Policy Statement

PS11/11

Financial Services Authority

Use of non-EEA rules in calculating group capital requirements

Feedback on CP11/6 and final rules

Financial Services Authority

September 2011

Contents

This Policy Statement reports on the main issues arising from Consultation Paper 11/6 (*Use of non-EEA rules in calculating group capital requirements)* and publishes final rules.

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Copies of this Policy Statement are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

BIPRU	Prudential sourcebook for Banks, Building societies and Investment firms
COREP	Guidelines on Common Reporting
CP	Consultation Paper
CRD	Capital Requirements Directive
EEA	European Economic Area
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000

1 Overview

1.1 In Consultation Paper 11/6 (*Use of non-EEA rules in calculating group capital requirements*), we set out our proposals for removing the rules permitting the use of non-European Economic Area (non-EEA) regulators' rules in calculating the group capital requirements of a UK banking/investment firm group on a standardised approach.

1.2 This will remove the risk of information asymmetry between the Financial Services Authority (FSA) and firms, as non-EEA regulators would no longer be relied upon to verify capital levels used to determine consolidated capital requirements for UK consolidation groups. It will also have the added advantage of bringing the UK in line with other EU Member States.

Background

Use of non-EEA equivalence

1.3 At present (and as set out in BIPRU[1] 8.7.35R), a UK consolidation group may use certain non-EEA regulators' rules for calculating the standardised requirements of a non-EEA subsidiary, which are then aggregated into the group's consolidated capital requirements. This allows firms operating in foreign jurisdictions to use non-EEA rules, so they do not need to maintain two sets of capital calculations for the same business.

1.4 A firm may make use of this rule where we have determined that the non-EEA regulators' standardised rules are 'equivalent' to the FSA's rules (a list of such non-EEA regulators is set out in BIPRU 8 Annex 6R by reference to the individual risk components); and either:

- the firm has no reason to believe that applying those rules to the relevant group member would produce a capital requirement figure that is lower than would be produced under FSA rules; or

1 Prudential sourcebook for Banks, Building Societies and Investment Firms.

- the firm increases the capital requirement produced under those rules, and the firm has no reason to believe that the use of this amount would produce a lower figure than would be produced under FSA rules.

1.5 However, where a firm wishes to include in its group calculation local capital requirements calculated under the rules of a non-EEA regulator that we have not assessed as being equivalent to the FSA's rules, it would need to apply for a waiver. In addition to demonstrating that it meets the conditions for a waiver (under s148 of the Financial Services and Markets Act – FSMA), the firm will need to demonstrate that the local capital requirements will result in a capital charge that is at least as much as is required under the FSA rules that implement the Capital Requirements Directive (CRD).

Proposal to revoke the equivalence provisions

1.6 In 2010, we carried out an internal review of the equivalence rules. This review was not a reassessment of the local requirements in the jurisdictions and regulators that we have previously deemed to be equivalent. We have simply considered the continuing validity of the equivalence approach as a whole in the context of group capital requirements.

1.7 As a result of the review, we proposed, in CP11/6, to revoke the equivalence rules by deleting BIPRU 8.7.35R, 8.7.36G and 8.7.38R from the FSA Handbook. This will mean that, for the purpose of calculating the consolidated capital requirements of a UK consolidation group, firms will use the FSA rules rather than local (i.e. non-EEA) rules in calculating the capital requirements of the non-EEA subsidiary.

Who should read this paper?

1.8 This Policy Statement (PS) will be of interest to banks, building societies and BIPRU investment firms that are part of UK consolidation groups which have subsidiaries in jurisdictions outside the EEA.

Responses

1.9 The consultation period closed on 30 June 2011 and we received three responses (from two authorised firms and one industry association).

1.10 This PS summarises the comments we received from the consultation to our proposals and sets out our responses to them. We include the final amended Handbook text in the Appendix to this PS.

CONSUMERS

Our prudential requirements for BIPRU firms are a means of achieving our consumer protection and market confidence objectives. Removing these equivalence provisions will provide greater market transparency and ensure adequately capitalised groups, thereby meeting our objectives.

2

Summary of responses to CP11/6

2.1 In this chapter, we report on the responses that we received to the questions posed in CP11/6, our views on those responses and our policy decisions on how to proceed.

2.2 Only one respondent expressly objected to the proposal to revoke the equivalence rules. However, all respondents objected to the timeframe for implementation, mainly citing that it was too short and that there were other regulatory developments to be implemented in the near future.

Summary of responses

Q1: Do you agree with our proposal to revoke the equivalence provisions and require the consolidated capital requirements of a UK consolidation group to be calculated under FSA rules (for standardised approaches)?

2.3 One respondent disagreed with the proposal, arguing that the rationale for the existing policy remained (i.e. to ensure that a firm does not have to maintain two sets of calculations for the same business) and that information asymmetry could be addressed using alternative approaches. This respondent stated that it could support the proposed change for non-banks (e.g. broker-dealers) for which it felt that there were considerable divergences in regulatory standards, unlike banks which, the respondent argued, largely complied with Basel II.

2.4 Another respondent, whilst stating that it had no objection to the proposal in principle, noted that it had an issue with the timeframe for firm-specific reasons.

2.5 One respondent, whilst not directly objecting to the proposal, noted that the proposal was in its view another example of London's status as a financial centre being slowly eroded by

reducing its flexibility and attractiveness. It added that the industry did not understand the FSA's reasoning for proposing to revoke the equivalence rules.

Our response

The equivalence provisions were included in the Handbook partly to assist UK firms (with non-EEA subsidiaries) to deal with the differing (sometimes delayed) timelines for Basel II implementation by different non-EEA regulators. Since enough time had passed, it was appropriate for us to review them and consider whether to revoke them. We have decided that the most appropriate way to ensure that we can be confident about the capital adequacy of UK consolidation groups is by applying UK rules to such groups. That is, we will no longer rely upon non-EEA regulators' rules to verify capital levels used to determine consolidated capital requirements for UK consolidation groups.

Q2: Do you have any reason for believing that this is not a suitable transitional timeframe?

2.6 The respondents all felt that the proposed timeframe for implementation (by 30 December 2011) was too short, for varying reasons. A respondent opined that the timeframe was unrealistic in view of other ongoing work (such as CRD 3 and the Guidelines on Common Reporting (COREP)) while other respondents had firm-specific concerns which meant that they would prefer to have more time.

2.7 A respondent suggested aligning implementation of the changes with the implementation of COREP, and that firms should be given 12 to 18 months to implement. One respondent suggested a delay in implementation to mid-2012 while another respondent suggested that the implementation date should be later in 2012.

2.8 One respondent also questioned why the proposed implementation timeframe (by 30 December 2011) was not aligned with the CRD 3 implementation date (of 31 December 2011).

Our response

Under the current equivalence rules, a firm may use certain non-EEA regulators' rules only if the firm had no reason to believe that applying them would produce a capital requirement figure that was lower than would be produced under FSA rules or it must increase the figure appropriately. As such, it was always inherent in this approach that a firm had to have the appropriate systems in place to ensure

compliance. Therefore, we do not believe that the systems changes required to comply with our rules following the revocation of the equivalence provisions should require a disproportionate or unreasonable amount of time to upgrade or develop.

Further, firms have had since March 2011 (the date of the consultation) to prepare for the change and in some cases were made aware of the proposals, during a pre-consultation survey, well ahead of the CP.

Also, the fact of there being other implementation priorities does not lead us to conclude that the implementation timeframe for this change should be unnecessarily extended. However, we have concluded that it would be appropriate to align it with CRD3 implementation date. Therefore, the changes set out in this PS will come into force on 31 December 2011.

Q3: Do you think that the CBA has identified the relevant costs and benefits?

2.9 Respondents were of the view that the CP underestimated the likely costs to firms of implementing the changes. They argued that the proposal would likely result in additional operational risks as a result of firms:

- deciding to divert resources and attention away from other work; and
- having dual reporting systems and controls.

2.10 The respondents contended that these 'operational risks' had not been factored into the estimates contained in the CP.

2.11 One respondent raised doubts over whether there were any benefits from the proposed change since implementing the standardised approach would be time-consuming.

2.12 Another respondent noted that new entrants to third countries would also incur costs as a result of having to build two sets of systems to comply with FSA requirements and local requirements.

Our response

The fact that a firm may have dual reporting systems is a natural consequence of expansion into other jurisdictions and, so regulatory capital requirement calculations is not the only area in which some duality of systems would be required. Similarly, we do not accept the argument that additional operational risks would be created as a result of firms having to divert resources and attention away from other work in order to comply with the changes. We expect firms to devote adequate resources and attention (including senior management time) to the implementation of all our rules, in order to remain compliant with their regulatory obligations.

Other

2.13 Further to the expressed timeframe concerns, two respondents put forward alternative options for the FSA to consider before finalising its policy in this area. They were:

i) Use of equivalence assessments undertaken by firms themselves (subject to external legal or audit opinion).

ii) Use of industry guidance to demonstrate the equivalence of non-EEA regimes.

iii) Requiring firms to provide supplementary information to address information asymmetries.

iv) Enhanced supervisory cooperation, through supervisory colleges, to alleviate the FSA's concerns on the equivalence of the requirements of non-EEA requirements and the appropriateness of capital held in non-EEA subsidiaries

The FSA policy

2.14 Having given due consideration to the suggestions put forward by industry, we do not believe that any, or a combination, of the four options above would achieve the aims of revoking the equivalence provisions.

2.15 The changes align our approach to consolidated capital resources and consolidated capital resources requirements. That is, since the FSA's rules are required to be used for calculating the consolidated capital resources of a UK consolidation group, it follows that the FSA's rules should also be used to calculate the consolidated capital resources requirements of that group.

2.16 One respondent asked for clarification that the FSA does not intend to set the capital requirement that must be held in a non-EEA subsidiary going forward. We can confirm that this is not the intention of this Handbook change. Therefore, in the event that the FSA consolidated capital requirement for a non-EEA subsidiary is higher than the local requirement, the FSA's rules do not require the FSA amount to be held in the non-EEA subsidiary.

2.17 We have made minor changes to the new BIPRU 8.7.38A R to reflect the fact the Glossary definition of "sectoral rules" refers to FSA rules in a group context, whereas this rule is concerned with corresponding rules maintained or administered by a non-EEA regulator. These technical changes are not intended to change the policy outcome and should not result in any difference to the costs for firms. Therefore, as permitted by section 155(8) of FSMA, we have not prepared a revised cost benefit analysis.

2.18 The changes set out in this PS will come into force on 31 December 2011.

Annex 1

List of respondents

Barclays

Royal Bank of Scotland

British Bankers' Association

Appendix 1:

Made rules (legal instrument)

PRUDENTIAL SOURCEBOOK FOR BANKS, BUILDING SOCIETIES AND INVESTMENT FIRMS (GROUP RISK CONSOLIDATION) INSTRUMENT 2011

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 150(2) (Actions for damages);
(3) section 156 (General supplementary powers); and
(4) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on 31 December 2011.

Amendments to the Handbook

D. The Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) is amended in accordance with Annex A to this instrument.

E. The Supervision manual (SUP) is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Prudential Sourcebook for Banks, Building Societies and Investment Firms (Group Risk Consolidation) Instrument 2011.

By order of the Board
22 September 2011

Annex A

Amendments to the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

8 Group risk consolidation

…

8.7 Consolidated capital resources requirements

…

~~Use of the solo requirements of a regulator outside the EEA~~

8.7.35 R (1) ~~This *rule* applies where:~~

~~(a) an *institution* in a *firm's UK consolidation group* or *non-EEA sub-group* is subject to any of the *sectoral rules* applicable to its *financial sector* for a state or territory outside the *EEA* that correspond to the *FSA's rules* that would otherwise apply under this section;~~

~~(b) those *sectoral rules* are shown in *BIPRU* 8 Annex 6R (Non-EEA regulators' requirements deemed CRD-equivalent for individual risks) as having been assessed as being equivalent to the *FSA rules* in relation to the *consolidated requirement component* in question; and~~

~~(c) that *institution* is incorporated in and has its head office in that state or territory.~~ [deleted]

(2) ~~If the conditions in this *rule* are satisfied, a *firm* may apply the *sectoral rules* referred to in (1) in order to calculate the *risk capital requirement* for the *institution* referred to in (1) provided that:~~

~~(a) the *firm* has no reason to believe that the use of the *sectoral rules* referred to in (1) would produce a lower figure for the *consolidated requirement component* than would be produced by calculating the *risk capital requirement* under the *FSA's rules* in accordance with this section; or~~

~~(b) the *firm* increases the amount produced under the *sectoral rules* referred to in (1) and the *firm* has no reason to believe that the use of such figures would produce a lower figure for the *consolidated requirement component* than would be produced by calculating the *risk capital requirement* under the *FSA's rules* in accordance with this section.~~ [deleted]

8.7.36 G ~~If a *firm* wants to include in its *consolidated capital resources requirement* a solo capital resource requirement for an individual risk calculated under the rules of a non-*EEA* regulator not assessed as equivalent in *BIPRU* 8 Annex 6R (Non-EEA regulators' requirements deemed CRD-equivalent for individual risks) it will need to apply for a *waiver*. A *firm* applying for such a *waiver* should demonstrate that the local requirements result in a capital charge that is at least as much as required under the corresponding *FSA rules*.~~ [deleted]

…

~~Use of the consolidated requirements of a regulator outside the EEA~~

8.7.38 R ~~(1)~~ ~~This *rule* applies if:~~

~~(a)~~ ~~a *firm* is applying an accounting consolidation approach to part of its *UK consolidation group* or *non-EEA sub-group* under method three as described in *BIPRU* 8.7.13R(4)(a);~~

~~(b)~~ ~~the part of the group in (a) constitutes the whole of a group subject to the consolidated capital requirements of a *third country competent authority* under the *sectoral rules* for the *banking sector* or the *investment services sector*; and~~

~~(c)~~ ~~those *sectoral rules* are shown in *BIPRU* 8 Annex 6R (Non-EEA regulators' requirements deemed CRD-equivalent for individual risks) as having been assessed as being equivalent to the *FSA's rules* in relation to the *consolidated requirement component* in question.~~

~~(2)~~ ~~If the conditions in this *rule* are satisfied, a *firm* may apply the consolidated capital requirement in (1)(b) as the *risk capital requirement* for the group identified in (1)(a) so far as that consolidated capital requirement corresponds to the *FSA's rules* that would otherwise apply under this section. However a *firm* may only do this if it also complies with *BIPRU* 8.7.35R(2).~~ [deleted]

Prohibition on using the standardised rules of a regulator outside the EEA

8.7.38A R (1) This *rule* applies to a *firm* if:

(a) an *institution* in its *UK consolidation group* or *non-EEA sub-group* is subject to any of the rules or requirements of, or administered by, a *third-country competent authority* applicable to its *financial sector* that correspond to the *sectoral rules* applicable to that *financial sector* ("corresponding sectoral rules"); or

(b) a part of its *UK consolidation group* or *non-EEA sub-group* constitutes the whole of a group subject to the consolidated capital requirements of a *third-country competent authority*

under the corresponding sectoral rules applicable to the *banking sector* or the *investment services sector* for a state or territory outside the *EEA*.

(2) A *firm* may not use the requirements under any of the corresponding sectoral rules of a state or territory outside the *EEA* in order to calculate the *consolidated capital resources requirement* of its *UK consolidation group* or *non-EEA sub-group* for the purpose of this chapter.

…

8.8 Advanced prudential calculation approaches

…

Prohibition on using the rules of an overseas regulator

8.8.3 R Even if a *firm* has an *advanced prudential calculation approach permission* that allows it to use an *advanced prudential calculation approach* for the purposes of this chapter, the *firm* may not use the requirements of another state or territory to the extent they provide for that *advanced prudential calculation approach*. Therefore a *firm* may not use *BIPRU* 8.7.34R ~~to~~ and *BIPRU* ~~8.7.38R~~ 8.7.37R (Use of the capital requirements of ~~an overseas regulator~~ another EEA competent authority) if that would involve using an *advanced prudential calculation approach*.

Annex B

Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text and striking through indicates deleted text.

16 Annex 25G Guidance notes for data items in SUP 16 Annex 24R

…

FSA003 - Capital adequacy

…

77A Total credit risk capital component

See *BIPRU* 3.1.5R, as modified if a firm has an IRB permission.

A further breakdown of this figure is provided quarterly in FSA004 for those firms that are required to report that data item.

For *UK consolidation group* reporting, this is the part of the *consolidated credit risk requirement* corresponding to the *credit risk capital component* (i.e. the capital requirements for credit risk excluding concentration risk and counterparty risk). This will be the sum of data elements ~~78A,~~ 79A and 80A.

[*CEBS' CA 2.1*]

78A Credit risk for UK consolidation group reporting calculated under non-EEA rules

~~This is only relevant for *UK consolidation groups*. The only amount to be included here is the part (if any) of data element 77A calculated (when this is allowed under *BIPRU* 8) using the rules of a non-*EEA* regulator.~~

~~If the *UK consolidation group* is comprised wholly of firms authorised and incorporated in the *EEA*, this data element will not be applicable.~~

This field no longer applies and should have a zero entered when being completed on a *UK consolidation group* basis. For any other reporting basis the element should not be submitted.

...

85A Total operational risk capital requirement

This is only relevant for *UK banks*, *building societies* and *full scope BIPRU investment firms*. It is also relevant for any *BIPRU limited activity firm* or *BIPRU limited licence firm* that has a waiver under *BIPRU* 6.1.2G (to apply an *ORCR* rather than a fixed overheads requirement).

See *BIPRU* 6.

A *full scope BIPRU investment firm* that meets the conditions set out in *BIPRU* TP 5.1R should enter here the full *ORCR* that would have applied but for *BIPRU* TP 5.7R. The reduction as a result of that rule should be reported in data element 90A.

A further breakdown of this figure is provided in FSA007 for firms on the standardised approach, alternative standardised approach or the advanced measurement approach.

For *UK consolidation group* reporting, this is the *consolidated operational risk requirement*. This will be the sum of data elements ~~86A,~~ 87A, 88A and 89A, but is subject to the restrictions in *BIPRU* 8 on combining certain methods of calculating *operational risk* capital requirements.

[*CEBS' CA 2.4*]

86A Operational risk for UK consolidation group reporting calculated under non-EEA rules

~~This is only relevant for *UK consolidation groups*.~~

~~The only amount to be included here is the part (if any) of their *consolidated operational risk requirement* calculated (when this is allowed under *BIPRU* 8) using the rules of a non-*EEA* regulator.~~

~~If the *UK consolidation group* consists wholly of firms authorised and incorporated in the *EEA*, this data element will not be applicable.~~

This field no longer applies and should have a zero entered when being completed on a *UK consolidation group* basis. For any other reporting basis the element should not be submitted.

…

93A Total market risk capital requirement

See *BIPRU* 7 and also *GENPRU* 2.2.46R.

A further breakdown of this figure ~~(less 94A in the case of *UK consolidation group* reports)~~ is provided in FSA005 for firms that meet the reporting thresholds defined in *SUP* 16.12.5R (note 4), *SUP* 16.12.11R (note 4), *SUP* 16.12.15R (note 4), *SUP* 16.16.12.22AR (note 4) and *SUP* 16.12.25AR (note 4).

For *UK consolidation group* reporting, this is the *consolidated market risk requirement*. This will be the sum of data elements ~~94A,~~ 95A and 102A.

[*CEBS' CA 2.3*]

94A Market risk capital requirement for UK consolidation group reporting calculated under non-EEA rules

~~This is only relevant for *UK consolidation groups*.~~

~~The only amount to be included here is the part (if any) of their *consolidated market risk requirement* calculated (when this is allowed under *BIPRU* 8) using the rules of a non-*EEA* regulator.~~

~~If the *UK consolidation group* consists wholly of firms authorised and incorporated in the *EEA*, this data element will not be applicable.~~

This field no longer applies and should have a zero entered when being completed on a *UK consolidation group* basis. For any other reporting basis the element should not be submitted.

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