

A decorative graphic on the left side of the slide, consisting of four overlapping, light green, stylized loops or ribbons that curve upwards and to the right, resembling a vertical stack of stylized 'S' or 'B' shapes.

Implementation of Basel 2 A Regulator's Perspective

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Outline

- ✓ **FSA's approach to Basel 2 implementation**
- ✓ **Special topics**
 - Senior Management understanding
 - The use test
 - Data quality
 - Validation
 - Documentation
- ✓ **Technical issues in PD, LGD and EAD estimation**
- ✓ **Approval process**

FSA's approach to regulation

The Financial Services and Markets Act requires us to do four things:

- ✓ **maintain confidence in the UK financial system;**
- ✓ **promote public understanding of the financial system;**
- ✓ **secure the appropriate degree of protection for consumers; and**
- ✓ **help to reduce financial crime.**

To achieve these four objectives we aim to:

- ✓ **promote efficient, orderly and fair markets;**
- ✓ **help retail consumers achieve a fair deal; and**
- ✓ **improve our own business capability and effectiveness.**

Basel 2 Proposals for IRB

✓ Pillar 1 – Minimum capital requirements

IRB

- Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD)
- Risk-based
- Makes use of firms' own internal risk estimates
- Qualitative requirements

✓ Pillar 2 – Supervisory Review

✓ Pillar 3 – Market Discipline

FSA's approach to Basel 2 implementation

- ✓ **Implementing the Capital Requirements Directive**
- ✓ **No compulsion, no prohibition for IRB**
- ✓ **Reliance on senior management and firms' own processes where we can**
- ✓ **Economic use of our resources**
- ✓ **Fees**
- ✓ **International aspects**
- ✓ **Thematic reviews**

FSA staff involved in Basel 2 / CRD implementation

- ✓ **Relationship management teams for each firm**
- ✓ **Basel project management teams in each line Division**
- ✓ **Specialist Risk Review teams**
- ✓ **Policy**
- ✓ **Senior management**
- ✓ **Others**

International regulatory coordination

✓ **Basel**

- Negotiation of Basel text
- Accord Implementation Group

✓ **Europe**

- Negotiation of CRD text
- Committee of European Banking Supervisors

✓ **Firm-specific**

- Coordination and consultation with other supervisors of a particular firm

Thematic visits

- ✓ **Cross-firm reviews based on asset classes**
 - Large Corporate
 - Mortgages
 - Credit cards
 - Unsecured Personal Lending
 - SMEs
 - Banks and Sovereigns
 - Others ...

Thematic Visit Feedback

See http://www.fsa.gov.uk/pubs/international/feedback_mar05.pdf
for full text of industry feedback on Mortgages, Credit Cards and
Unsecured Personal Loans.

Positive:

- ✓ Credit Decision Processes
- ✓ Quality of Model Development

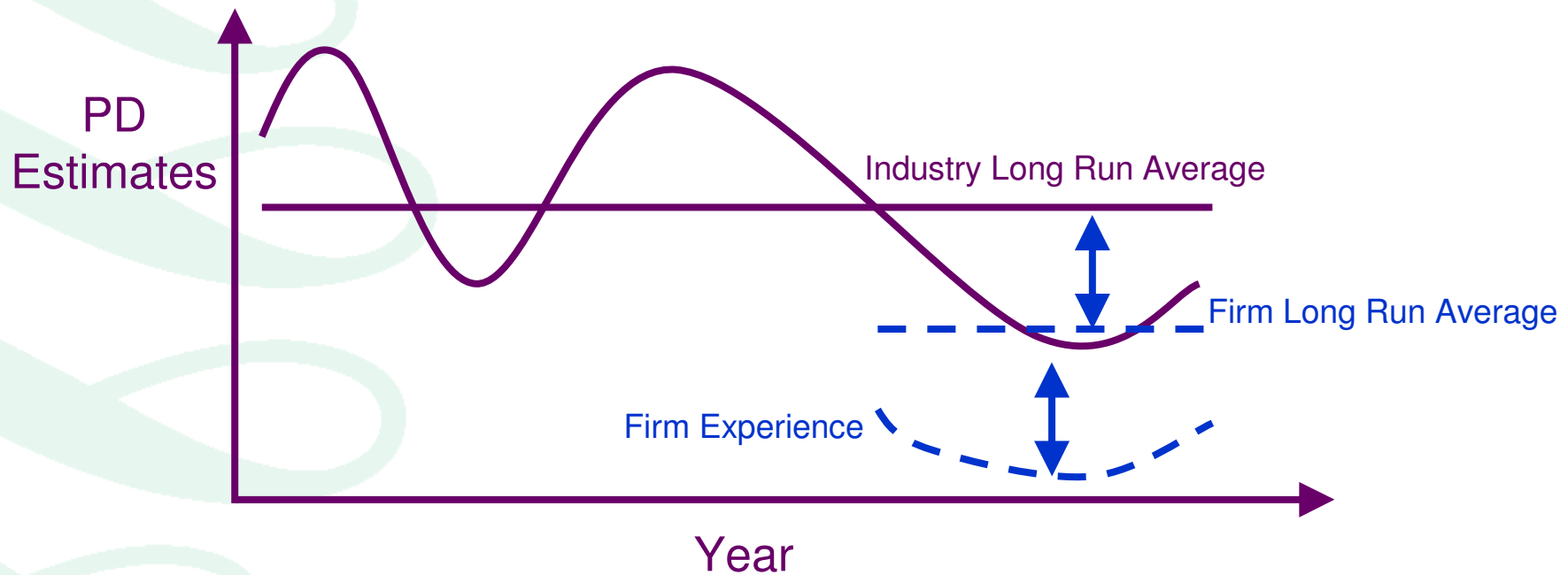
Needs Attention:

- × Senior Management understanding
- × Use Test
- × Data quality
- × Validation
- × Documentation

PD Estimation

- ✓ **Broadly Two Approaches Within Retail Market**
 - Stand Alone
 - Mapping from Existing Score
- ✓ **Both Approaches Have Advantage and Disadvantage**
 - Stand Alone...Use Test
 - Mapping...5 Years Data
- ✓ **Lack of Data Is Common Issue**
 - CRD is Quantitative Process...Lack of Data Can Not Be Used as Reason for Non-Compliance
 - Make Full Use of Benchmarking or External Data
 - Make Use of Confidence Intervals to Add Conservatism
- ✓ **‘Long Run Average’ PD is Essential Requirement**
 - Helps to smooth out capital fluctuations
 - Different Role to Conservatism

PD Estimates – Long Run Average



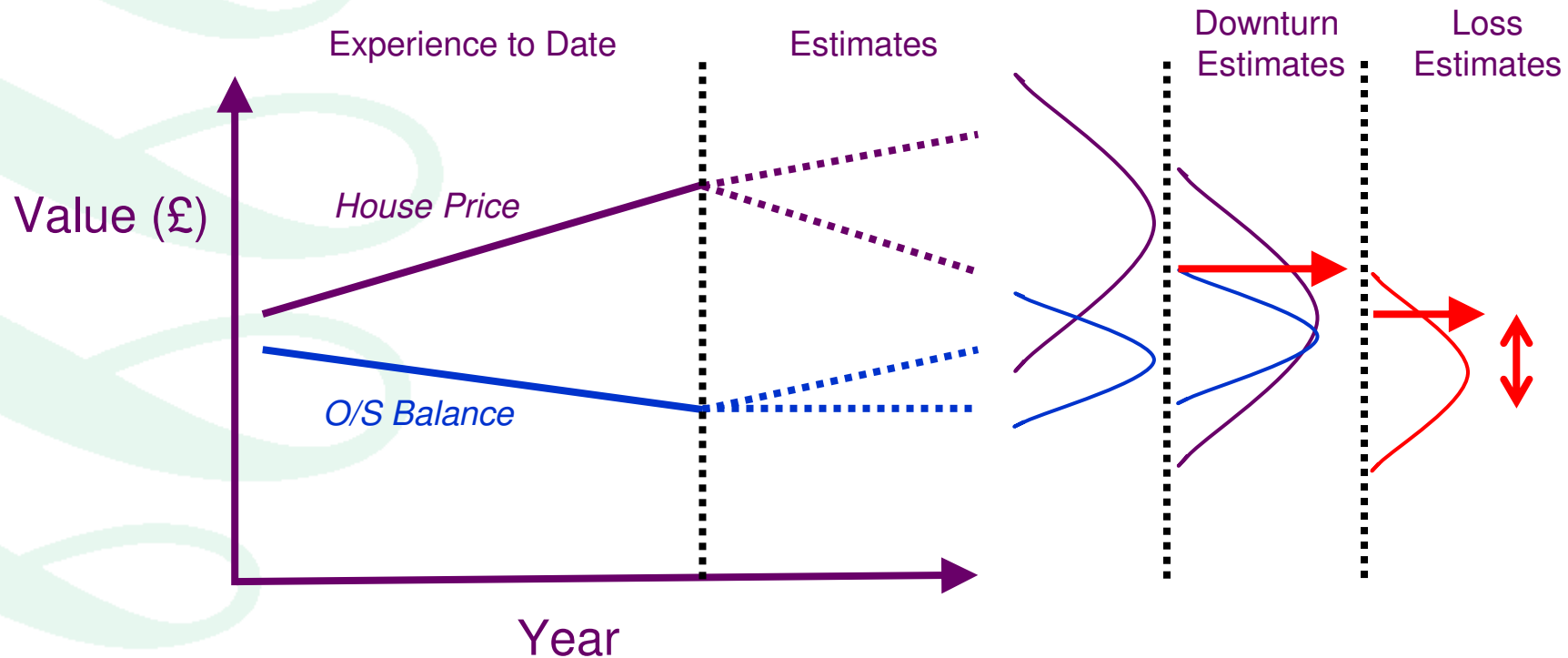
- ✓ Consider Confidence Intervals Around Estimates
- ✓ Estimate Accuracy Should Increase Over Time

Downturn LGD

“A bank must estimate an LGD for each facility that aims to reflect economic downturn conditions where necessary to capture the relevant risks. This LGD cannot be less than the long-run default weighted average loss rate. In addition, a bank must take into account the potential for the LGD of the facility to be higher than the default-weighted average during a period when credit losses are substantially higher.” (Basel Framework Document, June 2004, para 468)

“A bank must have a rigorous and well documented process for assessing the effects if any of economic downturn conditions on recovery rates and for producing LGD estimates consistent with downturn conditions.” (Guidance on Paragraph 468 of the Framework Document (July 2005) See <http://www.bis.org/publ/bcbs115.htm>)

LGD Estimates – Mortgages



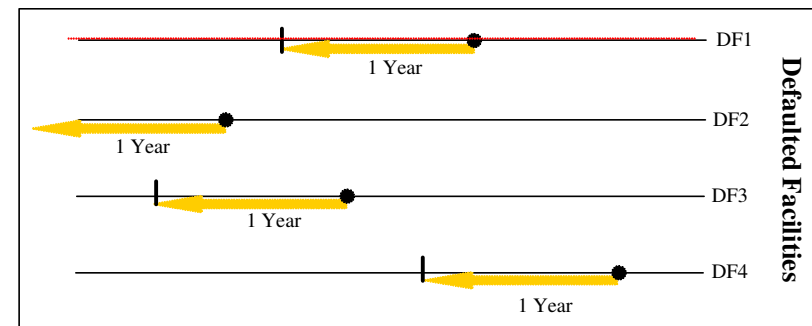
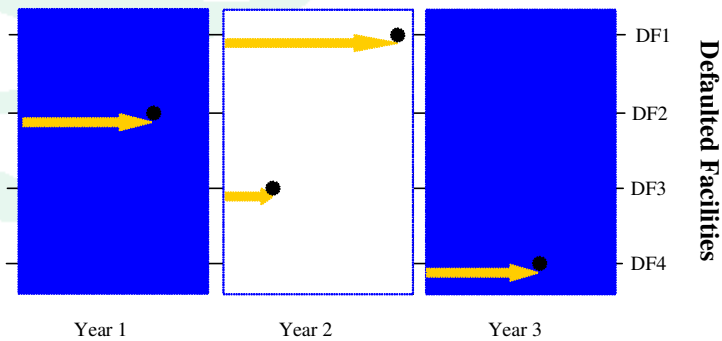
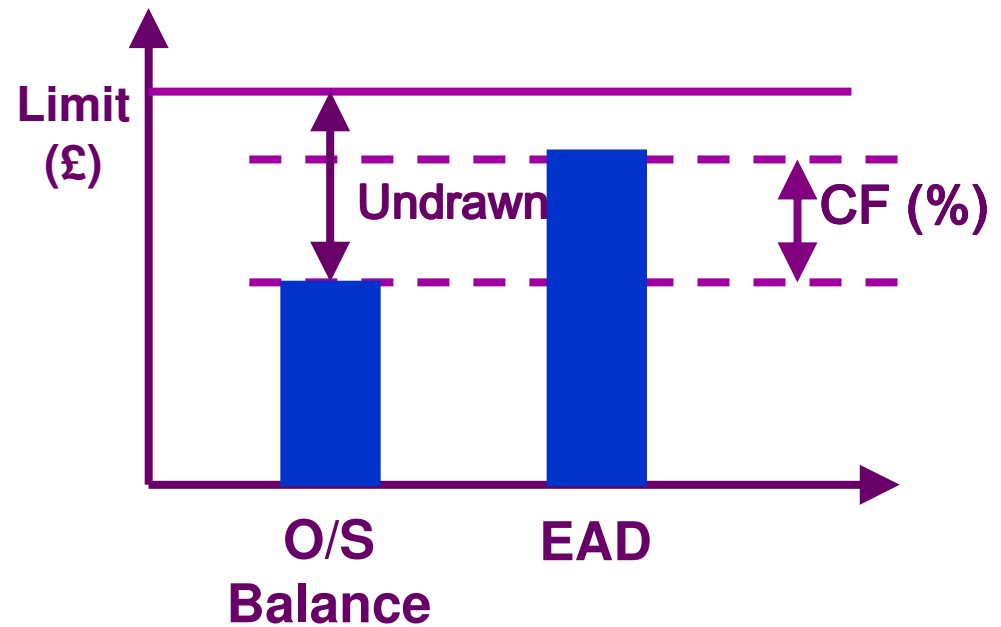
- ✓ Consider Confidence Intervals Around Estimates
- ✓ Estimate Accuracy Should Increase Overtime

LGD Estimation

- ✓ **Economic Downturn Estimates**
 - Use Benchmarking/Pooling where Appropriate
 - Conservatism and Downturn are Separate Elements of LGD Estimate
- ✓ **Economic Loss**
 - All Elements Associated with Loss Must be Documented
 - Effect of Discount Should be Included
 - Cost of Funds Should be Included
- ✓ **Material Drivers**
 - Document Analysis to Identify Drivers
- ✓ **LGD Floors**
 - Does Not Remove Need for Appropriate LGD Model

EAD Estimation

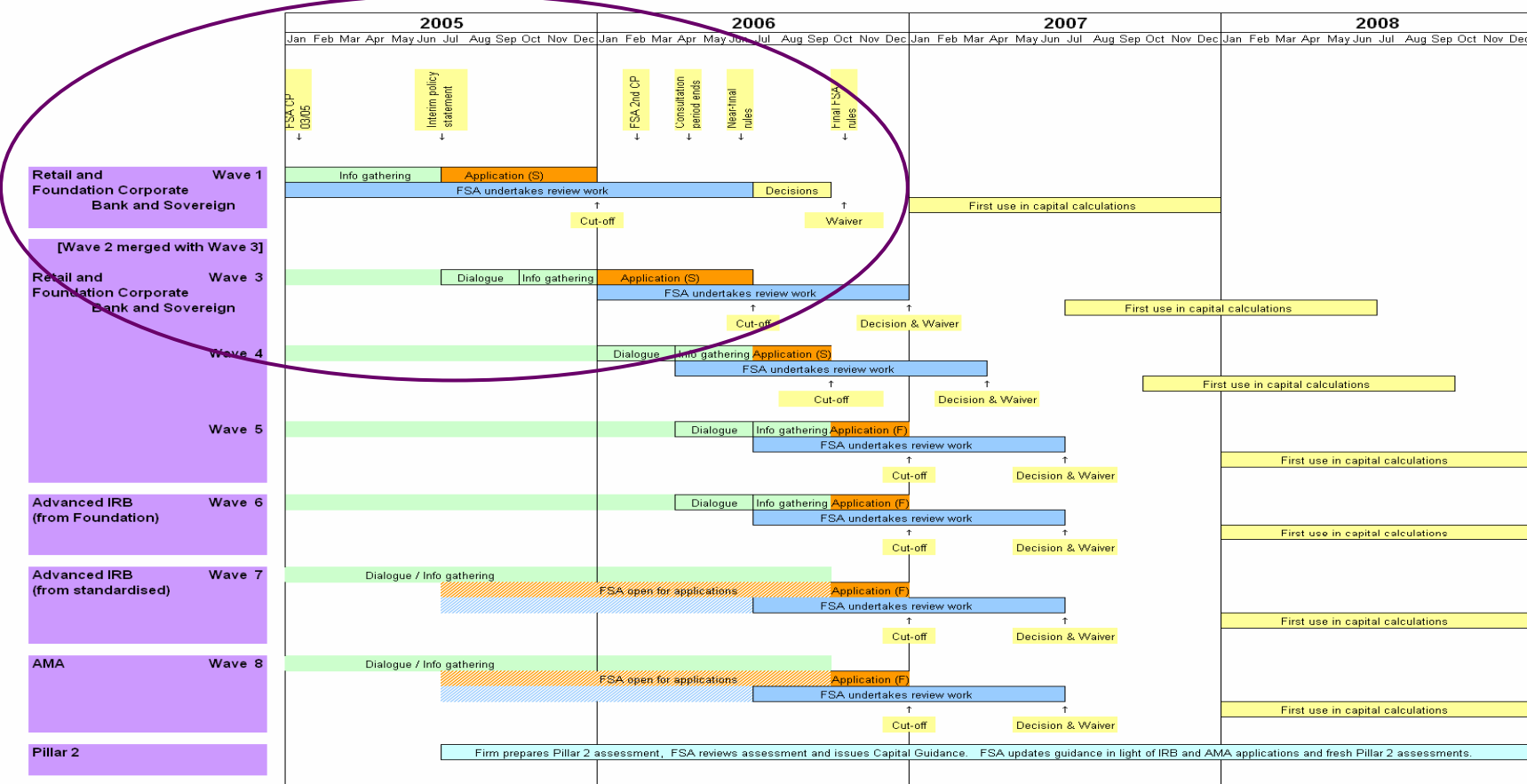
- ✓ Material Drivers
- ✓ Downturn EAD
- ✓ EAD Floors
- ✓ Conversion Factor



Applications

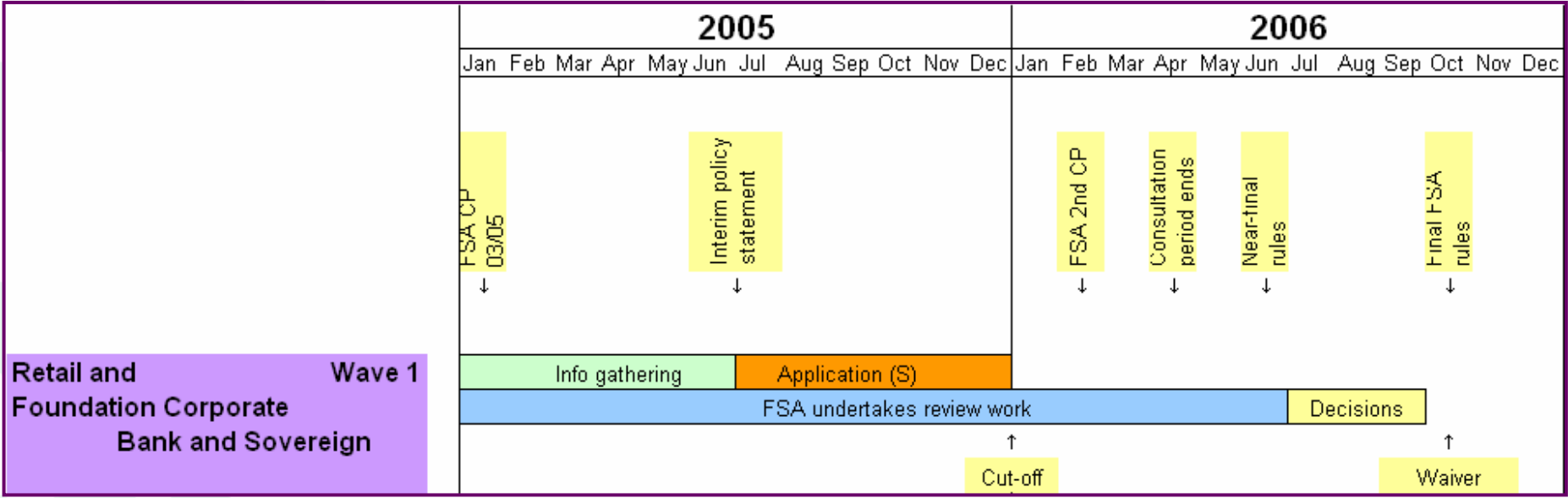


DIAGRAM 1: BASEL 2 / CRD APPROVALS PROCESS - IMPLEMENTATION TIMELINES FOR PILLAR 1 AND 2
(Based on planning assumption of 2nd CP in February 2006 & unchanged implementation dates)



Application (S) = Shadow Application, i.e. application made prior to making of final FSA rules. An application fee will be payable at this point.
 Application (F) = Formal Application, i.e. application made after making of FSA rules. An application fee will be payable at this point.

Applications



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