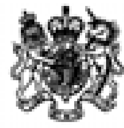
Transposition of the Capital Requirements Directive:

Consultation and Partial Regulatory Impact Assessment

February 2006

HM TREASURY



HM TREASURY

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Executive Summary

Developing a Single Market in financial services lies at the core of EU Member States' commitment to economic reform in Europe. An effective, integrated financial services market would reduce the cost of accessing capital and improve the allocation of capital across the EU; give institutions increased opportunities to access markets in other Member States as well as carrying out business effectively on a cross-border basis; and give consumers access to a wider range of more competitively priced financial services products.

Over the past five years the EU Financial Services Action Plan (FSAP) has been the legislative framework for developing a Single Market in financial services. The majority of the 42 FSAP measures have been adopted in the EU since its agreement by the European Council in Lisbon in March 2000.

The Capital Requirements Directive (CRD) is an important plank of the FSAP legislative measures. It was approved under the UK Presidency when Finance Ministers reached agreement, at a single reading, on the European Parliament's legislative resolution on the CRD on 11 October 2005. The Directive is expected to be formally adopted by the Council in spring 2006, following the translation of the Directive into all EU languages through what is known as the jurists-linguists process.

The CRD technically recasts two existing Directives – the Banking Consolidation Directive and the Capital Adequacy Directive – and introduces a supervisory framework in the EU which reflects the international Basel 2 rules on capital measurement and capital standards agreed by the Basel Committee on Banking Supervision in 2004. The CRD applies to all credit institutions and those investment firms defined by Article 4(1), Market in Financial Instruments Directive 2004/39/EC (MiFID).

Basel 2 is a revision of the existing capital adequacy framework, Basel 1, and is intended to further reduce the probability of consumer loss or market disruption as a result of prudential failure. It will do so by 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.

Member States must transpose, and firms should apply, the Directive from the start of 2007. During 2007, credit institutions and investment firms as defined by the MiFID, can choose between the current 'Basel 1 approach' and the simple or medium sophistication approaches of the new framework. The most sophisticated approaches will be available from 2008. From this date, all affected EU firms will apply Basel 2 through the CRD.

The transposition requirement of European Community law is for full effect to be given in national law to the CRD. This task is split between HM Treasury and the UK's Financial Services Authority (FSA). The FSA will be transposing the bulk of the CRD by making rules using its powers under the Financial Services and Markets Act. The FSA's second consultation paper CP06/3 'Strengthening Capital Standards 2' is published in parallel to this document and can be found at the FSA's website: www.fsa.gov.uk. HM Treasury will transpose into domestic legislation those provisions that place new duties on the FSA.

This consultation is concerned with the areas of transposition which are the responsibility of HM Treasury. These are: group model recognition for the advanced approaches to measuring Pillar 1 capital requirements; and the recognition of external credit assessment institutions (ECAIs) for the purposes of credit institutions measuring their Pillar 1 capital requirements using the standardised approach.

HM Treasury is seeking views on the implementation options for the two areas highlighted above.

1 Consultation Document

Single market in financial services

1.1 Developing a Single Market in financial services lies at the core of EU Member States' commitment to economic reform in Europe. An effective, integrated financial services market will:

- reduce the cost of accessing capital and improve the allocation of capital across the EU;
- give institutions increased opportunities to access markets in other Member States as well as carrying out business effectively on a cross-border basis; and
- give retail consumers access to a wider range of more competitively priced financial services products.

1.2 Over the past five years the EU Financial Services Action Plan (FSAP) has been the legislative framework for developing a Single Market in financial services. The majority of the 42 FSAP measures have been adopted in the EU since its agreement by the European Council in Lisbon in March 2000.

1.3 The Capital Requirements Directive (CRD) is a key part of the FSAP legislative measures. These measures aim to fill gaps and remove barriers to provide a legal and regulatory environment that supports the integration of financial markets across the EU, thereby contributing to the development of a Single Market in financial services.

1.4 More specifically, the CRD updates European legislation in line with international recommendations by implementing in the European Union the new Basel Accord, Basel 2, agreed by the Basel Committee on Banking Supervision in June 2004.[1] By transposing internationally agreed capital standards into a common EU legal framework, the Directive ensures that all EU countries will be in line with Basel 2, thereby creating a level playing field for all banks, building societies and affected investment firms across the EU. This in turn will further deepen the Single Market in financial services.

Background to the capital requirements directive

Basel 2

1.5 Basel 1, agreed by the international Basel Committee on Banking Supervision in 1988, led to substantial increases in capital ratios during the period 1988–92.[2] These international recommendations helped to strengthen the soundness and stability of the international banking system. They have also helped enhance competition among internationally active banks by reducing the potential for differences in regulatory treatment by providing for a common capital adequacy framework.

1.6 However, over the past 15 years, the global financial system has become increasingly complex. Consequently, the Basel Committee has been working since 1998

[1] Source: http://www.bis.org/publ/bcbs107.htm

[2] Source: http://www.bis.org/publ/bcbs04a.htm

to develop a new regulatory capital framework that recognises new and continuing developments in financial products, incorporates advances in risk measurement and management practices, and more precisely assesses regulatory capital charges in relation to risk.

1.7 The revised capital adequacy framework has been improved on the basis of three interlocking pillars.

- Pillar 1 - sets out the minimum capital requirements firms will be required to meet for credit, market, and operational risk. It also substantially increases the risk sensitivity of the minimum capital requirements by providing for a range of approaches of increasing sophistication for measuring credit and operational risk.[3]
- Pillar 2 - introduces a process of supervisory review to capital regulation which points to the need for banks to assess their capital adequacy positions relative to their overall risks, and for supervisors to review and take appropriate actions in response to those assessments.
- Pillar 3 - complements the above two pillars by developing a set of disclosure requirements that allow market participants to assess key information about a bank's risk profile and level of capitalisation, thereby encouraging market discipline.

Transposition of Basel 2 into EU legislation

1.8 The CRD transposes Basel 2 into EU legislation by revising the existing Banking Consolidation Directive (BCD) and Capital Adequacy Directive (CAD).[4] As with the implementation of Basel 1, in the interest of maintaining a level playing field the scope of Basel 2 has been extended in the CRD beyond internationally active banks to include all credit institutions and those investment firms defined by Article 4(1) of the Market in Financial Instruments Directive (MiFID).[5] Therefore, the CRD will directly affect banks, building societies and certain types of investment firms.

Transposition of CRD into UK law

1.9 The transposition requirement of European Community law is for full effect to be given in national law to the CRD. The UK Government aims to ensure that transposition does not impose additional requirements on UK firms above those specified in the CRD, that is not to be superequivalent in respect of EC law, unless it is shown to be justified on the basis of a rigorous cost–benefit analysis.

1.10 Transposition is split between HM Treasury and the FSA. The FSA will be transposing the bulk of the CRD by making rules using its powers under the Financial Services and Markets Act (FSMA).[6] The FSA's second consultation paper on CRD

[3] Measuring credit risk can be done by either using (in order of increasing sophistication) the Revised Standardised Approach (RSA), the Foundation Internal Ratings Based Approach (FIRB), or the Advanced Internal Ratings Based Approach (AIRB). Measuring operational risk can be done by either using (in order of increasing sophistication) the Basic Indicator Approach (BIA), the Standardised Approach (STA), or the Advanced Measurement Approach (AMA).

[4] The EU implemented Basel I through the Solvency Ratio Directive (now incorporated into the BCD) and Own Funds Directive adopted in 1989. Market risk was introduced through the first CAD in March 1993 (before Basel incorporated market risk) but was later amended in 1998 (CAD 2) to allow for the use of Value at Risk (VAR) models.

[5] Source: Directive 2004/39/EC.

[6] FSMA is an Act to make provision for the regulation of financial services and markets. It gives the FSA a variety of legislative functions in order to carry out its role. These include: making rules, issuing codes, issuing statements, giving directions and giving guidance.

implementation has been published in parallel to this document.[7] The consultation paper contains the full set of draft Handbook text for implementing the CRD provisions. It largely follows the format used in its first consultation (CP05/03) – reflecting feedback from that consultation paper and further discussions with industry which have taken place since – and takes account of the Trading Book Review. A comprehensive cost-benefit analysis forms an integral part of the FSA's second consultation paper, including an assessment of the areas of superequivalence in the FSA's proposed implementation of the CRD. HM Treasury will transpose into domestic legislation those provisions that place new duties on the FSA.

1.11 The UK transposition will affect all banks, building societies and certain types of investment firms in the UK, but not those firms in Overseas Territories or the Crown Dependencies.[8]

The implementation challenge

1.12 Implementation of an EC directive means the process of giving full effect to the legislation in the UK. The first element in implementation involves the transposition of the EC law into national law (as discussed above). The second is the putting in place of relevant administrative arrangements on the ground to ensure that the new rules are observed. This step may involve changes in business practices. The third element concerns the enforcement process to ensure that the new rules work effectively and are complied with across the EU. [9]

1.13 The challenge for Member States' authorities is to implement EU measures into national law in an effective, proportionate and consistent manner, working closely with their counterparts in other Member States. This approach is required across the whole of the EU if the potential benefits of the CRD are to be delivered and costly burdens on business avoided.

1.14 The UK outlined its approach to implementing the FSAP in May 2004. The paper outlined three areas where steps are being taken by the authorities towards delivering EU financial services measures:

- internal arrangements – joined up project management and analysis within HM Treasury, the FSA and other relevant authorities;
- working with business – better consultation and communication with affected business sectors; and
- co-operation with authorities in other Member States – through bilateral arrangements, through making use of existing institutional structures and through pressing the European Commission and other bodies to set up enhanced co-operation arrangements.

1.15 HM Treasury has followed <u>all</u> of these steps in the implementation of the CRD:

- internal arrangements – the CRD implementation team, composed of policy leads who completed the CRD negotiations and lawyers, has worked closely

[7] The FSA's first consultation paper was CP05/3 'Strengthening Capital Standards', January 2005.

[8] Overseas Territories: Anguilla, Bermuda, British Antartic Territory, British Indian Ocean Territory, British Virgin Islands, Cayman Islands, Falkland Islands, Montserrat, Pitcairn, Saint Helena and Dependencies, South Georgia and the South Sandwich Islands, Turks and Caicos Islands. Crown Dependencies: Jersey, Guernsey (including Alderney and Sark) and the Isle of Man.

[9] Source: 'The EU Financial Services Action Plan: delivering the FSAP in the UK' HM Treasury, FSA, Bank of England, May 2004.

with the FSA, analysed a range of different implementation options, and avoided adding to the regulatory change burden wherever possible. HM Treasury has also used project management disciplines in order to deliver its transposition responsibilities;

- working with business – HM Treasury has engaged in regular dialogue with industry via a Financial Services Presidency Forum as well as undertaking 'stocktake' meetings chaired alternately by HM Treasury and the FSA. HM Treasury has also had numerous 'round-table' discussions with stakeholders and continues to hold bilateral meetings as appropriate; and
- co-operation with authorities in other Member States – the Government and the FSA have encouraged the development of mechanisms to improve the implementation of financial services measures across the EU. With respect to the CRD, there are two mechanisms at the European level designed to help consistent Member State implementation: the Capital Requirements Directive Transposition Group (CRDTG), which aims to tackle legal interpretation issues and ensure consistent transposition into Member State law; and the Committee of European Banking Supervisors (CEBS). One of CEBS' key roles is to contribute to the consistent implementation of Community Directives and to the convergence of Member States' supervisory practices throughout the Community.

1.16 The challenge for business is:

- to contribute to the process of implementation by the public authorities, especially by engaging actively in consultation processes;
- to assess the strategic implications of the changing business environment in the UK and more widely in the EU and to amend their business plans accordingly; and
- to make any necessary changes to systems and practices to comply with new rules.

Why consult?

1.17 This is HM Treasury's second consultation on the CRD. The first consultation was held in 2003 at the pre-Directive proposal stage, the results of which helped to shape the UK negotiating position.[10] This consultation concerns the transposition of the Directive into national law and is specifically concerned with those areas which are the responsibility of HM Treasury.

1.18 These areas include:

- group model recognition for the advanced approaches to measuring Pillar 1 capital requirements; and
- the recognition of external credit assessment institutions (ECAIs) – commonly referred to as credit rating agencies - for the purposes of credit institutions measuring their Pillar 1 capital requirements using the standardised approach.

[10] Source: 'The new Capital Adequacy Directive, CAD 3: the transposition of the new Basel Accord into EU legislation'. Consultation Document, HM Treasury, December 2003.

1.19 This document lays out the relevant Directive text for the above two areas and provides an interpretation of the text, highlighting rights of firms, HM Treasury obligations and FSA responsibilities where necessary. It highlights the key questions and issues on which HM Treasury would welcome feedback. These questions are noted in the box below.

Questions

Group model recognition

- Is there sufficient legal clarity provided for in the Directive text? (p.12)
- If not, is further detail required in UK national law and if so, what would this be? (p.12)

ECAIs

- Is there sufficient legal clarity provided for in the Directive text? (p.15)
- If not, is further detail required in UK national law and if so, what would this be? (p.15)

1.20 The partial Regulatory Impact Assessment (RIA) should be read in conjunction with this document. The partial RIA lays out some implementation options for the two areas highlighted above and considers qualitative, and where possible, quantitative costs and benefits for each option. Risks, unintended consequences and any compliance and enforcement issues have also been incorporated as costs and benefits. Competition issues and the impact on small firms have also been considered.

1.21 When formally responding to the partial RIA, HM Treasury is seeking comments on the analysis of costs and benefits, likely risks and unintended consequences of the proposed options, along with supporting evidence where possible. If you feel that there are alternative options, or indeed alternative combinations of the proposed options, HM Treasury would welcome these suggestions. The feedback to this partial RIA will provide valuable information which will feed into the Final RIA following this consultation.

GROUP MODEL RECOGNITION

1.22 The CRD introduces provisions for the more effective supervision of pan-European groups consisting of credit institutions or investment firms through 'consolidated supervision'.[11] In most cases the 'consolidated supervisor' is the 'home supervisor' of the parent undertaking of a group, while the other relevant competent authorities are the 'host' supervisors of subsidiaries in other territories.[12]

1.23 This more integrated, risk-based and coordinated approach to supervision allows the 'consolidated supervisor' to take a lead role in certain EU group supervisory activities, often in cooperation with the 'host supervisor' as defined above.

[11] Investment firms are defined by reference to Article 4(1), Market in Financial Instruments Directive 2004/39/EC.

[12] In the case of subsidiaries controlled by a financial holding company the consolidated supervisor will be the competent authority which authorised a subsidiary, as decided by the provisions of the BCD.

Article 129(1) – BCD

1. In addition to the obligations imposed by the provisions of this Directive, the competent authority responsible for the exercise of supervision on a consolidated basis of EU parent credit institutions and credit institutions controlled by EU parent financial holding companies shall carry out the following tasks:

(a) coordination of the gathering and dissemination of relevant or essential information in going concern and emergency situations;

(b) planning and coordination of supervisory activities in going concern as well as in emergency situations, including in relation to the activities in Article 124, in cooperation with the competent authorities involved.

1.24 Provisions for cooperation between the FSA and other relevant competent authorities already exist under FSMA. However, Article 129(1) imposes specific tasks on the consolidated supervisor in relation to EU groups (as listed above) and HM Treasury will need to reflect these additional obligations in its implementing legislation.

Article 129(2) - BCD

2. In the case of applications for the permissions referred to in Articles 84(1), 87(9) and 105 and in Annex III, part 6, respectively, submitted by an EU parent credit institution and its subsidiaries, or jointly by the subsidiaries of an EU parent financial holding company, the competent authorities shall work together, in full consultation, to decide whether or not to grant the permission sought and to determine the terms and conditions, if any, to which such permission should be subject.

An application as referred to in the first subparagraph shall be submitted only to the competent authority referred to in paragraph 1.

The competent authorities shall do everything within their power to reach a joint decision on the application within six months. This joint decision shall be set out in a document containing the fully reasoned decision which shall be provided to the applicant by the competent authority referred to in paragraph 1.

The period referred to in subparagraph 3 shall begin on the date of receipt of the complete application by the competent authority referred to in paragraph 1. The competent authority referred to in paragraph 1 shall forward the complete application to the other authorities without delay.

In the absence of a joint decision between the competent authorities within six months, the competent authority referred to in paragraph 1 shall make its own decision on the application. The decision shall be set out in a document, fully reasoned and taking into account the views and reservations of the other competent authorities expressed during the six months period. The decision shall be provided to the applicant and the other competent authorities by the competent authority referred to in paragraph 1.

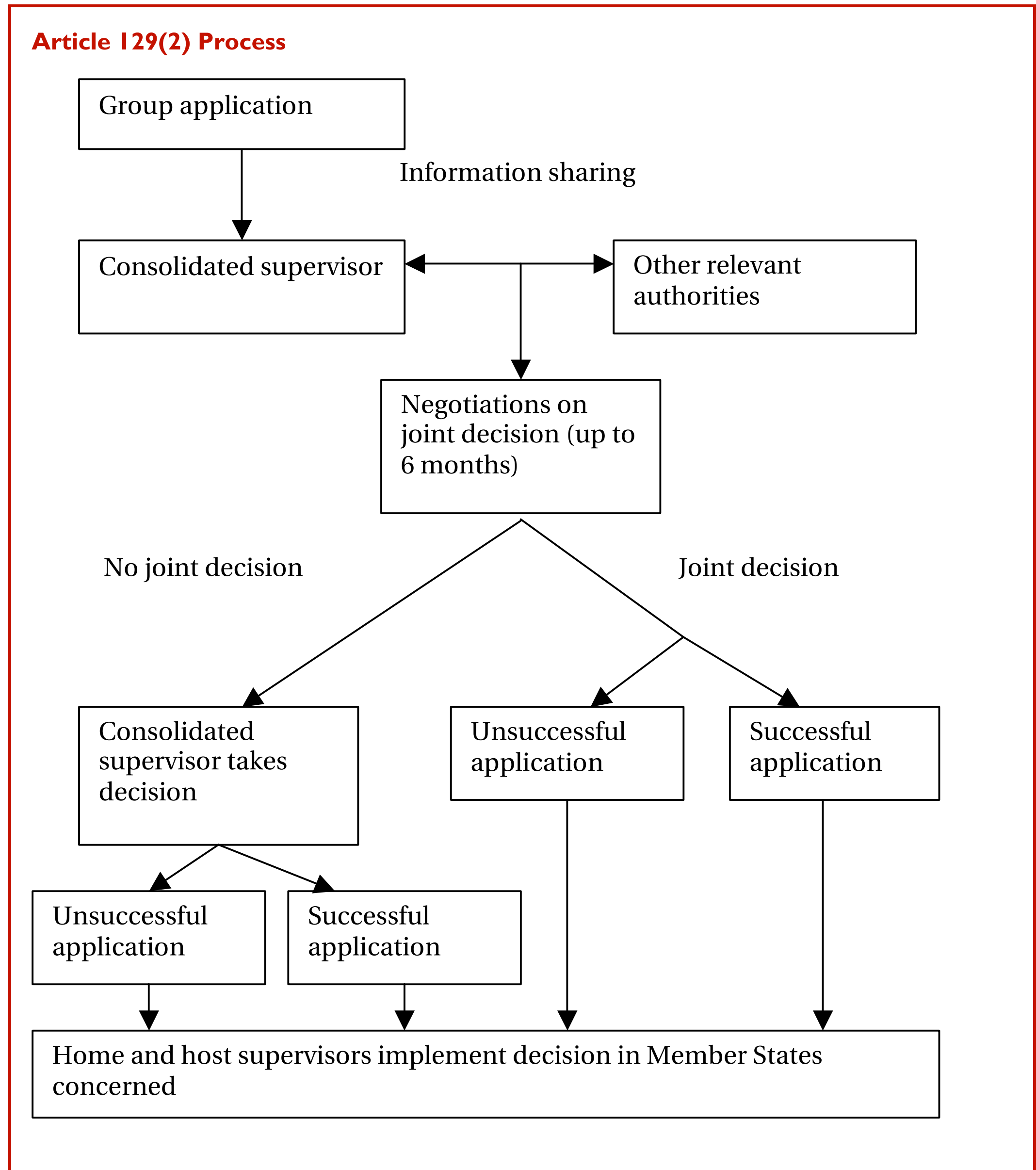
The decisions referred to in subparagraphs 3 and 5 shall be recognised as determinative and applied by the competent authorities in the Member States concerned.

1.25 This article provides a mechanism for EU groups to choose to make one joint application for model recognition for the advanced approaches to the consolidated supervisor. The resulting decision, made at EU level, will cover all members of that group (parents, subsidiaries, and branches). The consolidated supervisor and other

relevant competent authorities make the decision under Article 129(2) jointly. In the absence of agreement within six months the final decision falls to the consolidated supervisor. The diagram in the box below outlines this process.

1.26 Once a decision has been taken, whether jointly or by the consolidated supervisor, the decision under Article 129(2) binds all relevant competent authorities and must be implemented within each separate jurisdiction.

Article 129(2) Process



UK IMPLEMENTATION

1.27 In order to ensure that the relevant legal framework exists to allow the FSA to participate and carry out the necessary actions under the Article 129(2) process (see diagram above) HM Treasury will need to make provision to require the FSA to:

- co-operate with the relevant other competent authorities to come to a joint decision;

- make a decision and comply with the relevant obligations if it is the consolidated supervisor; and
- implement the decision (whether that decision was made jointly, by the FSA as consolidated supervisor or by another competent authority as consolidated supervisor).

1.28 The Directive does not stipulate how competent authorities should undertake their responsibilities under Article 129(2) in situations where, for example, a new member joins a group or a group makes changes to their risk models.

1.29 As highlighted above, the FSA will be responsible for fleshing out the detail of how these provisions will work in practice. However, HM Treasury must give the FSA the power to enable it to do so. This consultation document is concerned only with HM Treasury's implementation obligations. With this in mind, HM Treasury asks the following questions.

Questions

- Is there sufficient legal clarity provided for in the Directive text?
- If not, is further detail required in UK national law and if so, what would this be?

EXTERNAL CREDIT ASSESSMENT INSTITUTIONS (ECAIs)

Article 81 – Banking Consolidation Directive (BCD)

1. An external credit assessment may be used to determine the risk weight of an exposure in accordance with Article 80 only if the ECAI which provides it has been recognised as eligible for those purposes by the competent authorities, hereinafter "an eligible ECAI'.

2. Competent authorities shall recognise an ECAI as eligible for the purposes of Article 80 only if they are satisfied that its assessment methodology complies with the requirements of objectivity, independence, ongoing review and transparency, and that the resulting credit assessments meet the requirements of credibility and transparency. For those purposes; the competent authorities shall take into account the technical criteria set out in Annex VI, Part 2.

3. If an ECAI has been recognised as eligible by the competent authorities of a Member State, the competent authorities of other Member States may recognise that ECAI as eligible without carrying out their own evaluation process.

4. Competent authorities shall make publicly available an explanation of the recognition process, and a list of eligible ECAIs.

1.30 This article concerns the recognition of ECAIs. Paragraph 1 requires that any external credit assessment used by a credit institution for Article 80 purposes (that is, to determine the probability of default which is a component of the risk weight, for credit institutions' exposures to sovereigns, banks, corporates under Pillar 1 of CRD) must be provided by a recognised ECAI.

1.31 However, the FSA may recognise an ECAI only if the ECAI meets certain requirements. Article 81(2) BCD sets out the recognition criteria: the assessment methodology must comply with the requirements of objectivity, independence,

ongoing review and transparency, and the resulting credit assessments must be credible and transparent. These criteria are expanded upon in Annex VI, Part 2.

1.32 Article 81(3) BCD provides for mutual recognition. That is, if an ECAI has been recognised for Article 80 purposes by a competent authority in another Member State, then the FSA may recognise the ECAI without any further assessment.

1.33 It is therefore necessary for HM Treasury to impose an obligation on the FSA to recognise an ECAI in accordance with the Directive. HM Treasury must also empower the FSA to be able to revoke recognition if it considers that the requirements are no longer met, or if the competent authority in another Member State no longer recognises the ECAI.

1.34 Finally, as Article 81(4) BCD requires competent authorities to publish: (a) an explanation of its ECAI recognition process; and (b) a list of eligible ECAIs, HM Treasury must also impose this obligation on the FSA.

Article 82 – BCD

1. The competent authorities shall determine, taking into account the technical criteria set out in Annex VI, Part 2, with which of the credit quality steps set out in Part 1 of that Annex the relevant credit assessments of an eligible ECAI are to be associated. Those determinations shall be objective and consistent.

2. When the competent authorities of a Member State have made a determination under paragraph 1, the competent authorities of other Member States may recognise that determination without carrying out their own determination process.

1.35 HM Treasury must create an obligation for the FSA to determine, objectively and consistently, taking into account the technical criteria set out in Annex VI, Part 2, with which of the credit quality steps set out in Part 1 of that Annex the relevant credit assessments of an eligible ECAI are to be associated. Article 82(2) BCD also provides for mutual recognition. As such, if a competent authority in another Member State has made a determination with respect to Article 82(1), the FSA may recognise that determination without any further assessment.

Articles 97, 98 – BCD

Article 97

1. An ECAI credit assessment may be used to determine the risk weight of a securitisation position in accordance with Article 96 only if the ECAI has been recognised as eligible by the competent authorities for this purpose, hereinafter "an eligible ECAI".

2. The competent authorities shall recognise an ECAI as eligible for the purposes of paragraph 1 only if they are satisfied as to its compliance with the requirements laid down in Article 81, taking into account the technical criteria in Annex VI, Part 2, and that it has a demonstrated ability in the area of securitisation, which may be evidenced by a strong market acceptance.

3. If an ECAI has been recognised as eligible by the competent authorities of a Member State for the purposes of paragraph 1, the competent authorities of other Member States may recognise that ECAI as eligible for those purposes without carrying out their own evaluation process.

4. The competent authorities shall make publicly available an explanation of the recognition process and a list of eligible ECAIs.

5. To be used for this purpose a credit assessment of an eligible ECAI shall comply with the principles of credibility and transparency as elaborated in Annex IX, Part 3.

Article 98

1. For the purposes of applying risk weights to securitisation positions, the competent authorities shall determine with which of the credit quality steps set out in Annex IX the relevant credit assessments of an eligible ECAI are to be associated. Those determinations shall be objective and consistent.

2. When the competent authorities of a Member State have made a determination under paragraph 1, the competent authorities of other Member States may recognise that determination without carrying out their own determination process.

1.36 These articles provide for equivalent provisions as in Article 81 and 82 respectively, but apply to securitisations.[13]

Annexes

1.37 Annexes in the CRD tend to flesh out the technical detail required in the articles. In this case: Annex VI, Part 2 sets out detailed obligations on the recognition of ECAIs and the mapping of their credit assessments; Annex VI, Part 3 sets out detailed provisions on the use of ECAI's credit assessments for the determination of risk weights; and Annex XI provides further detail regarding the securitisations provisions in articles 97-98. The relevant text of these provisions is supplied in Annex A.

UK implementation

1.38 As highlighted above, HM Treasury must provide the framework within which the FSA will operate; the FSA will be responsible for fleshing out the detail of how these provisions will work in practice. This consultation document is concerned only with

[13] Securitisation is a financial technique that pools assets together and, in effect, turns them into a tradeable security. Financial institutions and businesses of all kinds use securitisation to immediately realise the value of a cash-producing asset.

HM Treasury's implementation obligations. In summary, HM Treasury will need to make provision for the FSA to:

- recognise an ECAI in accordance with the Directive;
- be able to revoke recognition if it considers that the requirements are no longer met;
- publish an explanation of its ECAI recognition process and a list of eligible ECAIs; and
- determine, in accordance with the Directive, with which of the credit quality steps the relevant credit assessments of an eligible ECAI are to be associated.

1.39 In doing so, HM Treasury will be giving effect to Articles 81(2)-(4), 82, 97(2)-(5) and 98, Annex VI Part 2 and Annex IX Part 3. With this in mind, HM Treasury asks the following questions.

Questions

- Is sufficient legal clarity provided for in the Directive text?
- If not, is further detail required in UK national law and if so, what would this be?

HOW TO RESPOND

1.40 The consultation period will begin on 28 February 2006 and run for 12 weeks until 23 May 2006. Please ensure that your response reaches us by that date. Please send responses to this consultation document to:

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Room 4.18
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SW1A 2HQ

Tel: (+44) (0) 207 270 5219

Fax: (+44) (0) 207 270 4322

Email: Gillian.Hood@hm-treasury.x.gsi.gov.uk

1.41 When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation please make it clear who the organisation represents, and where applicable, how the views of members were assembled.

1.42 A list of those consulted is attached in Annex B. If you have any suggestions of others who may wish to be involved in this process, please contact us.

1.43 All written responses will be made public on HM Treasury's website unless the author specifically requests otherwise. In the case of electronic responses, general

confidentiality disclaimers that often appear at the bottom of e-mails will be disregarded for the purpose of publishing responses unless an explicit request for confidentiality is made in the body of the response. If you wish part, but not all, of your response to remain confidential please supply two versions - one for publication on the website with the confidential information deleted and another confidential version for the CRD implementation team.

PARTIAL REGULATORY IMPACT ASSESSMENT

1.44 The partial RIA follows this document and should be read in conjunction with it. The partial RIA lays out implementation options for the two areas highlighted above and considers qualitative, and where possible, quantitative costs and benefits for each option.

THE CONSULTATION CRITERIA

1.45 The consultation is being conducted in line with the Code of Practice on Consultation. The criteria are listed below (a full version of the criteria can be found at http://www.cabinet-office.gov.uk/regulation/Consultation/Code.htm).

THE SIX CONSULTATION CRITERIA

1. Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
2. Be clear about who may be affected, what questions are being asked, and the timescale for responses.
3. Ensure that your consultation is clear, concise and widely accessible.
4. Give feedback regarding the responses received and how the consultation process influenced the policy.
5. Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
6. Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

If you feel that this consultation does not fulfil these criteria please contact:

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London
SW1A 2HQ

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2 Partial Regulatory Impact Assessment

Title of the directive

2.1 Recast Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions. When discussed in their recast form, these Directives are commonly referred to as the Capital Requirements Directive (CRD).

Purpose and intended effect

2.2 This section sets out:

- the objectives of the CRD;
- the CRD implementation timetable;
- the background to the CRD; and
- the rationale for intervention.

Objective of the CRD

2.3 The Capital Requirements Directive (CRD) is one of the FSAP legislative measures. These measures aim to fill gaps and remove barriers to provide a legal and regulatory environment that supports the integration of financial markets across the EU, thereby contributing to the development of a Single Market in financial services.

2.4 The main objective of the CRD is to update European legislation in line with international recommendations by implementing in the European Union the new Basel Accord, Basel 2, agreed by the Basel Committee on Banking Supervision in 2004. The CRD, when implemented, will:

- further reduce the probability of consumer loss as a result of prudential failure and thereby enhance consumer protection;
- further reduce the probability of market disruption as a result of prudential failure and thereby enhance financial stability; and
- encourage firms to further improve their risk management techniques.

2.5 By transposing internationally agreed capital standards into a common EU legal framework, CRD ensures that all EU countries will be in line with Basel 2, thereby creating a level playing field for all banks, building societies and affected investment firms across the EU. This in turn will further deepen the Single Market in financial services.

Implementation timetable

2.6 Finance Ministers reached agreement on the European Parliament's legislative resolution on the CRD on 11 October 2005. The Commission's proposal has therefore

been agreed in a single reading under the 'co-decision' procedure.[14] We expect the Directive to be formally adopted by Council in spring 2006, following the translation of the Directive into all EU languages through what is known as the jurists-linguists process.

2.7 Member States must transpose, and firms should apply, the Directive from the start of 2007. During 2007, credit institutions and affected investment firms can choose between the current 'Basel 1 approach' and the simple or medium sophistication approaches of the new framework. The most sophisticated approaches will be available from 2008. From this date, all relevant EU firms must apply Basel 2.

Background to the CRD

2.8 Global financial markets benefit from having commonly agreed standards to operate efficiently and effectively. Consequently, in parallel to the integration of financial services markets and the consequences arising from this process (systemic risk of financial contagion and financial crime), a complex framework of international committees and standard setting bodies has evolved, from the creation of Basel in 1974 through to the formation of the Financial Stability Forum in 1999.[15]

2.9 The international standard setting bodies play an increasingly important role in the global financial system through: 1) the codes and standards agenda; and 2) new financial services legislation – much new legislation at the national level emanates from the international standard setting bodies whose recommendations and guidelines are often subsequently translated into law, including through EU legislation.

2.10 The main objective of the CRD is to update European legislation in line with international recommendations by implementing in the EU Basel 2, agreed by the Basel Committee on Banking Supervision in 2004. The CRD achieves this by technically recasting two existing Directives – the Directive relating to the taking up and pursuit of the business of credit institutions, commonly known as the Banking Consolidation Directive (BCD) and the Directive on the capital adequacy of investment firms and credit institutions, commonly known as the Capital Adequacy Directive (CAD) – and introduces a supervisory framework in the EU which reflects the Basel 2 rules on capital measurement and capital standards agreed by the Basel Committee.

2.11 Basel 2 updates the existing capital adequacy framework, Basel 1. It develops a new regulatory capital framework that recognises new and continuing developments in financial products, incorporates advances in risk measurement and management practices, and more precisely assesses capital charges in relation to risk.

2.12 Basel 2 is therefore intended to further reduce the probability of consumer loss or market disruption as a result of prudential failure. It will do so by 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.

[14] Co-decision is the legislative process whereby the Commission proposes draft legislation and the Council and the European Parliament have equal rights to amend the Commission's proposal.

[15] International standard setting bodies include: Basel Committee on Banking Supervision (BCBS), Committee on the Global Financial System (CGFS), Committee on Payment and Settlement Systems (CPSS), Financial Action Task Force (FATF), International Association of Insurance Supervisors (IAIS), International Accounting Standards Board (IASB), International Auditing and Assurance Standards Board (IAASB), International Monetary Fund (IMF), International Organisation of Securities Commissions(IOSCO), Organisation of Economic Cooperation and Development (OECD), CPSS-IOSCO Task Force on Securities Settlement Systems, BCBS Transparency Group and IOSCO TC Working Party on the Regulation of Financial Intermediaries. Other relevant international financial services committees: G7, Financial Stability Forum (FSF), Bank for International Settlements (BIS).

2.13 As with the implementation of Basel 1, in the interest of maintaining a level playing field the scope of Basel 2 has been extended in the CRD beyond internationally active banks to include all credit institutions and those investment firms defined by Article 4(1), MiFID.[16] As such, the CRD will directly affect banks and building societies and certain types of investment firms.

Rationale for intervention by the Basel Committee on Banking Supervision

2.14 Basel 1 led to substantial increases in capital ratios during the period 1988–92, which has helped to strengthen the soundness and stability of the international banking system. It has also helped enhance competition among internationally active banks in reducing the potential for differences in regulatory treatment through a common capital adequacy framework.[17]

2.15 However, the global financial system has become increasingly complex over the past 15 years. Consequently, the Basel Committee has been working since 1998 to develop a new regulatory capital framework that recognises new and continuing developments in financial products, incorporates advances in risk measurement and management practices, and more precisely assesses charges in relation to risk.

2.16 Basel 2 was agreed in June 2004 by the Basel Committee. The revised capital adequacy framework has been improved on the basis of three interlocking pillars: by substantially increasing the risk sensitivity of the minimum capital requirements (Pillar 1) and by developing capital regulation that encompasses not only minimum capital requirements, but also supervisory review (Pillar 2) and market discipline (Pillar 3).[18]

Rationale for intervention by the EU

2.17 The CRD is one of the remaining FSAP legislative measures. These measures aim to fill gaps and remove barriers to provide a legal and regulatory environment that supports the integration of financial markets across the EU, thereby contributing to the development of a Single Market in financial services.

2.18 The CRD will transpose Basel 2 into EU legislation by revising the existing BCD and CAD. It could be argued that Member States should be left to update their own legislation to comply with the Basel 2 recommendations. However, by transposing internationally agreed capital standards into a common EU legal framework, the Directive ensures that all EU countries will be in line with Basel 2, thereby creating a level playing field for all banks, building societies and affected investment firms across the EU.

Rationale for intervention by the UK Government

2.19 The UK Government believes the revised capital adequacy framework will:

- further reduce the probability of consumer loss as a result of prudential failure and thereby enhance consumer protection;

[16] Directive 2004/39/EC.

[17] A detailed overview of the original Basel 1 accord and the new Basel 2 accord can be found in: Chapter 2 'the new Basel Accord' of the December 2003 consultation document: 'the new Capital Adequacy Directive, CAD 3: the transposition of the new Basel Accord into EU legislation', HM Treasury.

[18] Source: http://www.bis.org/publ/bcbs107.htm

- further reduce the probability of market disruption as a result of prudential failure and thereby enhance financial stability;
- encourage firms to further improve their risk management techniques; and
- deepen the Single Market in financial services further by creating a more level playing field among firms in the EU.

2.20 From a UK perspective, failure to implement Basel 2 via the CRD would mean that affected firms would have to comply with an outdated capital adequacy framework provided for by Basel 1. In doing so, these firms could potentially face a competitive disadvantage vis-à-vis their EU and global counterparts.

2.21 Remaining on the existing Basel 1 capital framework would not allow for:

- the recognition of new and continuing developments in financial products;
- the incorporation of advances in risk measurement and management practices; and
- the more accurate assessment of regulatory capital charges in relation to risk.

2.22 Once a Directive is adopted, each Member State must take such action as is required to: a) give effect in national law to the rights and obligations created by the Directive; and b) ensure that the Directive is implemented in a transparent manner. Failure to implement the Directive properly runs the risk of the UK being infracted and fined by the Commission. This is the 'do nothing' option. The threat of infraction proceedings is not to be dismissed as the Commission has become increasingly active in recent years in its use of infraction powers.[19]

2.23 Intervention is also important in order for the UK Government to fulfil its international obligations. Many of the requirements in the CRD stem from agreed international Basel 2 recommendations. The latter are global financial standards and are used by the IMF and World Bank in their Financial Sector Assessment Programme of countries. Compliance with Basel recommendations is important to reassure other Governments and financial institutions that the UK has a sound, stable and competitive banking system.

CONSULTATION

2.24 This partial RIA concerns the transposition of the Directive into national law, and is specifically concerned with those primary areas of transposition which are the responsibility of HM Treasury. These areas include:

- group model recognition for the advanced approaches to measuring Pillar 1 capital requirements; and
- the recognition of external credit ratings agencies for the purposes of credit institutions measuring their Pillar 1 capital requirements using the standardised approach.

[19] For example, in 2003 the Court fined Spain €624,150 per year per percentage point that they fell below the Directive requirements for compliant bathing waters. At the time of the judgment, they were 20 per cent non - compliant, so the annual fine was £12,483,000. This will decrease as Spain improves its standards.

2.25 This partial RIA lays out the implementation options for the two areas highlighted above and considers qualitative, and where possible, quantitative costs and benefits for each option. Risks, unintended consequences and any compliance and enforcement issues have also been incorporated as costs and benefits. Competition issues and the impact on small firms have also been considered.

2.26 When formally responding to the partial RIA HM Treasury are seeking comments on the analysis of costs and benefits, likely risks and unintended consequences of the proposed options, as well as supporting evidence wherever possible. If you feel there are alternative options, or indeed alternative combinations of existing options, please suggest these. The feedback to this partial RIA will provide valuable information which will feed into the final RIA following this consultation.

2.27 The consultation document and partial RIA should be read together. They are also published in parallel to the FSA's second consultation paper.[20]

IMPLEMENTATION OPTIONS: GROUP MODEL RECOGNITION

2.28 As Article 129(2) imposes obligations on the FSA which must be given effect and because existing provisions of Financial Services and Markets Act are not appropriate for the effective transposition of this Directive provision, HM Treasury needs to consider how best to provide for this.

2.29 More specifically, to enable the FSA to carry out its functions under Article 129(2) HM Treasury needs to make provision to require the FSA to:

- co-operate with the other relevant competent authorities to come to a joint decision;
- make a decision and comply with the relevant obligations if it is the consolidated supervisor; and
- implement the decision, whether that decision was made jointly by the FSA as consolidated supervisor, or by another competent authority as consolidated supervisor.

2.30 However, the Directive does not stipulate how competent authorities should undertake their responsibilities under Article 129(2) in situations where, for example, a new member joins a group or a group makes changes to their risk models. In order to enable variations or revocations to be made to an Article 129(2) decision, HM Treasury will need to provide suitable powers to the FSA in its implementing legislation.

2.31 To this end, four implementation options are being considered.

- Option 1 - do nothing
- Option 2 - copy out of the Directive text
- Option 3 - copy out but with additional provisions for variation and revocation of a group application
- Option 4 - detailed legislative framework

[20] http://www.fsa.gov.uk/Pages/Library/Policy/CP/index.shtml

2.32 Costs, benefits, risks, compliance, enforcement and competition issues need to be considered for all options for decision-making purposes. Results from both initial consultation and HM Treasury's own research is included below.

Option 1: do nothing

2.33 As with all proposals for legislation, HM Treasury has considered the option of making no changes. The implications of this are likely to be the following:

- without this directive, European, and therefore UK legislation would not recognise new and continuing developments in financial products nor incorporate advances in risk measurement and management practices. European and UK legislation would therefore stipulate regulatory capital requirements that do not accurately reflect risk;
- failure to implement the Directive requirements would also forfeit the deregulatory opportunities offered by Directive implementation;
- failure to implement the Directive requirements would put the UK in breach of Community obligations and thereby open the UK to infraction proceedings and claims for damages; and
- failure to implement the Directive would also prevent the UK Government from fulfilling its international obligations and thereby fail to reassure other Governments and financial institutions that the UK has a sound, stable and competitive banking system.

Option 2: copy out

2.34 This option involves copying out the provisions of the Directive directly into UK legislation. This option would imply a light touch, high-level, principles based UK legislative framework, enabling HM Treasury to meet its requirements in EU law, while leaving the FSA to implement and undertake its obligations under Article 129(2) using both its existing powers and its discretion to provide the necessary guidance where appropriate.

2.35 The principal cost involved with this option concerns the administrative costs of applying for group model recognition under Article 129(2). As this is a Directive requirement, the UK cannot implement this article in a way which would avoid this cost. There is also a risk that UK legislation would not provide sufficient legal clarity to enable a variation or revocation of an Article 129(2) decision to take place.

2.36 Clear benefits include the removal of any risk that UK legislation inadequately implements the Directive. This option would implicitly support the work of the Capital Requirements Directive Transposition Group (CRDTG) in encouraging consistent legal transposition into Member State law, as well as the work of the Committee of European Banking Supervisors (CEBS) in encouraging greater harmonisation of supervisory approaches across the EU.[21] This option would also be the most straightforward for EU parent credit institutions domiciled in other Member States with subsidiaries in the UK to understand with respect to UK implementation.

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[21] Please see consultation document, paragraph 1.15.

Option 3: copy out but with additional provisions for variation and revocation of a group application

2.37 This option involves copying out the provisions of the Directive directly into UK legislation but with additional specific provisions for variation and revocation of a group application. These provisions would give the FSA discretion to request an application to vary an Article 129(2) decision where it was deemed necessary, such as following a substantial takeover or the addition of a new member to the group.

2.38 Any variations proposed to or by the FSA as the consolidated supervisor would follow the Article 129(2) procedure. However, it would not make business sense to require that all changes to underlying models go through the Article 129(2) procedure. As a result, this option would not define what constitutes a variation, but would leave this issue to the FSA and the other competent authorities party to an Article 129(2) decision.

2.39 Greater legal clarity would therefore be provided for in situations requiring the variation or revocation of group applications, for example, a situation where the structure of the EU group changes significantly as a result of a merger or acquisition. At the same time, this proposed discretionary approach for the FSA will minimise unnecessary administrative burdens on firms as well as providing for a degree of flexibility which is necessary in rapidly changing financial markets.

2.40 As this option builds on Option 2, the principal cost involved is also the cost of applying for a joint application under Article 129(2). However, there are additional costs associated with this option. Firstly, there is the risk of differences between the UK's and other Member States' implementation of this article. Inconsistent Member State implementation could impact on the attractiveness of the UK as a place to do business as well as having negative implications for the development of a Single Market in financial services. Secondly, a provision to vary or revoke a group application may be costly if, for example, both institutions in a merger or acquisition already have model recognition for the advanced approaches to calculating credit and operational risks, but are required to have models reassessed in the light of the new situation.

Option 4: detailed legislative framework

2.41 This option could compensate for any perceived lack of legal clarity by providing for detailed systems and processes in UK legislation beyond those specified in the Directive text. For example, the legislation could set out detailed systems and processes for the FSA to follow regarding the application procedure for an Article 129(2) decision which explains:

- how the FSA will share information with other relevant authorities;
- how decisions with other relevant authorities are taken;
- how the decision is disseminated; and
- how the decision is implemented in the UK.

2.42 As this option builds on Option 3 the costs discussed for Option 3 also apply for Option 4. There is also the risk that overly prescriptive legislation for dynamic markets will quickly become out-of-date, with potentially unintended and negative consequences for business and the attractiveness and competitive position of the UK as an international financial centre.

Competition assessment

2.43 Implementing Article 129(2) is unlikely to have significant competition impacts for EU financial services. The provision provides EU groups with an option to make a group application for the advanced approaches to measuring Pillar 1 capital requirements, and therefore does not impose any obligations on industry that might have a competitive effect.

2.44 The aim of Article 129(2) is to provide a more streamlined approach to supervision, which in turn should lessen application costs for EU groups whom otherwise would have had to make numerous separate applications for IRB model recognition. Implementation of this provision is therefore unlikely to affect any firms that are not part of an EU group or that do not choose to make use of the IRB approach to calculating credit and operational risk.

2.45 Article 129(2) should lessen costs for EU groups, while having no affect on market structure, cost implications for new or potential firms or restrict the ability of firms to choose the price, quality, range or location of their products.

Small firms impact test

2.46 As Article 129(2) provides a mechanism for EU groups to choose to make one joint application for model recognition for the advanced approaches to the consolidated supervisor and only applies to financial groups with businesses across the EU Member States (as opposed to groups with business operations solely contained within the UK) it does not impact on small firms.

Consultation

Questions

1. Do you agree with the analysis of the costs and benefits for the different implementation options, as well as the impact on competition and small firms?

2. Are there any alternative options, or indeed alternative combinations of the proposed options, that should also be considered?

Initial recommendation

2.47 HM Treasury's initial view is that Option 3 - copy out but with additional provisions for variation and revocation of a group application is the most appropriate implementation option for Article 129(2) based on the costs and benefits outlined above.

Question

Do you agree with HM Treasury's initial view? If not, please specify your reasons.

IMPLEMENTATION OPTIONS: RECOGNITION OF EXTERNAL CREDIT ASSESSMENT INSTITUTIONS (ECAIS)

2.48 It is only following recognition that ratings issued by an ECAI can: 1) be used as external credit assessments by authorised credit institutions and affected investment firms opting to use the standardised approach for measuring credit risk under Pillar 1; and 2) have the potential to be used as external credit assessments by firms for capital adequacy purposes in other Member States without further direct recognition. As the relevant articles impose obligations on the FSA which must be given effect, and because existing provisions of FSMA would not adequately transpose these Directive provisions, HM Treasury needs to consider how best to provide for this.[22]

2.49 To this end, four implementation options are being considered.

- Option 1 – do nothing
- Option 2 - copy out
- Option 3 - copy out but with additional provisions for an appeals process
- Option 4 - detailed legislative framework

2.50 Costs, benefits, risks, compliance, enforcement and competition issues need to be considered for all options for decision-making purposes. Results from both initial consultation and HM Treasury's own research is included below.

Option 1: do nothing

2.51 As with all proposals for legislation, HM Treasury has considered the option of making no changes. The implications of this are likely to be the following;

- without this directive, European, and therefore UK legislation would not recognise new and continuing developments in financial products nor incorporate advances in risk measurement and management practices. European and UK legislation would therefore stipulate regulatory capital requirements that do not accurately reflect risk;
- failure to implement the Directive requirements would also forfeit the deregulatory opportunities offered by Directive implementation;
- failure to implement the Directive requirements would put the UK in breach of our Community obligations and thereby open the UK to infraction proceedings and claims for damages; and
- failure to implement the Directive would also prevent the UK Government from fulfilling its international obligations and thereby fail to reassure other Governments and financial institutions that the UK has a sound, stable and competitive banking system.

Option 2: copy out

2.52 This option involves copying out the provisions of the Directive directly into UK legislation. This option would imply a light touch, high level, principles based UK legislative framework, enabling HM Treasury to meet its requirements in EU law, while

[22] The Directive provisions regarding ECAIs are: Articles 81 (1,2,3,4), 82, 97, 98 and Annex VI part 2 and 3, Annex IX.

giving the FSA flexibility in its approach. This option is in line with UK Government policy which is not to be superequivalent, that is not to impose additional requirements on UK firms above those specified in the CRD, unless these are shown to be rigorously justified by cost-benefit analysis.

2.53 The principal cost involved with this option is that of applying for recognition. Estimates have been received from market participants that range from £50,000–£250,000 for the initial application, hence this would be a one-off cost, and £12,500-£200,000 for ongoing compliance. However, it is likely that the long-term benefits of the CRD would outweigh this cost.

2.54 There is also a risk that UK legislation is not clear enough with respect to how ECAIs are granted recognition and the process for dealing with negative recognition decisions. However, this risk is mitigated by CEBS' proposed guidance regarding the recognition process. CEBS published its guidelines for the recognition of ECAIs in a consultation document on 29 June 2005. The paper set out CEBS' proposed common approach to the recognition of eligible ECAIs and covered: the recognition process; the implementation of the CRD recognition criteria; and the criteria for the 'mapping' of external credit assessments to the CRD risk weights. The consultation period ran until 30 September 2005. Feedback on the responses received, along with amended guidelines, will be published early 2006.[23] All of this work by CEBS will encourage greater harmonisation of supervisory approach across the EU.

2.55 There could be a possible increase in demand for ratings by financial institutions and, to a lesser extent, demand for ratings by issuers. However, it is possible that equivalent growth would occur in the absence of the new ECAI recognition process.

2.56 More concrete benefits include the lack of risk of UK legislation inadequately implementing the Directive. Similarly, there would be no risk of more burdensome UK implementation vis-à-vis other Member States. This in turn facilitates CEBS' role in ensuring consistent implementation of CRD across Member States and therefore the creation of the Single Market in financial services. Consistent implementation is vital to ECAIs and to banks using ECAI ratings; different recognition processes or mapping would be very confusing and costly for all parties concerned and anything which compromises the global comparability of credit ratings would be detrimental to financial markets.

2.57 Lastly, a copy-out approach would mean that it would be straightforward for ECAIs in other Member States to understand the UK legislative position. This is especially important for international ECAIs which may have outstanding ratings in the UK (the largest European market for corporate ratings) without having local representation.

Option 3: copy out, but with the addition of an appeals process

2.58 This option involves copying out the provisions of the Directive directly into UK legislation but with an additional specific provision for an appeals process: the Financial Services and Markets Tribunal. Option 2 does not include an express appeals mechanism, but the option of judicial review would be available. Judicial review involves the High Court considering whether the decision met the standards of

[23] Source: http://www.c-ebs.org/pdfs/CP07.pdf

administrative decision making. If the required standard had not been met, the Court would usually order the decision maker to retake the decision. However, in judicial review, the Court does not usually impose its own decision on the decision maker.

2.59 Unlike the judicial review process, appeals to the Financial Services and Markets Tribunal could be on the merits of the case, rather than the administrative element of the decision. The outcome of an appeal to the tribunal may involve reconsidering the decision taken by the FSA. The tribunal could make its own determination and direct the FSA to follow any such determination. This option would still imply light-touch, high level, principles based UK legislative framework, enabling HM Treasury to meet its requirements while ensuring that ECAIs have the opportunity to challenge negative recognition decisions via the tribunal mechanism.

2.60 There are benefits associated with having a financial services tribunal appeals mechanism. A tribunal appeals mechanism would give an ECAI the right to challenge a negative recognition decision in a specialist court which would examine the merits of the case. This mechanism would afford applicant ECAIs the opportunity to ensure that they receive a fair hearing, thereby generating comfort among market participants that recognition and oversight of that decision is subject to scrutiny that is both impartial and consistent.

2.61 As this option builds on the copy-out approach, the principal cost is again that of applying for recognition. Estimates have been received from market participants that range from £50,000 to £250,000 for the initial application and £12,500 to £200,000 for ongoing compliance.

2.62 However, there are additional costs associated with the inbuilt appeals process. Firstly, there is the actual cost of pursuing the tribunal appeal mechanism to dispute a negative decision. Secondly, the possibility of an ECAI contesting a negative recognition decision in the tribunal could in turn result in the FSA requesting more detailed information from ECAIs and performing more detailed analysis before reaching a recognition decision. This would increase compliance costs for ECAIs as well as costs for the FSA. Thirdly, there is a low risk of quasi-regulation of ECAIs. ECAIs are currently not regulated. However, precedents from tribunal decisions may set 'case regulation' which in turn may result in the FSA taking an increasingly prescriptive approach in their recognition of ECAIs. Therefore, by building on the basis of ECAIs' access to the Tribunal's process, the regulatory grip on ECAIs could be strengthened over time. This could have unintended consequences for their current non-regulated status.

2.63 Finally, there is a risk that there will be differences between the UK's and other Member States' implementation and that this could encourage other Member States to follow unique transposition routes. Inconsistent Member State implementation would undermine the work of the CRDTG in encouraging consistent legal transposition into Member State law as well as CEBS' work in encouraging greater harmonisation of supervisory approach across the EU, which in turn could have unintended and negative consequences for the Single Market in financial services.

2.64 As noted with Option 2, there could be a possible increase in demand for ratings by financial institutions, and to a lesser extent, demand for ratings by issuers. However, it is possible that equivalent growth would occur in the absence of the new ECAI recognition process.

Option 4: detailed legislative framework

2.65 This option could create a detailed legislative framework, for example, by prescribing in UK legislation:

- the recognition process;
- the CRD recognition criteria;
- the criteria for the 'mapping' of external credit assessments to the CRD risk weights; and
- an appeals process.

2.66 This option could therefore provide for greater legal clarity than is provided for by the original Directive text and therefore by Options 2 and 3. Providing detailed provisions within UK legislation could minimise any uncertainties regarding compliance with Directive requirements for both the FSA and credit rating agencies. However, this option would contradict the international consensus that rating agencies' practices and business models are best captured through a high-level, principles-based approach, rather than through prescriptive legislation.

2.67 In addition to the costs discussed for Option 2, there would also be two additional risks with this option. Firstly, there is the risk that overly prescriptive legislation could compromise the independence of rating agencies and stifle innovation – that is, rating agencies' activities may be increasingly determined by legislative requirements rather than market signals, with the possible unintended consequences of uniform, more costly and lower quality ratings. Secondly, there is the risk that overly prescriptive legislation for dynamic markets quickly becomes out of date, with potentially unintended and negative consequences for the attractiveness and competitive position of the UK as an international financial centre.

COMPETITION ASSESSMENT

2.68 The market for credit ratings can be analysed either on geographical basis or on a product basis. A high-level, overview measure involves global industry share. Industry estimates from 2004 show that Standard and Poor's have approximately 40 per cent of global industry share, Moody's 39 per cent and Fitch 14 per cent. A.M Best has 3.5 per cent and 'others' occupy 3 per cent.

2.69 The sector is characterised by human capital in the performance of qualitative and quantitative analysis. Information technology plays an increasingly important role: the agencies are increasingly using quantitative models to refine and increase the transparency of their opinions. However, technical developments are used to support rather than replace analysts' and committees' judgment. The credit ratings sector is innovative, as it continuously needs to adapt to fast evolving markets for credit risk products.

2.70 There is currently little or no regulation of rating agencies within Europe. As such, it is likely that the costs of regulation will come as an additional burden to all market participants in the UK (and across the EU), if Option 2 is pursued. However, if Options 3 or 4 are followed and UK national law ends up differing to that in other Member States, then the costs of firms applying for recognition in the UK could be greater than at a European level.

2.71 However, the information requirements required for the recognition criteria may mean that a start-up agency has to build critical mass, market credibility, and the necessary information requirements before applying for recognition and may have to have a more intense pre-recognition dialogue with the FSA. An existing, established ratings agency would only incur the administrative costs of applying for recognition. Once an ECAI has been recognised, the ongoing costs attributable to the legislation should be the same for new and existing firms alike.

2.72 Feedback from ratings agencies suggests there are no anticipated adverse impacts with respect to ECAIs' ability to choose the price, quality, range or location of their products with Option 2. Adverse impacts may arise with Options 3 and 4. The CRD may over time increase the demand for credit ratings but this business opportunity, along with associated compliance costs arising from the recognition process, is not likely to be enough to result in significant changes to the structure of the market, that is, the number or size of firms in the credit ratings market.

Small firms impact test

2.73 Initial consultation suggests that it is highly unlikely that there will be a disproportionate impact on smaller firms. HM Treasury has consulted the Small Business Service who agree with this view.

Consultation

Questions

1. Do you agree with the analysis of the costs and benefits for the different implementation options, including the impact on competition and small firms?

2. Are there any alternative options, or combinations of the proposed options, that should also be considered?

Initial recommendation

2.74 HM Treasury's initial view is that the copy out approach in Option 2 is the most appropriate implementation option for ECAI recognition based on the costs and benefits outlined above.

Question

Do you agree with HM Treasury's initial view? If not, please specify your reasons.

HOW TO RESPOND

2.75 The consultation period will begin on 28 February 2006 and will run for 12 weeks until 23 May 2006. Please ensure that your response reaches us by that date. Please send responses to this partial RIA to:

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Tel: (+44) (0) 207 270 5219

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Email: Gillian.Hood@hm-treasury.x.gsi.gov.uk

2.76 When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

2.77 A list of those consulted is attached in Annex A. If you have any suggestions of others who may wish to be involved in this process, please contact us.

2.78 All written responses will be made public on HM Treasury's website unless the author specifically requests otherwise. In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of e-mails will be disregarded for the purpose of publishing responses unless an explicit request for confidentiality is made in the body of the response. If you wish part, but not all, of your response to remain confidential please supply two versions - one for publication on the website with the confidential information deleted and another confidential version for the CRD implementation team.

CONSULTATION DOCUMENT

2.79 As highlighted above, the consultation document is published with this document and should be read in conjunction with it. A copy of the consultation document can be found on HM Treasury's website: www.hm-treasury.gov.uk or requested through HM Treasury's correspondence and enquiry unit. Contact details can be found on the inlay of the consultation document.

THE CONSULTATION CRITERIA

2.80 The consultation is being conducted in line with the Code of Practice on Consultation. The criteria are listed below, a full version of the criteria can be found at http://www.cabinet-office.gov.uk/regulation/Consultation/Code.htm.

THE SIX CONSULTATION CRITERIA

1. Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
2. Be clear about who may be affected, what questions are being asked, and the timescale for responses.
3. Ensure that your consultation is clear, concise and widely accessible.
4. Give feedback regarding the responses received and how the consultation process influenced the policy.
5. Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
6. Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

If you feel that this consultation does not fulfil these criteria please contact:

Julie Humphreys
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1 Horse Guards Road
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SW1A 2HQ

Tel: (+44) (0) 207 270 5543

Email: Julie.Humphreys@hm-treasury.x.gsi.gov.uk

Annex VI – Part 2: Recognition of ECAIs and mapping of their credit assessments

1. METHODOLOGY

1.1. Objectivity

1. Competent authorities shall verify that the methodology for assigning credit assessments is rigorous, systematic, continuous and subject to validation based on historical experience.

1.2. Independence

2. Competent authorities shall verify that the methodology is free from external political influences or constraints, and from economic pressures that may influence the credit assessment.

3. Independence of the ECAI's methodology shall be assessed by competent authorities according to factors such as the following:

(a) ownership and organisation structure of the ECAI;

(b) financial resources of the ECAI;

(c) staffing and expertise of the ECAI;

(d) corporate governance of the ECAI.

1.3. Ongoing review

4. Competent authorities shall verify that ECAI's credit assessments are subject to ongoing review and shall be responsive to changes in the financial conditions. Such review shall take place after all significant events and at least annually.

5. Before any recognition, competent authorities shall verify that the assessment methodology for each market segment is established according to standards such as the following:

(a) the backtesting must be established for at least one year;

(b) the regularity of the review process by the ECAI must be monitored by the competent authorities;

(c) the competent authorities must be able to receive from the ECAI the extent of its contacts with the senior management of the entities which it rates.

6. Competent authorities shall take the necessary measures to be promptly informed by ECAIs of any material changes in the methodology they use for assigning credit assessments.

1.4. Transparency and disclosure

7. Competent authorities shall take the necessary measures to assure that the principles of the methodology employed by the ECAI for the formulation of its credit assessments are publicly available as to allow all potential users to decide whether they are derived in a reasonable way.

INDIVIDUAL CREDIT ASSESSMENTS

2.1. Credibility and market acceptance:

8. Competent authorities shall verify that ECAIs' individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments.

9. Credibility shall be assessed by competent authorities according to factors such as the following:

(a) market share of the ECAI;

(b) revenues generated by the ECAI, and more in general financial resources of the ECAI;

(c) whether there is any pricing on the basis of the rating.

(ca) in case at least two banks use the ECAI's individual credit assessment for bond issuing and/or assessing credit risks.

Transparency and Disclosure

10. Competent authorities shall verify that individual credit assessments are accessible at equivalent terms at least to all credit institutions having a legitimate interest in these individual credit assessments.

11. In particular, competent authorities shall verify that individual credit assessments are available to non-domestic parties on equivalent terms as to domestic credit institutions having a legitimate interest in these individual credit assessments.

3. 'MAPPING'

12. In order to differentiate between the relative degrees of risk expressed by each credit assessment, competent authorities shall consider quantitative factors such as the long-term default rate associated with all items assigned the same credit assessment. For recently established ECAIs and for those that have compiled only a short record of default data, competent authorities shall ask the ECAI what it believes to be the long-term default rate associated with all items assigned the same credit assessment.

13. In order to differentiate between the relative degrees of risk expressed by each credit assessment, competent authorities shall consider qualitative factors such as the pool of issuers that the ECAI covers, the range of credit assessments that the ECAI assigns, each credit assessment meaning and the ECAI's definition of default.

14. Competent authorities shall compare default rates experienced for each credit assessment of a particular ECAI and compare them with a benchmark built on the basis of default rates experienced by other ECAIs on a population of issuers that the competent authorities believes to present an equivalent level of credit risk.

15. When competent authorities believe that the default rates experienced for the credit assessment of a particular ECAI are materially and systematically higher then the benchmark, competent authorities shall assign a higher risk step in the credit quality assessment scale to the ECAI credit assessment.

16. When competent authorities have increased the associated risk weight for a specific credit assessment of a particular ECAI, if the ECAI demonstrates that the default rates experienced for its credit assessment are no longer materially and systematically higher than the benchmark, competent authorities may decide to restore the original step in the credit quality assessment scale for the ECAI credit assessment.

Part 3 - Use of ECAIs' credit assessments for the determination of risk weights

1. TREATMENT

1. A credit institution may nominate one or more eligible ECAIs to be used for the determination of risk weights applicable to asset and off-balance sheet items.

2. A credit institution which decides to use the credit assessments produced by an eligible ECAI for a certain class of items must use those credit assessments consistently for all exposures belonging to that class.

3. A credit institution which decides to use the credit assessments produced by an eligible ECAI must use them in a continuous and consistent way over time.

4. A credit institution can only use ECAIs credit assessments that take into account all amounts both in principal and in interest owed to it.

5. If only one credit assessment is available from a nominated ECAI for a rated item, that credit assessment shall be used to determine the risk weight for that item.

6. If two credit assessments are available from nominated ECAIs and the two correspond to different risk weights for a rated item, the higher risk weight shall be applied.

7. If more than two credit assessments are available from nominated ECAIs for a rated item, the two assessments generating the two lowest risk weights shall be referred to. If the two lowest risk weights are different, the higher risk weight shall be applied. If the two lowest risk weights are the same, that risk weight shall be applied.

2. Issuer and issue credit assessment

9. Where a credit assessment exists for a specific issuing program or facility to which the item constituting the exposure belongs, this credit assessment shall be used to determine the risk weight applicable to that item.

10. Where no directly applicable credit assessment exists for a certain item, but a credit assessment exists for a specific issuing program or facility to which the item constituting the exposure does not belong or a general credit assessment exists for the issuer, then that credit assessment shall be used if it produces a higher risk weight than would other wise be the case or if it produces a lower risk weight and the exposure in question ranks pari passu or senior in all respects to the specific issuing program or facility or to senior unsecured exposures of that issuer as relevant.

11. Paragraphs 9 and 10 are not to prevent the application of paragraphs 65 to 68 of Part 1 of this Annex.

12. Credit assessments for issuers within a corporate group cannot be used as credit assessment of another issuer within the same corporate group.

3. Long-term and short-term credit assessments

13. Short-term credit assessments may only be used for short-term asset and off-balance sheet items constituting exposures to institutions and corporates.

14. Any short-term credit assessment shall only apply to the item the short-term credit assessment refers to, and it shall not be used to derive risk weights for any other item.

15. Notwithstanding paragraph 14, if a short-term rated facility receives a 150% risk weight, then all unrated unsecured exposures on that obligor whether short-term or long-term shall also receive a 150% risk weight.

16. Notwithstanding paragraph 14, if a short-term rated facility attracts a 50% risk-weight, no unrated short-term exposure shall attract a risk weight lower than 100%.

4. Domestic and foreign currency items

17. A credit assessment that refers to an item denominated in the obligor's domestic currency cannot be used to derive a risk weight for another exposure on that same obligor that is denominated in a foreign currency.

18. Notwithstanding paragraph 17, when an exposure arises through a credit institution's participation in a loan that has been extended by a Multilateral Development Bank whose preferred creditor status is recognised in the market, competent authorities may allow the credit assessment on the obligor's domestic currency item to be used for risk weighting purposes.

Annex IX - Part 3: External credit assessments

1. Requirements to be met by the credit assessments of ECAIS

1. To be used for the purposes of calculating risk-weighted exposure amounts under Part 4 of this Annex, a credit assessment of an eligible ECAI shall comply with the following conditions.

(a) There shall be no mismatch between the types of payments reflected in the credit assessment and the types of payment to which the credit institution is entitled under the contract giving rise to the securitisation position in question.

(b) It shall be available publicly to the market. Credit assessments are considered to be publicly available only if they have been published in a publicly accessible forum and they are included in the ECAI's transition matrix. Credit assessments that are made available only to a limited number of entities shall not be considered to be publicly available.

2. Use of credit assessments

2. A credit institution may nominate one or more eligible ECAIs the credit assessments of which shall be used in the calculation of its risk-weighted exposure amounts under Articles 94 to 101 (a 'nominated ECAI').

3. Subject to paragraphs 5 to 7 below, a credit institution must use credit assessments from nominated ECAIs consistently in respect of its securitisation positions.

4. Subject to paragraphs 5 and 6, a credit institution may not use an ECAI's credit assessments for its positions in some tranches and another ECAI's credit assessments for its positions in other tranches within the same structure that may or may not be rated by the first ECAI.

5. In cases where a position has two credit assessments by nominated ECAIs, the credit institution shall use the less favourable credit assessment.

6. In cases where a position has more than two credit assessments by nominated ECAIs, the two most favourable credit assessments shall be used. If the two most favourable assessments are different, the least favourable of the two shall be used.

7. Where credit protection eligible under Articles 90 to 93 is provided directly to the SSPE, and that protection is reflected in the credit assessment of a position by a nominated ECAI, the risk weight associated with that credit assessment may be used. If the protection is not eligible under Articles 90 to 93, the credit assessment shall not be recognised. In the situation where the credit protection is not provided to the SSPE but rather directly to a securitisation position, the credit assessment shall not be recognised.

3. Mapping

8. The competent authorities shall determine with which credit quality step in the tables set out in Part 4 each credit assessment of an eligible ECAI shall be associated. In doing so the competent authorities shall differentiate between the relative degrees of risk expressed by each assessment. They shall consider quantitative factors, such as default and/or loss rates, and qualitative factors such as the range of transactions assessed by the ECAI and the meaning of the credit assessment.

9. The competent authorities shall seek to ensure that securitisation positions to which the same risk weight is applied on the basis of the credit assessments of eligible ECAIs are subject to equivalent degrees of credit risk. This shall include modifying their determination as to the credit quality step with which a particular credit assessment shall be associated as appropriate.

Annex IX – Part 4: Calculations

1. Calculation of risk-weighted exposure amounts

1. For the purposes of Article 96, the risk-weighted exposure amount of a securitisation position shall be calculated by applying to the exposure value of the position the relevant risk weight as set out in this Part.

2. Subject to paragraph 3,

(a) Where a credit institution calculates risk-weighted exposure amounts under paragraphs 6 to 35, the exposure value of an on-balance sheet securitisation position shall be its balance sheet value;

(b) Where a credit institution calculates risk-weighted exposure amounts under paragraphs 36 to 74, the exposure value of an on-balance sheet securitisation position shall be measured gross of value adjustments; and

(c) The exposure value of an off-balance sheet securitisation position shall be its nominal value multiplied by a conversion figure as prescribed in this Annex. This conversion figure shall be 100% unless otherwise specified.

3. The exposure value of a securitisation position arising from a derivative instrument listed in Annex IV, shall be determined in accordance with Annex III.

4. Where a securitisation position is subject to funded credit protection, the exposure value of that position may be modified in accordance with and subject to the requirements in Annex VIII as further specified in this Annex.

5. Where a credit institution has two or more overlapping positions in a securitisation, it will be required to the extent that they overlap to include in its calculation of risk-weighted exposure amounts only the position or portion of a position producing the higher risk-weighted exposure amounts. For these purposes 'overlapping' means that the positions, wholly or partially, represent an exposure to the same risk such that to the extent of the overlap there is a single exposure.

2. Calculation of risk-weighted exposure amounts under the Standardised Approach

6. Subject to paragraph 9 the risk-weighted exposure amount of a rated securitisation position shall be calculated by applying to the exposure value the risk weight associated with the credit quality step with which the credit assessment has been determined to be associated by the competent authorities in accordance with Article 98 as laid down in the following tables 1 and 2.

Table 1

Positions other than ones with short-term credit assessments

Credit quality step	1	2	3	4	5 and below
Risk weight	20%	50%	100%	350%	1250%

Table 2

Positions with short-term credit assessments

Credit quality step	1	2	3	All other credit assessments
Risk weight	20%	50%	100%	1250%

7. Subject to paragraphs 10 to 16, the risk-weighted exposure amount of an unrated securitisation position shall be calculated by applying a risk weight of 1250%.

B CONSULTATION LIST

Industry

3i
ABN AMRO Bank N.V.
Aberdeen Asset Management
Abbey National plc
American International Group Inc
AMC Group plc
Alliance and Leicester plc
Alliance Capital Management L.P.
Allianz Cornhill Insurance plc
Amedeus Capital Partners Ltd
Amalgamated Metal Corporation plc
AMVESCAP plc
A.M. Best Company Inc
Aon Ltd
Apax Partners
Barclays Bank plc
Baseline Capital Ltd
BP plc
Brit Insurance Ltd
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Royal Dutch Shell plc
Sempra Metals Ltd

Singer and Friedlander Ltd
S.J. Metrics Ltd
Skandia Group
Standard Chartered Bank Ltd
Standard Life Bank Ltd
Standard and Poor's
Stroud and Swindon Building Society
Threadneedle Asset Management
Travers Smith Braithwaite
Triland Metals Ltd
UBS
United Guaranty Corporation

Trade Associations

Association of Private Clients Investment Managers and Stockbrokers
British Bankers Association
Building Societies Association
British Venture Capital Association
Chartered Institute of Public Finance and Accounting
Confederation of British Industry
Council of Mortgage Lenders
Consumers Association
Factors and Discounters Association
Federation of Small Businesses
Finance and Leasing Association
Financial Services Consumer Panel
Futures and Options Association
Institute of Chartered Accountants in England and Wales
International Petroleum Exchange
International Swaps and Derivatives Association
Investment Management Association
London Investment Banking Association
London International Financial Futures Exchange
London Metal Exchange
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National Housing Federation
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