance contained in the CP, the FSA appears to have shifted the focus of compliance onto the pillar II ICAAP process, placing the onus on firms to establish and justify their own methodologies.

It is possible the FSA intends to firm up its position on some areas of Basel following drill-down visits and firms' responses to the CP, but its approach is far less prescriptive and more reactive than that put forward in CP189.

The emphasis is now on fit-for-purpose methodologies which are proportionate to a firm's size and

relevant to the nature of its business, and that firms both define and justify themselves.

Key developments

One area of concern to many firms, but not addressed in the draft EU directive, is low default portfolios (LDPs).

The FSA states it will take as flexible an approach as possible to implementing the directive requirements in the case of LDPs.

This, however, must surely be balanced against the FSA's stated commitment to taking the most risk-sensitive approach to implementation where possible.

Without more detailed guidance from the FSA, it is unclear how the two aims are to be made compatible and so what the final rules on LDPs are likely to resemble.

In CP189 the FSA proposed a "scorecard", or tick-box, approach to compliance. Following firms' response to CP189, these "scorecards" have been removed, although their content remains as part of the pillar II ICAAP process.

For example, although there is no longer a validation "scorecard", the principles will still form the basis of ICAAP discussions. The FSA has not relaxed validation requirements following removal of the "scorecard" approach, but intends to be superequivalent to the EU directive.

Stress testing is an area where there is an explicit reliance on methodologies specific to individual firms' portfolios. As in CP189, the macro-economic scenario for stress testing will be defined by the FSA, but it will be up to individual firms to determine how this translates into an impact on their business.

The FSA's decision in the CP that the impact may be assumed to be instantaneous can be seen as a response to the scarcity of long-run data in the banking industry.

However, while it will now be easier for many firms to meet stress testing requirements, it is likely some will challenge the assumption this macro-economic scenario would occur instantaneously, an assumption likely to increase capital requirements.

Further work on LDPs and stress testing, as well as on validation, is expected to be undertaken later this year by FSA working groups and the CEBS. It will be interesting to see how prescriptive the resulting guidance is, and how much it aids firms in working out the details of their compliance programmes.

Another issue on which firms are likely to seek guidance is that of timescales. The CP guidance is designed to allow for the current split implementation date, and the possibility that a single implementation date may either be agreed due to pressure from national supervisors, or made necessary by a delay in the EU process.

Consequently it is difficult to take a definite view, from the information in the CP, on the various dates relevant to implementation.

The final rules

The FSA's latest paper does not take firms much closer to understanding what the final requirements for IRB compliance will be.

This is because of reluctance to give full guidance prior to finalisation of the EU directive, as well as the shift of responsibility for defining and justifying methodologies away from the FSA and onto individual firms.

So will firms be given further guidance before implementation? Once the final EU directive is published in July this year, the FSA intends to release a further paper, which may contain more detail.

The FSA and CEBS working groups are planning to consult on some areas of implementation over the coming months, and a fourth impact study will be undertaken at the end of the year.

However, any further guidance that emerges as a result of these processes is unlikely to be available in time for the first wave of applications for retail IRB planned for July.

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key points

● The shift to pillar II means less prescription and more responsibility on firms.

● More guidance is needed, but will it be in time for the first wave of applications?

● Timescales are now a key issue.