Response to FSA CP09/29: Strengthening Capital Standards 3

Introduction

The joint associations (AFME, BBA, and ISDA) welcome the opportunity to respond to CP09/29 – Strengthening Capital Standards 3.

The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1st November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association.

The BBA is the leading association for the UK banking and financial services sector, speaking for over 200 banking members from 60 countries on the full range of UK or international banking issues and engaging with 35 associated professional firms. Collectively providing the full range of services, our member banks make up the world’s largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

ISDA represents participants in the privately negotiated derivatives industry, and has over 810 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.
Overarching comments

CRD 3 – Substance not finalised

Although we recognise the proposed timetable contained within the draft CRD indicates an implementation date of the end of the year, leaving the FSA with little opportunity but to consult on its provisions at this time, we are concerned by the fact that the consultation is based on draft text, which has yet to be agreed at the European level and which may change. Not only are amendments likely as a result of the parliamentary process, but some elements (notably the trading book) are still the subject of discussion in the Basel Committee.

Furthermore the comprehensive QIS exercise, on which firms are currently working, may also result in changes to the calibration. It is essential that further consultation occurs post the QIS analysis to ensure that the right decisions are made, and that the calibration and pace of any change is implemented in a manner that supports market and economic recovery.

It is critical that the FSA remains aligned with European and international counterparts to ensure a level playing field exists for the financial industry globally to operate. Moving ahead of others will create competitive distortions, with the potentially damaging consequences for UK economic recovery.

We would urge the FSA to take note, as well as act upon, our concerns regarding certain elements of the CRD package and its impact, and that the UK authorities will engage strongly with MEPs to promote any necessary amendments to CRD3. We appreciate that consequent amendments would be needed to the draft handbook text to reflect finalised EU legislation and trust that the FSA would expedite these with appropriate industry consultation.

CRD 3 – Impact and timing

We are very concerned by the proposed timing of the CRD 3, which imposes material capital increases and significant systems development (particularly modelling and validation) by firms as well as robust supervisory review by the FSA. As a result we strongly believe that the UK authorities should be seeking a more appropriate timetable for implementation, involving deferral/phasing; appropriate transition periods, and appropriate grandfathering provisions. In addition, we would seek confirmation from the FSA that it would not intend to implement the CRD provisions in advance of its European peers, even if, by virtue of this consultation, it feels it is able to do so. The effects of these changes on the wider economy need to be fully considered before these proposals are finalised to ensure that recovery and future growth are not undermined. This will only be understood when the Basel Committee has finalised its response to the comprehensive QIS later this year. Neither do we think it is in the best interest of supervisors or firms to rush ahead when a more robust approach can be developed with a little more time. The FSA should take account of other pending changes at the European and international level, and support deferral of changes in areas such as securitisation, trading book, and hybrid capital until European and, where relevant, international standards are agreed.
A silo-ed approach

We are concerned that the FSA’s proposals, in each area, have been developed in isolation and do not necessarily take full account of the inter-linkages between policy developments, both current and forthcoming. For example, in relation to the treatment of Intra-Group Exposures (IGE), the FSA seems to provide incentives for a branch-based model whereas for recovery and resolution plans, its preference could be interpreted as being for subsidiarisation. We do not believe that either subsidiarisation or branching is inherently better. What matters is that the group’s board has determined that group structure is appropriate for its business model and can justify its use to supervisors. We therefore think that prudential policy should be capable of being implemented by firms whatever their structure and the FSA should not be encouraging one structure over another. To do otherwise risks sending a confusing message. Furthermore the FSA should be mindful of the inter-linkages between the large exposures policy and the liquidity policy and of future developments such as the proposal in CRD 4 to use Tier 1 as the capital base, before reaching conclusions on policy matters that it may subsequently have to amend.

Super-equivalence/national discretions

We are pleased that the FSA has again adopted a copy out approach which we very much support. However, we note that in a number of areas, such as hybrid capital, the FSA has chosen to go beyond the requirements of European legislation and CEBS guidelines. This could disadvantage our members vis-à-vis other banks subject to the CRD 2 and place the UK generally at a competitive disadvantage in Europe. The FSA should not introduce any areas of super-equivalence, particularly given the proposal in CRD 4 for it to become a maximum harmonisation Directive. We would also note that in a number of areas the FSA has decided not to take up discretions available and consider that more justification needs to be provided for these proposals – for example in relation to large exposures: the €150m inter-bank exemptions for smaller firms and the FSA’s right to allow ‘off balance sheet’ items to be reflected as a 50 % rather than 100 % ‘weighting’.

Intelligent copy-out

Additionally in some areas, we believe that straight copy-out is confusing, mainly as a result of issues with the underlying text and that the FSA needs to consider how to make it more intelligible for users. One example of this would be the treatment of CRM in BIPRU 10 - large exposures. Clarity is an important principle for both supervisors and the supervised to ensure that there is a clear and transparent level of understanding from the outset.

Use of waivers

We note a significant increase in the number of waivers that have been introduced in CP09/29. Firms have found the FSA’s current waiver application process to be lengthy and burdensome in practice. We are not convinced that the CBAs for these sections have adequately reflected the amount of resource that will be required by both firms and supervisors to complete these additional waivers and still meet the demands of business as usual. We recommend that the FSA reviews the need for some of these full waiver requirements, and rather considers the use of non- objection approaches, or a Waiver by Consent to increase responsiveness and flexibility. Shadow Waiver approaches, as undertaken with the original implementation of the CRD, should also be considered to minimise disruption. This will allow firms to notify the FSA of their intention in advance of its intended action and then carry out the activity knowing that the FSA supports it. In addition, in certain cases, such as where transactions having the same characteristics as other transactions that the firm has undertaken, and/or are with the same counterparties, we
consider it essential for these more practical approaches to be utilised. Examples of where these practical approaches will be relevant are in relation to hybrid capital buy-backs (so that market opportunities are not missed), securitisation activities and trading book activities as well as in the implementation of the large exposure regime.

Forthcoming changes

We are in the process of finalising our responses to BCBS 164 and 165 and are under no illusion that the proposals therein could radically change the approach to financial services regulation. To the extent that any of the FSA’s CP09/29 proposals are likely to be superseded by global standard setters we would ask that the FSA consider how best to minimise the burden of implementation on firms to ensure that impact of implementation only occur once not multiple times, and the cost of systems development, project management and resource time etc is minimised. We reiterate that the FSA should take account of other pending changes at European and international level, and support deferral in changes until such time as European, and where relevant, international standards are agreed.

Key comments in relation to the specific topics covered by CP09/29

Large exposures

Members are very concerned by the changes to the large exposures requirements and would urge the FSA to reconsider their implementation in light of the approach taken in other Member States once this information is available. The FSA should also take account of the need not to disadvantage international firms operating in third country jurisdictions.

In particular our members have found the intra-group proposals extremely difficult to interpret. While we note that you are due to explain the provisions to members very shortly we would like to outline our concerns based on our current understanding of the proposed tightening of the BIPRU text. Clearly this is our initial response, and we reserve the right to make further comments following our industry discussion with you.

We are very concerned by the loss of the additional LE limit in the WIG (wider integrated group), which will have a very significant impact on those members with extensive overseas operations. We continue to believe that being part of a group can be a source of strength, not just a source of weakness. Intra-group transactions not only facilitate the efficient use of funds, thereby reducing the reliance of local entities on local markets, but also centralised risk management, which reduces operational risks and concentrates dealing expertise. We believe that the effect of these changes will be significant and therefore further consideration should be given to the impact on the wider economy. A balance needs to be struck between strengthening the regime and economic recovery and growth. We do not believe that the current proposal achieves this. If the FSA is determined to pursue this approach, then at the very least the transitional periods for compliance will need to be significantly lengthened, to 2015 at the earliest.

Members do not believe that the application of a hard limit of 25% is appropriate for exposures in the trading book. A large portion of these exposures will be driven by supervisory haircuts on transactions that are already collateralised and therefore the mitigants suggested are not appropriate. In addition trading book exposures can change quickly as a result of delayed settlement or underwriting commitments. We would note that the vast majority of settlement failures result from operational issues that resolve in a matter of days and that underwriting commitments are typically short term. Therefore in practice firms will have to manage their exposures to a much lower limit than 25% to avoid the
possibility of breach. We think that the FSA should re-consider its approach to the trading book.

Members are particularly disappointed by the FSA’s approach to the inter-bank exemption. We had understood that the UK authorities shared the industry’s concern about the disproportionate impact of the removal of the inter-bank exemption on smaller institutions. Indeed as we understand it, HM Treasury were supportive of this exemption. We think that the FSA should revisit its decision to reduce the €150m limit to €100m. This provision will put smaller institutions at a significant disadvantage by either forcing them to increase their credit and operational risks by placing funds with lower-quality counterparties and in the process reduce liquidity provided to larger well-rated institutions. Firms may also be forced to price away excess liquidity as the alternative would be to place funds by investing in government securities. At a time when the authorities are seeking ways to increase the lending to the wider economy it seems odd that the FSA is pursuing measures that run counter to increasing diversity in the financial system. While we recognise that the implementation plans for other jurisdictions are not available to us, we would also ask that the FSA bear in mind the approaches taken in other jurisdictions to ensure that smaller firms and international firms are not disadvantaged with respect to cross-border business. As regards the ability for firms to obtain a waiver for exposures above 100%, Members are concerned by the introduction of a waiver. Although we recognise that the Directive requires a case-by-case approach to be taken, the waiver process is particularly burdensome for smaller firms, for whom this provision was designed, and we think that it may be possible to achieve the same objective by less onerous means. One approach could be to copy out the text from Article 111(4) into BIPRU and introduce a non-objection process, where firms seek to continue with their existing approach and existing counterparties. A non-objection process has been used in the past in the large exposure and securitisation areas. We recognise that where firms are seeking to change their approach, or change counterparties, the FSA may want to take a more structured approach. In this instance perhaps, for example, a waiver by consent might be used. Should the FSA pursue a waiver approach, we believe that the current approach is an over-zealous interpretation of Article 111(4), which does not require ‘exceptional circumstances’ to exist for approval to be given. There should not be an additional layer of unspecified criteria to be met for approval to be given; this is super-equivalent and will put smaller firms, an important source of liquidity, at a further competitive disadvantage.

There are several areas, apart from intra-group where the BIPRU text and the FSA’s intentions could be made clearer. In particular, the approach to exposures to central counterparties. The decision not to adopt the discretion in Article 30(4) suggests that such exposures would be subject to the 25% limit. However, BIPRU 13 would suggest that there is no exposure to record. If the FSA’s position is the former, then we think that it runs counter to the regulatory direction respect to derivatives more generally and should be reconsidered. The CRM provisions are also extremely confusing and difficult to follow - the position in relation to trading book eligible collateral is particularly unclear.

The FSA should also recognise that many of its firms have operations globally whose footprints can also be a source of strength providing security from concentrated shocks. A significant tightening of rules may have the unintended consequence of structural changes, and restrictions which would not be in the interest of either the authorities or firms. International franchises should not be disadvantaged by these changes.

Finally, members are concerned with the drafting of the CEBS Guidelines on the implementation of the revised Large Exposures regime, and look forward to detailed consultation before these guidelines are implemented into BIPRU text.
Securitisation

As a general observation, we understand CRD 2 and 3 to be applicable to both credit institutions and investment firms. In terms of specific key issues these are as follows:

CRD 2 related issues

As currently specified members do not believe that the current approach to significant risk transfer, either by notification or waiver, is workable. As a starting point, we would ask the FSA to confirm that the significant risk transfer provisions only apply to new transactions and not existing ones. Applying these requirements to existing transactions will be extremely burdensome for both firms and supervisors and should not be necessary given the acceptance of the existing approaches that firms have taken. In addition, it appears that the FSA may be seeking to apply significant risk transfer requirements to sponsors, which we do not believe to be required.

The notification requirement actually appears to be a non-objection process and therefore firms will, in practice, have to submit their proposed approach to meeting the commensurate element of the test, in advance of the transaction date, to ensure that the FSA has no objection to the proposed reduction in capital requirements. To make the notification approach workable, we recommend that a materiality threshold is introduced and/or agreement with the FSA that a firm carrying out a transaction that matches previous structures which qualified for commensurate risk transfer will do so again and therefore would accordingly qualify for reduced capital requirements.

The waiver response time should be reduced to three months. Six months is an unacceptably long time to wait and could result in opportunities to transact being missed in the early part of next year at a time when securitisation maybe an important source of funding as emergency measures run off. In addition, we would recommend that the FSA introduce a shadow waiver process, in line with that conducted for IRB. We also think that an ‘in principle’ approach, accompanied by self-certification, should be considered, which would allow firms to transact where the transactions are in relation to asset classes on which they have already transacted and where they are using the same calculation methodology as previously, for determining significant risk transfer. We would also like to engage in further dialogue with the FSA on how the waiver process will operate in practice, to ensure that it is not unduly restrictive, and on the asset classes, where we recommend the use of the COREP categories plus insurance and PFI.

CRD 3 related issues

Securitisation is one area where we strongly believe that the timing of introduction should be re-considered and grandfathering and transitional provisions are necessary in CRD 3. It is not possible to retrofit existing transactions to the new requirements and we think the emphasis should be on modifying behaviour going forward.

We note the FSA’s commentary in the CP regarding the treatment of exposures to ABCP conduits and the absence of accompanying BIPRU text. As these vehicles provide an important source of funding to the real economy we think that the provisions should be included within the main body of the Directive so that convergence is achieved across the EU and we look forward to discussing this further in our Standing group meetings.

We are hopeful that the Council position on highly complex re-securitisation positions is adopted in the final Directive text. The provisions are unnecessary because of the due
We are also concerned by the ‘self guarantee’ requirements in respect of transactions where the level of unfunded support provided is not material. In particular we think that RMBS and SME CLOs will be particularly affected, where there is the provision of a small liquidity facility and/or foreign exchange or interest rate hedges. Hedges provided to ABCP conduits are also likely to be affected. We think that the impact of these provisions has been understated and that amendment is required to the CRD that enables the provision to reflect the level of support provided.

As regards the implementation of the CRD 3 provisions, we seek confirmation that the FSA has not changed its view on the exclusion of A/B loan splits from the definition of securitisation and that further clarity will be provided in BIPRU on internally re-structured transactions to confirm that these would not fall within the definition of re-securitisation.

Finally while not able to address its contents in this consultation response, we note the FSA’s letter to trade associations of 26 February on tranche protection trades. As discussed in the Securitisation Standing Group of 8th March, the industry is intending to respond to this letter and look forward to obtaining further clarification on the FSA’s thinking in the proposed ad-hoc meeting of the SSG to cover this development.

Trading book

Our concerns around the trading book changes are related to the fact that the CRD has not yet been agreed and to the outstanding issues in relation to the correlation trading carve-out and the recent QIS exercise, on which Basel is still working. In particular we are keen to ensure that the correlation trading carve-out is included within the final Directive text. We do not believe that a floor on the correlation carve out should be included, unless Basel has agreed upon the need and the form that it should take. Members indicate that the floor, as currently drafted, would have a very significant impact on capital requirements that would not be justified by the risk. We think there are a number of technical issues coming out of the QIS regarding the calculation of the requirements that will need to be addressed in the Basel Accord and, indeed, in the CRD – for example a max loss cap. Furthermore, we think that the CBA understates the impact of these proposals quite significantly.

The combination of these issues, combined with the fact that firms are still developing their models, means that it is premature to be developing implementation guidance. Given the FSA’s CRD 3 implementation questionnaire we are very concerned that the FSA will move ahead (and potentially in a different direction from other regulators) and that insufficient flexibility will be provided if the implementation date remains as currently stated. We strongly believe that it is in the best interests of both regulators and firms for sufficient time to be given for robust modelling and validation, as well as supervisory review and dialogue, and therefore think that the UK authorities should give very serious consideration to the timing of introduction of these provisions and support the industry call for delay.

One further area of change in the CRD 3, which causes significant problems, is the removal of the ‘equivalent’ from the 10 day holding requirement for VaR. This apparently small change will have a significant impact on the way that firms calculate VaR and will divorce the regulatory VaR from that used for risk management purposes. This change is also divergent from the Basel Accord. We think the UK Authorities should push for a change to the draft Directive on this point.
We would also like to discuss with the FSA the definition of exposure value for credit derivatives under the standard rules approach in the trading book.

Finally, we would request that the FSA consider further the approach to the relationship between BIPRU 7 and BIPRU 9. As currently drafted we do not think that incorporating sections of BIPRU 9 in BIPRU 7 fully incorporates all the necessary elements suggested (for example various approaches such as inferred ratings) and opens the possibility for future discrepancies. We would prefer that BIPRU 7 reference BIPRU 9.9 to 9.15.

**Hybrid capital**

We support the FSA’s proposals as they implement the CEBS Guidelines which are principles-based and reflect the Sydney press release. Whilst we have doubts about the mechanics of activating write-down or conversion mechanisms, our main concern relates to the FSA’s super-equivalent retention of the requirement that **SPV issues should be restricted to the 15% bucket**. This should be removed as it creates a competitive disadvantage.

The FSA has chosen to use *professional opinions* to supplement and reinforce the regulatory process in a number of areas. Whilst we generally support this, the FSA must be clearer on which aspects of, for instance, legal or accounting treatment it is seeking reassurance. Without this greater clarity our members are likely to commission expensive opinions that may not meet its requirements.

We would be happy to discuss any of these comments further, and look forward to hearing your views on our response.

Yours sincerely

Simon Hills  
Executive Director  
BBA

Diane Hilleard  
Managing Director  
AFME

Richard Metcalfe  
Head of Global Policy  
ISDA
Response to Chapter 3- Hybrid Capital

Key issues

We generally support the FSA’s proposals as they introduce greater transparency and consistency and are based on the CEBS Guidelines for Hybrid Capital Instruments which are themselves principles based.

We stress the need to ensure grandfathering arrangements are put into place that allow any issuance that would qualify as hybrid capital under CRD 2 to be carried forward as such for the life of the instrument, irrespective of further regulatory change that may arise post Basel and CRD 4 etc consultations. The FSA must provide this assurance if the FSA is to ensure that firms can continue now, when and where necessary, to bolster capital levels with the issuance of hybrid instruments, and not have the unintended consequence of stopping such capital raising altogether which can only be detrimental to the industry.

Limitation of SPV issuance

We do not support however the super-equivalent requirement that SPV issues should be restricted to the 15% bucket. This should be removed.

Use of professional opinions

We note that in a number of places the draft handbook text requires an opinion from a professional adviser to be given on aspects of legal or accounting treatments – for instance in relation to whether an instrument’s structure would not hinder recapitalisation (2.2.118 cross-referenced to 2.2.64 (6) (b) ) or how cross-border legal risks (2.2.128A) have been mitigated. It is not possible for advisers to give subjective judgements about refinancing hindrance or risk mitigation in a professional opinion.

Where the FSA believes it does need the further reassurance that at professional opinion, be it legal or accounting, might bring it should be quite specific about the issues to be addressed by the opinion. Otherwise the additional flexibility and reassurance that the FSA believes a professional opinion could bring will be illusory.

Q1: Do you agree it is appropriate to restrict SPV issues to the 15% hybrid tier one bucket?

No, we do not agree that it is appropriate to restrict SPV issuance to the 15% bucket. The FSA has openly acknowledged that its proposed approach is super-equivalent but such acknowledgment does not make it right. We note that the HM Treasury consultation paper implementing amendments to the Capital Requirements Directive\(^1\) in paragraph 1.15 states that,

>The UK Government aims to ensure that transposition does not impose additional requirements on UK firms above those specified in the amending Directive: that is, it should not be super-equivalent in respect of EC law unless it is shown to be justified on the basis of a rigorous cost–benefit analysis

We have long counselled the FSA to be extremely wary of introducing measures in the UK that are super-equivalent to EU requirements. We are of the view that this super-equivalent

\(^{1}\) http://www.hm-treasury.gov.uk/d/consult CAPITAL REQUIREMENTS DIREC TIVE.pdf
limitation will cause UK banks to have a competitive disadvantage vis-à-vis non-UK EU banks in terms of capital raising activities.

Whilst we recognise that the FSA is continuing its current policy as articulated in GENPRU this will now no longer be the case for non-UK EU banks. As a result UK banks issuance of tax deductible hybrids will be limited to the 15% innovative bucket – a restriction that will not apply to other EU banks, which may therefore be able to structure tax deductible hybrids beyond that level. The FSA should therefore delete the existing text at GENPRU 2.2.125 in order that there is no limit on indirect issuance, and thereby ensure the UK is on a level playing field with its European counterparts.

We also remind the FSA that SPVs are widely used, accepted and understood in a wide range of different financing transactions, including securitisation transactions (including UK securitisations regulated by the FSA). The FSA should therefore not limit the use of finance SPVs in connection with Tier 1 capital raising transactions by UK banks where such SPV financing structures are indeed available in the United Kingdom in the context of other types of financing transactions.

While solo Tier 1 consolidation treatment (i.e. to achieve the same overall benefit as a directly-issued hybrid tier 1 instrument) is beyond the scope of this specific question, we would like to refer the FSA to the recent CEBS implementation guideline 139 on hybrids to further support our position. Guideline 139 of the release allows the inclusion of SPV-issued structures as part of solo capital with permission from the relevant competent authority. To ensure a level playing field in relation to both regulatory and tax treatment it is important that the FSA continues to permit solo consolidation of SPV-based structures by banks pursuant to BIPRU 2.1.

By confining the use of partnership based SPVs to UK governed entities the FSA is potentially limiting the investor base for bank capital be it in the UK or elsewhere. The FSA should be aware of this impact in considering whether or not to restrict the use of issuing vehicles in the way that is proposed.

The use of English LLPs is not straightforward and the interaction with other regulatory regimes, such as, the unregulated collective investment scheme regime and the financial promotion regime need to be evaluated. Our current understanding is that the interaction between these regimes prevents securities issued by an LLP being listed on the London Stock Exchange, which is clearly an undesirable result.

Whilst GENPRU 2.2.128 offers a possible way forward in the use of non UK law incorporated SPVs we note that the required legal opinion would be asked to opine that any legal risks associated with the use of a foreign issuing vehicle have been adequately mitigated. We do not believe that a legal opinion would be able to opine on the adequacy of the mitigation of cross-border legal risks – this is not a matter of legal interpretation. The FSA’s proposed way forward thus, in effect, limits hybrid issuance to UK incorporated vehicles, restricting our members choices in how these instruments are structured.

It should be noted that some operational features of capital instruments can be simplified when indirect issuance is used. We continue to support simpler issuance mechanisms so encourage the FSA to continue to enable the use of SPV issuance and to allow these to not just be confined to vehicles incorporated in UK law. Basel and the European Commission under CRD 4 are broadly supportive of such instruments although it is important to ensure that the detailed requirements (e.g. for on-lending) are consistent with the practical usage of SPV structures.
In summary, the use of SPVs should not be limited to the 15% hybrid tier 1 bucket and the FSA should allow SPVs to be incorporated in jurisdictions that will continue to allow UK banks to issue tier 1 capital on par with non-UK EU banks both in the domestic home market as well as in international markets.

**Q2: Loss absorbency mechanism – what practical issues do you foresee in structuring securities with conversion or write-down features?**

We agree that loss absorbency is a key feature of going concern capital. However, would like to point out to the FSA that the task of including conversion or write-down features in such securities’ will be difficult. There will be a tension between, on the one hand, providing enough clarity to investors so that they understand (and thus, price) the nature of the risks associated with investing in these securities (and also to enable legal advisors to give an opinion that the conditions in GENPRU 2.2.117B have been met), and, on the other hand, being over-prescriptive about the point at which the trigger should be activated, the result of which might be to make a bad situation worse (such as the overly aggressive shorting of the firm’s common equity in a deteriorating market situation).

We assume that the FSA envisages that the trigger points and mechanisms will be the same for both write-down and conversion although we expect demand for structures containing conversion mechanisms to be more limited, as many hybrid Tier 1 investors are not likely to be permitted to hold securities that could convert into common equity.

A further issue that arises in relation to conversion is whether the conversion ratio should be fixed based on the market price of the instruments into which it converts at issuance of the hybrid, or be ambulatory, thereby allowing it to be adjusted in a way that is established upon issuance but nonetheless reflect changes in underlying instrument’s price over the life of the instrument. We firmly believe flexibility is of critical importance and that therefore firms be allowed to choose either a fixed or ambulatory approach depending upon what best suits their needs and the instrument/ market dynamics at time of issuance.

Generally speaking, the market reaction to a conversion mechanism will always need to be considered to ensure that the conversion process, in and of itself, does not perpetuate a deterioration of the situation for any given firm, or lead to ‘short selling’ of the common equity of the issue.

**Write down**

We generally support the use of temporary principal amount write-downs to create core capital treatment through loss absorbency as is permitted in the proposed handbook text under 2.2.117A (5) (b). We further note that Basel III/CRD 4 include the requirement of write-downs for non-core Tier 1 capital instruments only where such instruments are considered to be liabilities under national insolvency law. If that is the case, it is likely that principal amount write-downs may not be required in the United Kingdom under Basel III/CRD 4.

It should be made clear in Table 5 that hybrid capital holders share in losses on a pari passu basis with common equity holders – Table 5 can be interpreted to suggest that they take all of the loss.
Q3: Trigger for activation of loss absorbency mechanism – Do you agree that in order for the mechanism to be effective in supporting the firm’s core capital in times of stress that the trigger needs to be activated at the discretion of the firm?

It is indeed correct that the trigger mechanism should be activated by the firm in a way that provides clarity and transparency to investors in the hybrid capital securities based on objective triggers that are established at issuance. A firm should be able to set its own triggers, of course in consultation with the FSA about what the proposed trigger would be and the availability of any cure periods or mechanisms that may provide the firm with any flexibility in periods of stress. We support the position that, whatever the trigger mechanisms are, they must be documented in the offering circular at issuance.

Should the loss absorbency trigger be activated by the firm, then we also agree that the firm should have the discretion to enact the conversion or write-down, as the case may be, in light of other actions it may take that may be deemed more appropriate at the time and in consultation with the FSA as appropriate.

Q4: Is the draft Handbook text for GENPRU 2.2 clear? Is any further guidance needed?

We note that 2.2.9 refers to tier 1 capital being ‘available when required’ and seek clarity about the exact meaning of this. We assume this wording caters for convertible capital instruments.

We also seek clarification to

- 2.2.79D R (2) that mentions 5% threshold for “market making” where the CEBS December 2009 Guidelines mentions “10% of the relevant issue or 3% of total amount of outstanding” in paragraph 73;

- 2.2.69D G (3) and (4) where it is unclear what a firm “not being committed to finding new investors’ refers to: Does this preclude a voluntary arrangement for finding new investors, where the hybrid investors would bear the risk of such new investors not being found?

We have also made some suggestion below as to how text could be changed to aid clarity and consistency with the CEBS standards.

Q5: Are the proposed changes to FSA003 clear? Is any further guidance needed?

Guidelines are clear however we believe the FSA’s reporting and categorisation changes suggested for FSA003 might be better delayed to take account of (i) the data collection from the current QIS exercise the FSA is co-ordinating for BCBS & CEBS and (ii) clarification of the BCBS proposals.

Q6: Has the CBA identified the relevant costs and benefits and have the costs been appropriately estimated?

We consider that the one off costs to the UK banks of developing new instruments which will satisfy the new CP09/29 requirements should also be considered in the CBA.
### Detailed Comments on Draft Handbook Text in Appendix 1

<table>
<thead>
<tr>
<th>Section</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.2.68B</td>
<td>Based on CEBS implementation guideline 114(b), it should be made clear that a dividend stopper does not hinder recapitalisation if it acts pari passu with common equity during operation of on-going loss-absorption mechanisms.</td>
</tr>
<tr>
<td>2.2.69C 2</td>
<td>We are not clear in what circumstances such a payment would deplete financial resources or cause a firm to not meet its CRR?</td>
</tr>
<tr>
<td>2.2.69D 1</td>
<td>We think this sentence can be deleted – we cannot envisage a circumstance in which the issuance of a coupon in the form of a core tier 1 instrument would decrease the firm’s core tier 1 capital.</td>
</tr>
<tr>
<td>2.2.69D 2</td>
<td>‘Without delay’ is rather a nebulous term. We suggest its replacement with the words ‘in a timely and reasonable manner’ which will allow the bank to manage the issuance of the instrument promptly but in a way that also takes into account changing market dynamics.</td>
</tr>
<tr>
<td>2.2.69E</td>
<td>We suggest the deletion of this sentence – we do not envisage any circumstances in which a core tier 1 based ACSM would not meet the requirements of 2.2.69 C, subject to the change to 2.2.69D suggested above, changing the time reference to a ‘timely and reasonable manner’.</td>
</tr>
<tr>
<td>2.2.69F 3</td>
<td>This sentence should be deleted – we do not understand how a bank could be in breach of the threshold conditions in relation to adequacy of financial resources because of the issuance of newly issued core tier one capital instruments.</td>
</tr>
<tr>
<td>2.2.74A 1</td>
<td>We consider the word comprehensive to be too wide a requirement. In the vast majority of cases the explanation will be obvious – i.e. ‘it is cheaper’ and we would only expect to present a relatively short case to the FSA to enable it to ensure compliance with 2.2.74R.</td>
</tr>
<tr>
<td>2.2.74A 4</td>
<td>We assume that the firm will use its own scenarios to test to.</td>
</tr>
<tr>
<td>2.2.79B</td>
<td>We would prefer that FSA permission to purchase Tier 1 instruments before their fifth anniversary be granted without the requirement to submit a formal waiver application, which we believe is excessive and time consuming. This could be achieved by constructing a rule enabling the FSA to give consent to such a request rather than requiring a waiver application.</td>
</tr>
<tr>
<td>2.2.79G</td>
<td>This draft clause requires an institution wishing to buy back an instrument to give the FSA one month’s notice. We note that there is no such requirement in the CEBS guidelines and hope that the FSA would be able to rely on the regular dialogue it has with a firm about its capital plan as an alternative to formal notification.</td>
</tr>
<tr>
<td>2.2.79H 2</td>
<td>This requirement does not feature in the CEBS Guidelines so should be deleted.</td>
</tr>
<tr>
<td>2.2.115A</td>
<td>By requiring a capital instrument to satisfy all the other requirements in relation to tier 1 and hybrid capital the FSA risks choking off innovation. The key determinant for its inclusion should be whether or not it converts into core tier 1 capital. If it does so unequivocally it should be included in the capital calculation.</td>
</tr>
<tr>
<td>2.2.115C 2</td>
<td>In deciding whether or not to require a firm to convert an instrument we expect that the FSA will also be considering, in conjunction with the firm, what other options are available, for instance under the firm’s recovery plan. Conversion may not always be the best option and may create market wide problems; if for instance, conversion is imposed on the firm before a trigger point is reached.</td>
</tr>
<tr>
<td>2.2.117A 3</td>
<td>We prefer, for consistency’s sake, the CEBS wording of ‘not hindering recapitalisation’ rather than the draft wording ‘making recapitalisation more likely’ and recommend that this be changed.</td>
</tr>
<tr>
<td>2.2.125</td>
<td>We believe this is a super-equivalent requirement so should be deleted.</td>
</tr>
<tr>
<td>2.2.127</td>
<td>We believe other jurisdictions should be allowed for incorporation and governance, and the text here amended appropriately,</td>
</tr>
</tbody>
</table>
Response to Chapter 4 - Large exposures

Key issues

As noted in the introduction to our response, there are elements of the large exposures proposals, which we think are not clear. As such, this section of our response should not be regarded as our definitive view, as it is based on our current understanding of the FSA’s intentions. Hopefully the proposed meeting on this subject will provide greater clarity and alleviate some of our concerns. If this is the case we will re-submit this section of the response.

Large exposures is an important part of the supervisory package in CP09/29, as members consider that the proposed changes will have a significant impact on their ability to do business at a time when economic recovery is not assured. Therefore, based on our current understanding members are particularly concerned by the following issues:

Interrelationship with other changes to the framework

Members consider that further consideration needs to be given to the implementation of the large exposures framework in light of other changes that are in train because they will have a significant bearing on the true impact of these proposals. For example changes within the proposed Basel framework will increase the exposure value attributed to counterparty credit risk and CRD 4 considers whether Tier 1 should be used as the capital base to assess large exposures against. It is inappropriate to create a framework where hedging becomes more difficult because of the large exposures requirements.

Intra-group exposures

We understand the desire, outlined in the Turner Review paper, to understand group structures and to ensure that they are appropriate for the business models that firms are running. We also recognise that the recent crisis has highlighted how geographic barriers to cross border flow can be created. However, Members are extremely concerned by the extent of the tightening of the intra-group requirements and think that this approach should be revisited.

It is still important to remember that being part of a group can also be a source of strength, not just weakness, and intra-group transactions facilitate centralised risk management as well as efficient use of funding and reduction in overall operational risk. Many groups have managed their cash flows on the basis of a ‘hub and spoke’ arrangement, whereby funds raised in units that are long of cash are lent to the central treasury for onward lending to those units that are short of funds. The central treasury function either places the net surplus or borrows the net deficit in the market. Similarly central functions are used to hedge, for example, interest rate positions with the subsidiaries, and then hedge the group’s net position with the market. This arrangement is more efficient, concentrates dealing expertise at the centre, thereby reducing operational risk and reduces market facing exposures. It is important to understand that reducing one risk (intra-group flows across jurisdictional boundaries) will only create other risks – counterparty risks where local units are forced to either lend surplus funds to the market or from hedging exposures; or liquidity risks where local units are forced to rely more extensively on wholesale funding.

The tightening that is proposed for exposures to overseas intra-group counterparties will have a significant impact on firms ability to continue to function in those markets particularly given the very tight timetable in which the FSA envisages reducing the limits. Within the
current intra-group framework, taking account of the full range of concessions firms may have intra-group exposures up to around 300% of capital base. It is simply not possible to reduce those to 100% by the end of 2012 and the consequences of doing so will be material and is likely to hinder economic recovery. If the FSA decides to continue to pursue the approach outlined, then transitional provisions must be extended. We strongly recommend that the date should be no earlier than 2015. Furthermore we would like further clarity on how the new regime would fit with the existing WIG waivers which run until mid 2011.

It is therefore essential that an appropriate balance is struck between strengthening the large exposures framework and economic growth. Whilst a firms’ overseas operations provide a source of diversity of risk, which can help protect them from economic shocks in one country or region, it may not be the only reason why a firm incurs an exposure to overseas subsidiaries. For example, a firm may raise an element of customer funding via transactions involving overseas subsidiaries. Large internationally active groups have a continued role to play in the financial markets, providing finance to large and cross-border businesses and projects. Given the loss of the inter-bank concessions, a tightening of intra-group exposures could result in a higher risk of failure for entities within a group – individual entities will be more reliant on the wholesale markets, where it may prove to be more difficult to hedge and obtain funding.

The incentives created by the proposals would also appear to be at odds with the approach that the FSA, and other regulatory bodies, are taking elsewhere. DP09/4, ‘Turner Review Conference Discussion Paper, The EC Communication and Staff Working Paper on Cross Border Crisis Management, and the Basel Report and Recommendations of the Cross Border Bank Resolution Group in respect of mechanisms to facilitate resolution (such as recovery and resolution plans) appear to encourage a subsidiary model. In addition we would highlight that some other supervisors are actively encouraging the use of subsidiaries in their jurisdictions. However the large exposures proposals provide incentives to revert to a branch model. We believe that neither model is intrinsically better than the other; both pose challenges and can result in cross jurisdictional exposures. The key, therefore, will be for firms to ensure that they have a structure that is appropriate for the business model being run and for there to be a robust supervisory challenge to ensure that this is the case. Regulatory initiatives regarding appropriate resolution mechanisms, recovery and resolution plans and enhanced supervisory dialogue with firms will have a more important, and more effective, role to play in minimising the risk of group structure.

Finally, we find the detail of the intra-group proposals very difficult to unravel and think that they raise interesting legal issues. As regards clarity, one aspect on which members would particularly like further clarification is the interaction between the intra-group limit and the CNCOM calculation. Our view on the FSA’s intention to consider aligning intra-group with that of third party trading book exposures will be very much coloured by the FSA’s view on this point. A significant tightening of the trading book regime for intra-group exposures would be of great concern to members, in light of the proposed tightening to the rules for third party exposures and the loss of the inter-bank concession. The proposal to require legally binding commitments from unregulated members of the core UK group to the regulated members raises questions around Directors’ fiduciary duties, and we think that further consideration should be given to changes that would be required to UK Company Law to ensure that these types of financial arrangements are legally competent.

25% limit for third parties in the trading book

The trading book is important to the financial system, as it provides a means for banks to intermediate risks from the corporate sector to others who are looking to diversify their risk. A significant portion of firms’ trading books is customer driven, either by directly taking on risks, or through hedging them out to other market participants. The trading book is different
to the banking book, because of the speed at which exposures can change and the different approach to risk management. The imposition of a hard limit in the trading book, therefore, has a different and more significant impact than that imposed on the banking book. One of the main drivers of exposure in the trading book is the supervisory haircuts applied to collateralised exposures. Since these exposures are already collateralised, there is little firms can do to further mitigate their effects. The loss of the inter-bank exemption means that these will be a significant element of the trading book exposure value. As there is also more volatility in exposure value in the trading book, for example as a result of delayed settlement, firms will have to manage to a lower limit than 25% to ensure that they do not breach. The vast majority of such settlement exposures arise from operational issues and resolve within a matter of days. While it is possible that such exposures can go on to become credit exposures, to restrict the trading book as proposed will have a significant impact that is generally unwarranted by the risk and we do not understand why it has to be addressed by a hard limit and not some other means. Underwriting is another area where exposure may vary significantly over the course of a few days. The hard limit would potentially restrict this business thereby disrupting market functioning. Temporary excesses therefore need to be accommodated either by carve out or the approach taken in the existing regime to apply capital charges. In this regard we would note that significant changes to the trading book capital requirements are underway and the cumulative impact of these changes should be considered before determining whether it is appropriate to amend the large exposures regime as proposed. Further we would note that the proposal to introduce a limit is at odds with the approach taken in at least one other Member State.

**Treatment of exposures to central counterparties**

We are uncertain of the approach that the FSA intends with respect to exposures to central counterparties. If the proposed decision in respect of Article 30(4) is intended to mean that the 25% hard limit is intended to apply, then we do not think this approach is appropriate. It is clear that regulators, and indeed the G20, want to see derivative business cleared through central counterparties and all other regulatory initiatives, capital related and otherwise promote this direction of travel. Imposing a hard limit on such exposures will hinder this objective and restrict the ability of firms to provide hedging tools to corporates. If on the other hand the interrelationship with BIPRU 13.3.12 and 13 means that the FSA believes that there is no exposure to record, then the proposed approach would be appropriate. On the latter basis, it would be helpful if that could be made clearer in BIRPU 10.2.7.

**Inter-bank exemption**

We had understood that the UK authorities shared the industry’s, particularly smaller members’ concerns regarding the disproportionate impact of the changes to the inter-bank exemption when the CRD 2 provisions were being negotiated. We are therefore disappointed by the FSA’s proposal to reduce the effectiveness of this provision in implementation.

In particular, members are very concerned by the proposal to take up the national discretion to reduce the inter-bank exemption of €150m to €100m. As the FSA notes the exemption was included in recognition of the fact that it is not easy for smaller firms to diversify their exposures and that to do so potentially increases the credit risk to which they are exposed, as they would have to place their funds, often in smaller amounts, with lower quality counterparties or would be forced to price away excess liquidity as the alternative would be to place funds unprofitably by investing in exempt exposures such as government securities. If smaller banks switch from deposits with large institutions to buying government securities, it will remove a useful source of liquidity for larger banks, particularly in times of stress.
We think that the FSA should be seeking to encourage diversity and competitiveness in the financial system (often achieved by the activity of smaller or niche entities) rather than stifle it, by introducing measures that limit their ability to transact on a reasonable footing with larger firms. Members therefore challenge the assertion in the CP that this proposal is proportionate as a result. In addition, while the proposed limit may appear to the FSA to have limited impact in the current exchange rate environment it may turn out to be more significant over time, should sterling appreciate. In the absence of implementation plans in other jurisdictions we are unable to determine whether this would limit smaller firms’ ability to compete cross border, but think that this factor should also be taken into consideration as further information becomes available. The ability to compete cross-border will be further affected by the decision to continue with the current treatment to medium and low risk items. In practice this could mean that firms in a jurisdiction that took up the full €150m and the discretion for medium and low risk items could take on three times the exposure compared to a UK firm.

Members are concerned by the introduction of a waiver for exposures above 100%. Although we recognise that the Directive requires a case-by-case approach to be taken, the waiver process is particularly burdensome for smaller firms, for whom this provision was designed, and we think that it may be possible to achieve the same objective by less onerous means. One approach could be to copy out the text from Article 111(4) into BIPRU and introduce a non-objection process, where firms seek to continue with their existing approach and existing counterparties. A non-objection process has been used in the past in both the large exposures and securitisation areas. We recognise that where firms are seeking to change their exposure levels, or counterparties, the FSA may want to take a more structured approach. In this instance perhaps a waiver by consent might be used. Should the FSA pursue a waiver approach, we believe that the current approach is an over-zealous interpretation of Article 111(4), which does not require ‘exceptional circumstances’ to exist for approval to be given. There should not be an additional layer of unspecified criteria to be met for approval to be given; this is super-equivalent and will put smaller firms at a further competitive disadvantage.

Credit risk mitigation

Although we recognise that the FSA is addressing particular provisions in the CRD 2 text with the amendments to 10.2 and 10.3 the LE CRM amendments in CRD 2 were intended to bring the large exposures framework broadly into line with the credit risk framework (with a few exceptions). It would be helpful, clearer and open less scope for inadvertent divergence in the rules going forward if some way could be found to reduce the amount of text on CRM in BIPRU 10 and rely more on cross references to BIPRU 4.10, 5 and 9, with BIPRU focussing on those areas where the Directive actively requires/permits divergence. We appreciate that this is fundamentally a problem with the clarity of presentation of the underlying Directive text, but this an area where the FSA could usefully provide clarity rather than copy out.

In particular confusion arises in respect of the interrelationship between 10.2.14 and 10.3.3. Firms on the standardised approach may use either the simple approach or the comprehensive approach for collateral. The simple approach would result in a substitution of the original counterparty with that of the mitigant but under the comprehensive method the exposure value will be adjusted. Article 117 allows a firm to use both approaches (obviously not for the same exposure) or to continue to report to the original counterparty. Part (b) of 10.3.3 would seem to indicate that reporting to the collateral issuer is obligatory rather than optional, as it is missing a ‘may’ and the guidance in 10.3.3A would seem to require that the firm adopt the same approach as that used in the capital framework, although that is not required by the Directive. Although we agree that such flexibility should not be used for
arbitrage purposes, there may be legitimate reasons for a firm to have a different but consistent policy to a given set of circumstances.

We are also unclear on the FSA’s position with regard to eligible collateral under the trading book, which constitutes a wider pool than that in the non-trading book. BIPRU 5 is amended by BIPRU 14.2.15 to include a broader range of eligible collateral for repo transactions. However, 10.2.16 would appear to restrict the eligible collateral to that allowed under BIPRU 5 for the non-trading book. A restriction of this nature would have significant consequences for large exposures and exacerbate the issues described above in relation to the trading book. We would appreciate confirmation that the BIPRU 14 eligibility provisions apply.

**Waivers**

We note the increasing prevalence of waivers within the large exposures regime and elsewhere in the consultation. We are concerned that the FSA has not adequately considered the amount of resource required by both firms and the FSA itself to support these requirements. We seek commitment from the FSA that it will be able to continue to meet its service standards, so as to not unduly hinder market activity. We also reiterate the need to review these waiver processes and consider other more practical approaches.

**CEBS guidelines**

We recognise that at the time of printing it was not possible for the FSA to indicate how it might implement the CEBS guidelines on large exposures. However, as these are now available we would like to register a number of points, which we raised in our response to CEBS CP26 and seek clarity from the FSA on how it intends to implement the guidelines.

In particular, we are concerned by the lack of clarity in paragraph 48 regarding the treatment of exposures to conduits. As highlighted in our response the fact that a firm funds a number of ABCP conduits should not mean that they should be aggregated. While we recognise that regulators do not share our view that the proposal to amend the connected counterparties conditions for funding mixes liquidity and credit risk concentration, different conduits will have different investment criteria and will therefore represent different risks. It is also clear from market activity over the last two years that investors do differentiate between conduits sponsored by a single institution and therefore it should not be assumed that they constitute a single risk. At most, therefore, we believe that paragraph 48 should be interpreted to mean that exposures to a single conduit should be aggregated, although even here we reiterate our reservations in our response to CP 26.

We also reiterate our concerns regarding the look through approach, and recording of exposure to the scheme, proposed for exposures backed by other assets (both tranched and untranched). The CEBS guidelines are very burdensome, even with the 5% threshold, and do not reflect risk management. In addition we believe that the guidelines raise significant data protection issues that would need to be addressed. For exposures backed by retail (including retail SME) exposures we believe that there should be a general carve out from the need to look through.

---

2 [http://www.c-ebs.org/getdoc/019e5f45-99de-4c72-9c10-b4bff38e37e5/15_LIBA-ISDA-BBA.aspx](http://www.c-ebs.org/getdoc/019e5f45-99de-4c72-9c10-b4bff38e37e5/15_LIBA-ISDA-BBA.aspx)
Q7: Do you agree that we should implement this exemption (if we do not implement this exemption we would be super-equivalent)?

Although not an issue for our members, we believe that it is not appropriate for the FSA to be super-equivalent in this area.

Q8: Do you agree that setting a lower limit for the smaller firm exemption is both prudent and will reduce financial contagion in the banking sector?

No.

As noted in our key messages above, it is inappropriate for the FSA to tighten up an exemption designed to address the disproportionate impact of the inter-bank limit on smaller institutions. The FSA should be encouraging diversity and competition in financial services, by encouraging the existence of smaller or niche players, rather than putting them at a significant disadvantage to larger firms. In our view an adequate rationale for taking up this discretion has not been provided and we strongly urge the FSA to reconsider its position on this point.

In addition we think that the FSA should remove the unspecified, and super-equivalent, ‘exceptional circumstances’ requirement for the waiver to allow exposures above 100% of capital base.

Q9: Is our approach to the implementation of the national discretions clear?

While the approach to the implementation of the national discretions is clear in most instances (the approach to exposures to central counterparties in Article 30(4) is a notable exception), there are six discretions where we think the approach may be inappropriate

**Exposures to central counterparties**

Please see key messages above.

**Inter-bank exemption**

Please see key messages above

**Required minimum reserves and statutory liquidity requirements**

As these requirements represent exposures to central governments and central banks and are statutory requirements in those jurisdictions we would like to understand why it is thought that a waiver is necessary. We would be happy to discuss with the FSA the jurisdictions in which this is relevant.

**Covered bonds**

Covered bonds, in line with the Directive criteria, are indeed issued by credit institutions and therefore at first blush might be regarded as exposures to banks that issued them and therefore subject to the 25% limit. However, as required by the UCITS Directive criteria, covered bonds are designed to survive the failure of the issuing credit institution by giving their holders a direct claim on the underlying assets. Additional criteria around the sufficiency and quality of the covered bond pool must also be met to ensure that covered bond holders are sufficiently protected. As a result, exposures to covered bonds should, at the very least, be regarded as exposures to the underlying pools and not be considered part of any exposure to the bank that issued them. Since the FSA and HM Treasury invested a
lot of time and effort in establishing a UK covered bonds regime, we are puzzled by the FSA’s approach to this discretion, which will potentially limit this market. We therefore urge the FSA to rethink its proposal.

*Treatment of medium and low risk items*

Although we note that the FSA’s approach is consistent with the existing regime, Members do believe that the loss history associated with letters of credit where there are underlying groups does not warrant the full exposure to be recorded. We would like to understand what analysis the FSA has undertaken in respect of this national discretion, including the approach taken in other jurisdictions. Given the tightening of the large exposures regime in other areas, Members would like to engage in a dialogue with the FSA on the continued appropriateness of the approach to letters of credit.

*Treatment of exposures denominated in a foreign currency*

We would like to understand further the rationale for the approach that the FSA is taking in this area and whether waivers will be available.

**Q10: Are the provisions for the recognition of collateral and exemptions for residential and commercial property clear?**

As noted in the key messages above, we would prefer the BIPRU 10 to include minimal material on credit risk mitigation, as this introduces the possibility of inadvertent divergences. We would therefore like to see the material scaled back and for the focus to be on required or optional divergences.

**Q11: Do you agree that there is no clear rationale within a backstop regime designed to limit the impact of unforeseen event risk to treat trading book and non-trading book exposures differently?**

No. Please see key messages section.

In the bilateral discussions held with firms, the FSA indicated that it was reviewing the definition of exposure value. We would like further clarity on the FSA’s thinking in this area. Should the FSA be determined to press ahead with its current approach, then some amendment will be necessary.

**Q12: Are there other market failures or risk issues that we should consider?**

In relation to risk issues, we would ask the FSA to reflect on its proposals in light of the fact that in the attempt to reduce single name concentration risk, other risks are created – for example by reducing the limit on the inter-bank exemption, credit risks are potentially being created for smaller firms by encouraging them to move down the credit quality spectrum, or if they move toward investing in government securities removing funds from the market, therefore weakening market resilience in a liquidity stress.

FSA should also consider further the wider costs to the economy that the tightening of credit that will result from these proposals, given the current fragile recovery.
Q13: Are the criteria for the core UK group clear?

No. It is not clear why the FSA has decided to go further than Article 80(7) in determining entities that can form part of the core UK group, or the current guidance on UKIG. Please also see key messages section.

Members think that there are particular issues around the legality of the proposals to require intra-group agreements on repayment in BIPRU 10.8.5, the layering of additional requirements in BIPRU 10.8.6 and the interrelationship between CNCOM and the intra-group limit of 100%.

We would also note that this is a big change to the existing regime, which has not been in place very long and in which firms have expended a lot of time and effort in meeting. The benefits of a new regime have not been adequately explained and the costs of introducing a new regime so quickly on the back of the existing have not been fully reflected.

Q14: Do you support the application of a basic limit for all non-core UK group intra-group exposures?

While we understand the FSA’s desire to protect UK depositors, our members do not support the application of such a limit on these exposures, which we think will have an impact on firms’ ability to do business that is not warranted by the risks. As a result firms will have to seek waivers from the FSA on this point, the cost and we do not think that the resource implications of which have been fully reflected in the FSA’s cost benefit analysis and seek assurance from the FSA that it will have the resources available to meet the demand.

In line with our comments on Q13, we fail to understand why the FSA has gone further in its definition of the core group than Article 80(7), which would mean that certain exposures previously within UKIG will now be limited.

Members also find the rules very confusing and difficult to interpret and are concerned by whether the FSA will have sufficient resources to process the waivers. For example it is unclear how UK parts of the group that are not core, or exposures to entities that are not wholly owned, EEA sub-groups would be treated.

Q15: Do you think the benefits of applying a limit lower than 100% will outweigh the costs?

No. See key issues section

While we acknowledge the difficulty in assessing the costs we do not think that a limit lower than 100% outweighs the costs. The costs will relate to operational costs of managing liquidity locally, consequent liquidity constraints, lost income from reduced efficiency of managing liquidity locally rather than centrally and lost third party business from group entities resulting from intra-group constraints.

We would also like to understand how the approach is consistent with Treaty obligations to treat Members States equally.

Q16: Do you agree that the simplification of these proposals will enhance the clarity of the large exposures provisions?

While we are supportive of rationalisation of what are a complex set of rules, we are not convinced that the proposals have been simplified. Members find the rules confusing and
difficult to interpret. We reiterate our previous concerns about the implications these proposals will have for firms overseas operations and the consequent impact on recovery and future economic growth.

In relation to the removal of the parental guarantee provisions, we seek clarification from the FSA that the normal CRM rules would apply for such arrangements

**Q17: What limits do you think are appropriate for intra-group trading book exposures?**

Further to our key messages above, we would like to engage in further discussion with the FSA on an appropriate approach to the trading book and on how the CNCOM calculation should be performed under the current proposed approach.

**Q18: Do you think that aligning the treatment of intra-group exposures within the trading book to the treatment of intra-group exposures within the non-trading book will strengthen the protection offered to consumers and markets?**

No. Please see key messages.

We are unclear as to the benefits for consumers and markets of reducing firms’ ability to transact, particularly hedging. Such measures are likely to limit the variety of products and increase the cost for consumers (including corporates) who transact with banks to manage their risks. We would note that much of the exposure that will arise in the trading book will be driven by supervisory requirements – i.e. supervisory haircuts on collateralised transactions. Alignment with the trading book will also limit firms’ ability to risk manage centrally, thereby increasing operational risks and dependence on local markets. We note that there are significant changes to the trading book capital regime, which should already go a long way to addressing FSA concerns in this area.

We are aware that the FSA undertook a review of firms’ booking practices during 2009, we would like to know the results of the review and what action, if any, is proposed as a result.

**Q19: Is the proposed transitional option for intra-group provisions clear?**

The proposals are reasonably clear, but we think that the proposed approach to intra-group exposures should be reconsidered. If the FSA decides to continue to pursue the current approach, significantly more time will be required in the transitional provision, 2015 at the earliest.

**Q20: Are the changes to FSA008 clear?**

We do not think that the changes are clear or structure-neutral. The details required for funded and unfunded credit protection will be complex to make operational, especially for overseas operations. In addition, there is no reference to underlying credit risks and interaction with the new liquidity regime.

**Q21: Are there any costs or benefits mentioned above that you believe would not materialise or would be of a different value?**

Members believe that the costs will be higher than those the FSA have indicated. However, it is difficult to determine at this stage, because further clarity is required in certain areas of the proposals.
**Q22: Are there any other costs or benefits we should consider?**

We think that there will be further costs if the CEBS guidelines are incorporated into BIPRU and think that these should be investigated.

**Detailed Comments on Draft Handbook Text in Appendix 2**

<table>
<thead>
<tr>
<th>Section</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.9.2</td>
<td>Further clarity is sought on how non-EEA sub-groups should be treated.</td>
</tr>
<tr>
<td>8.9.2</td>
<td>Further clarity is sought as to what is meant by this provision.</td>
</tr>
<tr>
<td>8.9.4</td>
<td>Further clarity is sought on how non-core UK group exposures are treated.</td>
</tr>
<tr>
<td>10.2.2</td>
<td>As noted above, clarity is sought on the treatment of exposures to central counterparties.</td>
</tr>
<tr>
<td>10.2.2 (4) and (5)</td>
<td>We note that further guidance is expected from CEBS on these points, but would like to discuss with the FSA their current understanding of these provisions, as well as obtaining an indication of when the CEBS guidance will become available.</td>
</tr>
<tr>
<td>10.2.5</td>
<td>'Amount at risk' is not a defined term in the handbook, we think that it might be clearer to just state that exposure value should be calculated in accordance with GENPRU 1.3.</td>
</tr>
<tr>
<td>10.2.9 to 10.2.19</td>
<td>If at all possible we would prefer the use of cross references to the credit risk mitigation requirements rather than reproduction of parts of the text.</td>
</tr>
<tr>
<td>10.3.3</td>
<td>A more coherent approach to CRM needs to be taken, which also extends to this provision.</td>
</tr>
<tr>
<td>10.3.3(1)(b)</td>
<td>'may' should be inserted before 'treat'.</td>
</tr>
<tr>
<td>10.3.3(5)</td>
<td>While we agree that where the maturity of the collateral is shorter than that of the underlying exposure, no recognition should be given, it is appropriate to recognise the collateral if it has a longer maturity than that of the underlying exposure. We think that this issue needs to be clarified.</td>
</tr>
<tr>
<td>10.5.4</td>
<td>We note that the references 10.9.20 and 10.9.30 do not exist.</td>
</tr>
<tr>
<td>10.6.3</td>
<td>We think that the exemptions for statutory liquidity and minimum reserves should be included within this list and would like to understand why a waiver is considered necessary.</td>
</tr>
<tr>
<td>10.8 and 10.9</td>
<td>We seek further clarity on these provisions.</td>
</tr>
<tr>
<td>10.10.12</td>
<td>We seek further clarity on the calculation of excess in the table.</td>
</tr>
</tbody>
</table>
Response to Chapter 5 - Securitisation

Key issues

While we recognise that FSA has taken a predominantly copy out approach to implementation, there are a number of issues, both as regards CRD 2 but in particular in relation to CRD 3 (where the requirements have yet to be agreed in Europe), on which we have significant concerns. While we understand the proposed timetable makes the implementation process very difficult, we are concerned that (as noted elsewhere) that the UK will implement in advance of other jurisdictions and in certain instances this will lead to a divergent approach which we would not support. The industry has the overall following key concerns to which the industry seeks the FSA's response before implementation of the securitisation changes proposed:

Impact assessment, grandfathering and resource implications

We strongly support the work being done by the FSA and other regulators to assess the impact of the changes to the securitisation framework. However, we think that the capital implications, for example in relation to self-guarantees, are understated. An accurate assessment of the impact is essential to ensure that an appropriate balance has been struck between strengthening the prudential requirements and securitisation market recovery. Securitisation is important to that recovery and future economic growth as it helps to fund the real economy. Regulatory change is one of the factors that is hampering the recovery of the market, such as provisions that could require deduction by the investor. Not only will these have a regulatory impact but also a market impact by reducing the pool of potential buyers and affecting the price.

While we appreciate the desire of the authorities to change certain behaviours, it is not viable to do that, or change transaction structures, retrospectively. We therefore believe that the UK authorities should be pursuing grandfathering arrangements in CRD 3, which would significantly help the current position. We also think that the UK authorities should press for further consideration to the timing of introduction of these provisions, given the fragile state of market and economic recovery.

In reviewing this chapter of the consultation, we have come to the view that its application will require a considerable amount of supervisory resource and think that the FSA may have under-estimated this in the CBA. We seek assurance from the FSA that they have sufficient resource to not only implement the new requirements but to also maintain the business as usual functions.

Specific issues relating to CRD 2

Significant risk transfer

As the CP is currently drafted firms are unclear as to whether they will have to submit waivers or indeed notifications, in respect of transactions that they have already undertaken. To do so, particularly given the timetable for implementation, will be incredibly burdensome for both firms and the FSA. We believe that the SRT proposals as written should only apply to new transactions undertaken after the end of this year which cover different asset classes than transactions previously undertaken by the firm. We seek the FSA's agreement on this point.

We also note that by changing the title of Section 9.3, the FSA appears to be applying the significant risk transfer requirements to sponsors. Since a sponsor has never had the assets
on its balance sheet, it does not make sense to apply the provisions regarding significant risk transfer, nor do we believe it is required by the CRD.

While not able to address its contents in this consultation response, we note the FSA’s letter to trade associations of 26 February on tranche protection trades. As discussed in the Securitisation Standing Group of 8th March, the industry is intending to respond to this letter and look forward to obtaining further clarification on the FSA’s thinking in this area in the proposed ad-hoc meeting of the SSG to cover this development.

**Notification for mechanistic approach**

As currently written this appears to actually be a ‘non-objection’ process and one which will not be workable in practice as outlined, i.e. with notification up to one month after the transaction has been undertaken. The regulatory uncertainty introduced by the possibility that the FSA may decide that SRT has not been achieved, will mean that firms will in practice have to submit details of proposed securitisations some time in advance of the transaction to show how the proposed sale of the mezzanine/first loss positions would equate to a commensurate risk transfer, to ensure that when the transaction goes ahead the economics of the transaction stack up. This is not a practical approach. It was our understanding when the CRD 2 was being negotiated that the mechanistic approach was intended to be simple and therefore capable of being implemented by the full range of CRD firms. It is unreasonable to expect such smaller firms to have full economic capital models and therefore this safe harbour approach will not have the benefits we believe were intended. As a result we think that the approach outlined requires further review. It is recommended that consideration be given to a materiality level whereby any securitisation below that level will not be subject to notification and/or the agreement with the FSA that a firm carrying out a transaction that matches previous structures which qualified for commensurate risk transfer will do so again.

**Waivers for the commensurate risk transfer approach.**

Members consider that the period of 6 months is too long and would effectively prevent any public issuance in the early part of next year. While the recovery in the securitisation market is still very fragile there has been some public issuance in the last few months and it would be unfortunate if that was chopped off completely, particularly given the likelihood of the scaling back of central bank liquidity over the coming year. It is also unclear whether the comments in paragraph 5.27 encouraging firms to approach the FSA at an early stage amount to a shadow waiver process, as conducted in advance of the CRD implementation for IRB. As a result Members request clarity on the timing of the ability to submit waivers and for the period to be shortened to 3 months. Members would also like to pursue, with the FSA, the possibility of agreeing an ‘in principle’ approach, with self-certification by firms that they have abided by the agreement, which would allow them to pursue transactions. We think it particularly important that firms be allowed to pursue this self certification route when the structures and asset classes they cover are similar to, or the same as, previous transactions.

Members also seek further clarity on how the waivers will work in practice. Although we note that it is the FSA’s intention for them to be by asset class, members are concerned that if the waivers are drawn up very tightly, small tweaks to structures will effectively mean that waivers will need to be sought on a transaction-by-transaction basis, which will be a particular issue if the waiver period remains at 6 months. We would also like to discuss the potential asset classes further with the FSA. We think these should correspond to CEBS COREP guidelines as outlined below, plus include insurance and PFI assets: ie COREP guidelines cover: residential mortgages, commercial mortgages, credit card receivables, leasing, loans to corporates or small and medium sized enterprises (where these are treated
as corporates for regulatory capital purposes), consumer loans, trade receivables, securitisation (re-securitisation), and other. The ‘other’ category, therefore should include PFI and insurance.

Due diligence

Members look forward to getting further clarity, through CEBS, on the application of the investor due diligence requirements and penalty. As the deadline for implementation of CRD 2 is looming, Members would like to know when the consultation on this issue will become available, and how the FSA intends to implement the guidance once finalised.

BIPRU indicates that these provisions apply only to banks; we note that the generality of the CRD is intended to apply to both banks and investment firms.

Reporting

We note that there have been some fairly minor changes to FSA046 and that FSA058 has been introduced for the trading book. We are unclear as to the need for the introduction of FSA058 as we believe this requirement can be met by the completion of FSA046, with ‘asset class’ differentiating those securitisations relevant to trading book and those not. This will ensure a more streamlined and effective process. We urge the FSA to reconsider this and will be happy to discuss further.

Specific issues as regards CRD 3

As highlighted at the outset of our response to this chapter, we have significant concerns with the FSA seeking to move ahead with aspects of CRD 3 when this has yet to be agreed in Europe, although we recognise that the FSA has not sought to implement all these provisions in CP09/29. We are concerned by the potential for the UK financial services industry to be put at a disadvantage. Specifically we have key concerns over:

Grandfathering and implementation timeline

As previously highlighted, while we appreciate the desire of the authorities to change certain behaviours, it is not possible to do that, or change transaction structures, retrospectively. We therefore believe that the UK authorities should be pursuing grandfathering arrangements in CRD 3, which would significantly help the current position. We also think that the UK authorities should press for further consideration to the timing of introduction of these provisions, given the fragile state of market and economic recovery.

ABCP conduits

As regards the treatment of exposures to ABCP conduits, we note the FSA’s commentary in the text of the consultation paper, which is generally helpful. However there is no reference to this in the BIPRU rules. We believe that firms require certainty on the treatment of these exposures and these revisions should be included in the main body of the CRD. Convergence of approach across the EU is essential. We therefore look forward to discussing this issue with the FSA in the Securitisation Standing Group.

Highly complex re-securitisations

We note that the consultation does not address the issue, but we are very concerned by the Commission proposal for a concept of ‘highly complex re-securitisations’. We believe that the issues that this provision is trying to address are already covered by the stringent due
diligence and investor penalty requirements contained in Article 122a. Firms will not be able to invest in such transactions unless they are able to demonstrate to the FSA and other relevant supervisors that they have a good understanding of the risks of the position (including the underling assets) and the transaction structure and of the performance of the originator/sponsor. As a result we think that this provision is unnecessary and that the risk of automatic deduction is adding an additional drag on the currently very fragile securitisation market. While we appreciate the desire of policy makers to change certain behaviours and to ensure that positions are adequately capitalised, this measure is unnecessary. We would urge the UK authorities to continue to support the Council’s current position and push for a removal of this provision.

**Self guaranteed’ securitisation positions**

We understand the logic of the proposal in relation to transactions where the level of unfunded support is significant (for example liquidity facilities to ABCP conduits) and is a big driver of the rating assigned. However, based on our interpretation, it is a significant concern that this provision would also affect transactions where the level of support is not material, and, often provided as an ordinary banking service, for example small liquidity facilities, interest rate and foreign exchange hedging positions to transactions such as RMBS and SME CLOs and also to hedging facilities to ABCP conduits. The requirement, which withdraws the ability to use the rating on the securitisation positions can have a significant impact on the capital required (7% to 1250%/deduction in certain instances) and is unwarranted by the marginal risk associated with these ancillary instruments. Additionally the IAA will be unavailable for the majority of these positions and therefore they are not susceptible to the overlapping positions provisions. We therefore think that the UK authorities should seek a clarificatory amendment to the CRD that reflects the level of support provided and avoids capture of such ancillary structuring elements. Given that a large proportion of term and ABCP conduits require interest hedging facilities, the potential consequences are considerable in terms of the viability of these structures if hedging counterparties can not be found.

**CRD 3 implementation issues**

In terms of implementation of any proposals for re-securitisation, the proposed definition (i.e. any transaction that includes one or more securitisation positions) has highlighted an issue in relation to the definition of securitisation, namely whether there is a risk that A/B loan splits, which are used on commercial real estate transactions, are securitisation positions. In one of the early SSG standing groups this was discussed and the FSA indicated that such transactions would not be caught by the securitisation definition, but this was never reflected in specific wording in BIPRU. As a result members would like to confirm that this position remains the FSA view and that guidance will now be added to BIPRU.

In addition, Members have been in discussion with you in respect of the treatment of internally re-structured transactions, which have been undertaken to assist with current market problems. We were, as a result, expecting the consultation and BIPRU to provide guidance on this issue, but note that it has not been covered. Given the significance of being caught by the re-securitisation definition, we think that BIPRU should provide clear guidance on this point that would indicate that such transactions would not be caught by the definition.
Response to specific questions:

Q23: Would you find additional guidance useful? Please detail the specific areas and suggested text in your response.

Members would find further clarity helpful in the following areas:

- **9.1:** application of BIPRU 9 to the trading book – which parts apply and which do not and for appropriate cross referencing to be included in BIPRU 7. We are particularly concerned that in BIPRU 7 the approach taken only partially incorporates the appropriate elements of BIPRU 9, i.e. only the risk weight tables. It does not, for example capture the alternative approaches, such as ‘inferred ratings’, credit risk mitigation, or the 1.06 scalar on the risk weights. Further consideration is required as to how these elements of BIPRU fit together. BIPRU 7 should refer to all the applicable rules within BIPRU 9.9 to 9.15

- **9.1.1, 9.3.15 to 20** – Is there any reason why these provisions should apply to banks alone? The CRD is entirely cast using ‘credit institution’ but it applies to investment firms as well.

- **9.3.15:** origination standards applied to exposures for securitisation - Firstly we think that ‘whether’ should be replaced by ‘when’ in the first line, otherwise this could also be applied to a firm acting as investor. Secondly, but more importantly firms thinks that there needs to be further clarity on how these requirements would apply when purchasing a portfolio of assets. The due diligence that will be undertaken on a portfolio will undoubtedly be different to the processes undertaken when originating a single exposure. There needs to be recognition of this fact. In addition since firms may not necessarily have policies for purchasing portfolios to hold to maturity we would like to discuss further with the FSA how this requirement might be met.

- **9.3.16:** We acknowledge that this is copy out of the Directive text but this section has never been clear. Underwriting is considered a trading book activity only under the CRD, therefore we do not understand how you can have the same standards as transactions underwritten in the non-trading book. The standards for underwriting will also very much depend on what is being underwritten therefore it is also not possible to say that it should be the same as underwriting standards for other asset classes. Underwriting standards will also not be the same as origination standards for single exposures in the non-trading book. We would therefore like to discuss further with the FSA how this area will be approached in practice to determine what, if any, further guidance might be needed. As regards participations, we are also unclear as to what is meant and would like to discuss this issue further as well.

- **9.3.19:** We would like to discuss with the FSA the approach it would take in relation to existing transactions (caught by the substitution clause), where it may not be possible to obtain all the information required, particularly if the originator is in a third country and not bound by these requirements.

- **9.3.20:** We would like to discuss with the FSA how materially relevant data will be interpreted in practice, particularly in relation to the CEBS large exposures guidelines.

- **9.3.21:** application of penalty on originators when they fail to comply with disclosure requirements – We are uncertain how the penalty charge on securitisation positions would be applied to the originator, particularly if it is not holding positions in the transaction. This is an area where the Directive is particularly unclear as the penalty was introduced for investors and then subsequently applied to originators as well. As a result the text has been difficult to comprehend.

- **9.15.9R:** We would like to discuss with the FSA how certain jurisdictional variations would be treated e.g. Australian RMBS. In some third countries similar provisions
are in place, with local exemptions arising from special factors (such as government schemes not covered by 9.15.9).

**Q24: What guidance do you think should form part of CEBS guidelines? Please detail the specific areas and suggested text in your response.**

We think that the CEBS guidance should cover:

### Retention

- The additional methodologies for retention covered in the CEBS advice on Article 122a.
- The additional clarification that the advice contains in relation to master-trust transactions, where the liabilities revolve rather than, or in addition to, the assets.
- The implications for a firm, as investor, when the originator/sponsor/original lender has not retained the requisite 5%.
- How whole business transactions, undertaken on behalf of non-BIPRU firms such as corporates, should be addressed.

### Investor due diligence penalties

- The basis for scaling up of the 250% penalty charge.

**Q25: Do you agree with our approach to notification?**

No.

Please see key issues as regards specific issues re CRD 2.

**Q26: Do you agree that the high level information requested should be set out in guidance? Please detail any additional areas that firms should submit to help our analysis.**

Given the comments regarding the notification above we would like to discuss with the FSA the best way to make the provisions workable, including the information to be provided.

**Q27: Do you agree that one month is a reasonable long-stop time period to receive any notifications?**

As we do not believe that the notification requirement as currently drafted can work without firms contacting their supervisor well in advance of the transaction completion, the one month deadline is irrelevant. As noted above we would like to have further discussion with the FSA on how to make this requirement work in practice.

**Q28: Do you agree with our proposal to assess firms’ compliance via a waiver?**

We think that a waiver based approach is sensible, however we have significant concerns about how it would work in practice (please see key issues).

**Q29: Do you agree with our interpretation of the CRD?**

Yes.
Q30: Do you consider further guidance necessary in this area? Please provide detail on key concerns in this area.

We remain concerned that an appropriate interpretation of the requirements can be found for master trust structures as these transactions finance the real economy, particularly mortgages. We also think that the ‘L shaped’ retention requirement suggested in the CEBS Advice should be possible under the existing requirements. Transactions arranged for corporates should also be appropriately treated, as these also finance real assets and are not related to the problems identified with the originate-to-distribute model. Further we continue to think that the provisions on retention should reflect the risk retained and not focus on nominal.

We regard the disclosures necessary to ensure that investors are able to meet the investor diligence requirements in respect of retention to be a matter for the industry to resolve (as it will potentially involve transaction covenants and reporting), and therefore do not seek further guidance in BIPRU on this matter.

We would also like to discuss with the FSA the interrelationship between the requirements imposed under Article 122a and the CEBS guidelines on Large Exposures, which include look through. In chapter 4 we have highlighted our concerns on these guidelines and are seeking further clarity from the FSA on what it intends to do with the guidelines. However, one element is pertinent to the disclosure requirements in BIPRU 9. If all information that must be disclosed to meet the CEBS guidelines is deemed to be material information that should be disclosed to investors, we think that there could be serious problems in relation to data protection, since the guidelines cover retail transactions as well as other asset classes. We also do not think it would be possible to meet the level of disclosure that would be required by the CEBS guidelines.

Please also see Q23 and our comments on 9.3.19.

Q31: Do you agree with our approach of providing guidance when the CEBS guidance is issued? Please provide detail of what the guidance should cover.

European consistency is important, so we would not want UK to diverge from other countries. However, given implementation date, firms would like to know when the draft guidance will become available for consultation.

Please see our answer to Q24.

Q32: How should we implement the Directive to make the sanction for non-compliance practically effective to assets originated on the trading book? Please provide detailed reasoning for your proposed approach.

As well as the penalty aspect we think that there are other issues around the application of the requirements in the trading book that require further consideration, notably BIPRU 9.3.15 and 16 (see question 23).

Q33: Are the changes to FSA046 clear? Please detail if you think there are areas where the form could be improved.

The changes to FSA046 seem reasonable. However, we are unclear as to why a new report under FSA 058 has been introduced when we believe FSA046 can cater for this requirement. This will ensure a more streamlined and effective process. We urge the FSA to reconsider the requirement for FSA058, and will be happy to discuss further.
In addition members have highlighted some additional areas where clarification could usefully be provided:

- How should impairments under BIPRU 9.10.4 or 9.10.6 be treated?
- How should capped exposures be reported (BIPRU 9.12.8) in risk positions?
- Linked to the earlier point regarding grandfathering, how should existing transactions be reported where they pre-date the new requirements (columns I to P)?
- Should exposures subject to the IAA be reported in column M or allocated to a CQS?
- We would like to discuss the treatment of exposures to multi seller conduits.

**Q34: Do you agree with the securitisation CBA?**

As noted in the key issues, we think that the amount of capital required by the proposals may be understated and that the FSA may need more resource than is currently indicated. We are very concerned by the implications of the changes to the securitisation framework for the recovery of the securitisation market.

**Detailed Comments on Draft Handbook (not covered above)**

<table>
<thead>
<tr>
<th>Glossary definition of mezzanine</th>
<th>Clarification is sought that the most senior position for these purposes would not include swaps or liquidity facilities given that otherwise (a) and (b) do not always work. In addition we believe that the determination of mezzanine should be made at inception of the deal and seek confirmation that this is the FSA’s view.</th>
</tr>
</thead>
</table>
| Glossary definition of re-securitisation | Re-securitisation  
We would like to discuss with the FSA how the definition of re-securitisation positions should be applied in certain circumstances. For example, transactions in certain jurisdictions, where a two SPV structure is required. Italian securitisations of warehouses are subject to a lock-up period (Guercino) as a consequence of which the securitisation’s assets are initially the notes of the warehouse securitisation (the pool should be fixed at the term-out point). At the end of the lock-up period the warehouse notes fall away and the term securitisation has a direct interest in the pool of assets. To all intents in structuring the transaction and providing information to investors and raters, there is a look-through to the underlying pool. It is understood that there is no mix of assets in terms of the term deal including both warehoused and un-warehoused assets. We do not believe that these transactions should be regarded as re-securitisations. |
| 9.1.6 and 9.1.9 | CRD now refers to the term investor. This is not a defined term in BIPRU and we should like to discuss this further. |
| 9.3.7 | Further guidance is required on the suggested changes to significant risk transfer requirements in BIPRU 9.3.7 and the definition of mezzanine securitisation positions. We would suggest that the definition should refer to a securitisation’s tranching at inception. The definition of a mezzanine position dependant on the rating being between CQS2 and CQS11; however, due to credit rating migration a mezzanine position could be later downgraded to a risk weight of 1250%. An originator would then be limited to holding no more than 20% of the tranches rated at 1250% even though the there would still be protection provided by the original |
first loss note holders, as credit assessments do not reflect the intrinsic value within the assets.

9.3.19 Although this is a problem with the underlying CRD, we think that ‘securitisation exposure’ should be interpreted as ‘securitisation position’ and that collateral should be interpreted as ‘securitised exposure’ to make it consistent with CRD and BIPRU defined terms. We also note the use of ‘credit institution’ For avoidance of any doubt we suggest that 9.3.19 R be slightly amended: The sponsor or originator credit institutions of a securitisation must ensure that prospective investors have readily available access to all materially relevant data concerning it such securitisation, …

9.3.20 The punctuation in the original CRD text is non-existent, we think that, as transposed, the comma is in the wrong place and recommend that it would make more sense as follows: … and, where appropriate, due to the nature of the securitisation, thereafter.

9.3.21 We suggest that reference is made to this provision in BIPRU 9.12 as it applies to the originator in its capacity as investor in its own transaction

9.7.2 (5) and (6) While we note that the text is located in the section that is proposed in the CRD, this requirement does actually represent a treatment that firms must apply in specific circumstances rather than a general point about the recognition of credit assessments by ECAIs, as such we think it would be more helpful to users if this text was relocated to BIPRU 9.11 and 12.

9.7.4 Similarly 9.7.4 should be relocated to BIPRU 9.11.11 and 12. We note that the Draft Council text indicates that supervisory approval is necessary for this treatment but do not believe that this is required in Basel. Also there is an extra ‘s’ on commercial paper (also in 9.9.10)

9.15.3 We would like to discuss with the FSA who retain in the context of certain CDO transactions. Where the assets purchased into the structures are defined in their main characteristics (rating, concentration limits, maturity etc) by the equity and debt holders, we think the equity holder should be regarded as the sponsor on the grounds of ‘establishment’ and setting the parameters for ‘management’ rather than the asset manager hired to carry out the instructions.

9.15.5 The use of “at the origination” here is ambiguous since this word is invariably associated with the origination of the underlying assets being securitised. We would suggest that this should be interpreted as “at transaction close”.

We continue to believe that macro-hedging undertaken to address interest rate risk, should not be regarding as hedging for the purposes of this provision, as it does not change the originator/sponsor’s interest in the credit risk.

9.15.11 As intra-day trading would not constitute investing as there is no holding period, Members assume that the investor due diligence provisions would not apply.

In addition Members would like to discuss with the FSA the application of these requirements to hedging instruments.
Response to Chapter 6 - Trading Book Capital

Key issues

Alignment with international agreement is essential. It is not in the interest of the overall industry or regulatory communities for any one country to move ahead with changes prior to international agreement being reached, given the resultant potential unintended consequence of regulatory arbitrage.

The CRD 3, July Basel package amendments are still subject to discussion. In addition the Basel Trading Book Working Group has only recently received firms’ data under the QIS exercise and is considering the calibration of the requirements as well as the detail of some of the requirements. As a result it is difficult for the industry to come to a definitive view on the implementation of the requirements, when areas of policy are still not settled. The areas on which we have particular concerns are as follows:

- Correlation carve-out – the inclusion of this provision in the CRD is essential for international convergence, consistency and competitiveness.
- Floor on the correlation carve-out – only if the Basel Committee determines that a floor is necessary do we believe that one should be included in the CRD. The current calculation of the floor based on the standardised rules is impractical and creates perverse incentives, due to the inability to take proper account of hedges.
- Timing of introduction of changes – as discussions are ongoing and since it is difficult for firms to develop models in the absence of definitive text, given the current timetable for implementation, let alone supervisors review what firms have done and opine on the appropriateness of models, we believe that there should be a staggered timetable for implementation of the trading book requirements. In particular the standardised rules for securitisation positions and the correlation carve out should be deferred. If the EU does proceed ahead of Basel, we think there are some technical issues that will need to be resolved in the CRD, which are reflected in the guidance to firms for the Basel QIS exercise – for example a maximum loss cap and provisions around the application of the supervisory formula.
- 10 day holding period – We do not believe that a difference between Basel and the CRD is warranted and therefore are seeking the reinstatement of ‘equivalent’. The change to a 10 day holding period will have a significant impact on the way that firms model VaR for regulatory purposes thereby breaking the link between risk management and regulation and undermining the use test.
- Potential for double counting: the implementation of changes should ensure to avoid the introduction of ‘double counting’ of risk.

As regards implementation, although we recognise the tight timeline that is currently envisaged in the draft legislation, we reiterate the points made in the February Market Risk Standing Group and in the follow up letter to Paul Sharma on 12th February to which the FSA replied on 4th March. In particular members are concerned that the data received from the questionnaire will be used to develop detailed guidance before policy has been settled, a narrow approach to implementation will be adopted precluding investigation of other alternatives (firms are still in the process of model development); there will be divergences between the FSA’s approach and other international regulators; and, business as usual model recognition will suffer because of the focus on the new requirements. Flexibility of approach will be essential if firms are to meet the time deadlines. Rather than developing guidelines, at this stage members would like to engage in a further dialogue with the FSA so that they can understand how the FSA proposes to approach the supervision of these models; its risk tolerance, and the areas where it considers it can be more flexible and those
where it cannot. Sufficient resources still need to be made available to address business as usual model developments, as these are equally important to members and we remain concerned that FSA has not made sufficient allowance for this. Finally, we believe that the UK authorities, including the FSA, should support efforts to delay the implementation date in the Directive – better, more robust models will result, which is in the interests of both firms and supervisors.

Although we appreciate the direction of regulatory intent, we would like to engage in further discussion with the FSA over the issues that cause regulators to believe that it is inappropriate to include securitisation and correlation trades in VaR, stressed VaR and IRC. In the interests of developing risk management frameworks we think it is useful to continue discussions on this point.

Many of the questions in this section of the response, request information on which the industry would like further guidance. In light of our comments above, we do not believe that it is appropriate to include further guidance until agreement has been reached on the policy itself and supervisors have agreed on convergence of approach.

Members think that the costs included within the CBA are too low. As you are aware the results of the targeted QIS exercise have recently been submitted. Firms consider that the costs associated with the introduction of the non-trading book securitisation charges will have a very material impact. In addition, the results of the correlation carve out provisions differ markedly depending on the interpretation taken of certain provisions, in particular the ability to include a cap for maximum loss and the ability to use proxies to determine Kirb in the supervisory formula. These issues will need to be addressed if the EU process runs ahead of the Basel work stream.

We support the removal of BIPRU 7.11, which will remove the inconsistency between the UK and other jurisdictions. Many of the issues that it was intended to address will be tackled by other changes to the trading book regime, making it redundant.

As a general point, the industry would appreciate more clarity from the FSA on the proposed fundamental review of the trading book, its timing, scope and objectives.

Q35: Do you believe that we should provide more detailed guidance on the factors that firms should consider when selecting a stressed historical period?

No. Please refer to key issues.

However, members would like to engage in further discussion with the FSA on the flexibility that might be possible in determining the eligibility of stress testing data and how to address instances where there is no historical data for new products. In the latter case the industry considers that proxies should be used instead of historical data.

Q36: What other areas of the stressed VaR capital charge would you find useful to have guidance on?

No further guidance required.

In relation to stressed VaR, members note that the introduction of this measure is likely to reduce the quality of the dialogue with front office, since this is not the risk measure that is currently used for management purposes and may place undue emphasis on this period.

As regards VaR more generally, the industry would like to understand the supervisory view on what is missing from firms models in relation to securitisation positions, i.e. what would
need to be done to reincorporate these positions into the modelling framework. We acknowledge that the current proposed Directive will not permit this, but think that in the longer term a modelled approach would be more appropriate, particularly as a portfolio approach is more consistent with the risk management approach adopted by firms.

**Q37: What additional guidance on IRC should we provide?**

No guidance is sought, although a proposal is put forward for BIPRU 7.10.55J. The industry considers that the existing Basel text and CRD are sufficiently clear and provides sufficient information for the transposition of IRCs.

More specifically we fear that by compartmentalising the Incremental Risk Charges (IRCs) there is a risk of double counting with stressed VaR and VaR.

**Q38: Do you believe that we should provide additional guidance on the application of the implicit support rules and due diligence requirements to securitisation positions in the trading book?**

No further guidance required. Please refer to key issues here and within our response to chapter 5 on Securitisation.

**Q39: What other additional guidance would you find useful in helping to apply the non-trading book securitisation requirements to securitisation positions in the trading book?**

No further guidance required at this stage. As noted in the key issues, the industry believes that the quantitative impact of the correlation carve out provisions depend materially on certain interpretations taken in the calculations, in particular in relation to a cap on maximum loss and the calculation methodology used to arrive at Kirb. In addition since the provisions in this area of the trading book are not finalised and because the implications of the securitisation non-trading book capital charges are very significant and utterly intertwined with the correlation carve out we believe that these provisions should have a deferred implementation date.

We would also add that any guidance given should not give rise to perverse incentives to book in either the trading or non-trading books.

**Q40: Do you believe that we should provide additional guidance regarding what additional positions can be included in the correlation trading portfolio for hedging?**

No. The correlation carve out provisions should be finalised first.

**Q41: Which key areas should we focus on when developing industry guidance for the all price risks measure?**

We believe it is premature for the FSA to formalise an approach to the All Price Risk measure when international capital standards and recommendations are still under review. We recommend that the FSA postpone formalising guidance on price risk measures until the conclusion of the BCBS consultation process upon ‘Strengthening Resilience in the Banking Sector’ and parallel QIS analysis, with ensuing recommendations.

The current focus should be on benchmarking good industry practices though horizontal theme works.
Q42: What is the impact of this increase in the standard rules specific risk PRA to your firm?

The proposal does not have an impact on firms with equity CAD 2 approval.

Q43: What is the impact of this change in the treatment of nth to-default credit derivatives on your firm?

Members do not believe that the impact of this change will be significant.

Q44: Do you agree with this CBA?

The industry believes the cost assessment is under-estimated. The QIS analysis now underway with selective institutions should provide a clearer view. As regards point 6.51, the industry welcomes the fact that the FSA will subject its super-equivalent rules for securitisation credit derivatives to further consultation in 2010, and would reiterate that the FSA should align closer with existing CRD 2 rules and international agreement. We believe that it is essential for a level playing field to exist internationally in the adoption of capital standards and the UK financial services sector should not be disadvantaged in the international capital market by the enhancement of any one 'principle'.

We also regard the cost of capital figure of 4.7% (quoted in point 6.72) to be too low. Given the number of firms that will be seeking to raise capital over a very short period of time, the actual rate that firms will need to pay to entice investors will have to be significantly higher.

As regards the existing capital requirements for the trading book, we would also note that the baseline calculation will already be significantly higher than it was two years ago as a result of deteriorations in credit quality and the tightening of the supervisory approach to models

Detailed Comments on Draft Handbook Text in Appendix 4

| 7.2.35 | Scope of the Correlation Trading Portfolio: Please refer to our key issues and response to questions 39 and 40 above. We believe it is premature for the FSA to prescribe rules when Correlation Trading is still subject to international review |
| 7.2.47 A to I | As also noted in our comments on the Securitisation Chapter, we think that further consideration needs to be given to how BIPRU 7 and 9 link together. As currently drafted we do not think that BIPRU 7.2.47 A to I fully captures the approach that firms should be taking and think that it would be more appropriate to reference BIPRU 9.9 to 9.15 rather than partially re-create the requirements here. Such an approach would minimise the possibility of unintended consequences from transposition now and for any changes to the regime going forward, as well as better reflecting the draft CRD language. |
| 7.2.47 E | We would like to discuss with the FSA how the standards applying to the use of the supervisory formula would operate. |
| 7.10.30.A | The text currently reads as 12 months continuous vs historical period of 12 month minimum. CRD 3 is not that definitive and Basel is not that specific. Firms may have a legitimate reason for selecting a period in excess of 12 months and should not be precluded from doing so. We recommend the following amendment to paragraph 7.10.30.A : |
The stressed VaR measure must be based on inputs calibrated to historical data from a continuous twelve-month period of a minimum twelve months of significant financial stress to the firm's portfolio. " - as I said institutions may have a legitimate risk based reason to select a period longer than 12 months and should not be precluded from this by regulation.

<table>
<thead>
<tr>
<th>7.10.55J</th>
</tr>
</thead>
<tbody>
<tr>
<td>We request that one further sub-point be add in (4) Where default of instruments, bonds or CDS, is triggered by the same event, then exposures in these instruments are aggregated taking into account their different prices and different recovery factors provided that these instruments are outstanding at the point of default. This aligns with how portfolios are market risk managed and will not penalise institutions that have taken credit protection out.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>7.11 and 7.2.47B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Although we acknowledge that this is an existing issue with respect to the language used in BIPRU we would like to discuss with the FSA the basis for exposure value that should be used for credit derivative positions. BIPRU 7.11 and 7.2.47B both indicate that the notional amount should be used. However, if a credit derivative is used to hedge a cash position, for example, the use of the notional bond position will create a net position where none actually exists because the cash position will be recorded, in line with the rest of the market risk requirements, at market value. A discrepancy therefore arises between risk management and regulation, where really there should be none because the firm is fully hedged. We believe that it should be possible to interpret the requirement to reflect the reality if the market value of the bond is used, applied to the notional amount of the bond held.</td>
</tr>
</tbody>
</table>

In addition in relation to the CRD 3 proposals we would also highlight the need to consider the inclusion of a maximum loss cap. We are concerned that the standard rules may imply the use of legal maturity and undiscounted future premiums which may significantly overstate the potential future premia associated with bought protection.
Response to Chapter 7- Prudent Valuation

Key issues

The CRD amendments extend the prudent valuation framework to all fair valued positions and reiterate regulators' ability to require adjustments beyond those required by financial reporting standards.

We support the decision to retain the FSA's existing approach, i.e. applying to all fair valued positions in both the trading book and banking book.

We note however that it is stated that no decision has been taken on whether these changes may later apply to insurers. We would urge the FSA to apply the new rules to insurers for the sake of consistency and a 'level playing field' across the financial services industry.

A bank and an insurer may hold the same instrument, but value them differently- we do not believe this should occur and to ensure alignment strongly recommend the FSA extend the amendments outlined in this chapter of CP09/29 to insurers.

Although we note that regulators may have different objectives in reviewing accounting information from other users of accounts, from a firm’s perspective significant divergence from audited financial statements is undesirable as it is operationally intensive and potentially confusing if it results in “two sets of accounts”. There is no one, right value for an instrument but a range of values (otherwise there would be no markets), therefore the FSA should take account of the degree of conservatism in the firm’s approach. We acknowledge that full convergence would require movement in the position of both the accounting and regulatory professions.

Q45: Do you have any observations on the amendments to the prudent valuation framework?

Please note the above and as follows:

Policies and procedures

We support the issue of in-house guidance for the valuation of items where inputs are unobservable.

Whilst we agree with the sentiment that firms should mark to model “conservatively”, this idea raises issues which need to be considered. For example, if a firm cannot mark to an observable market price, how can it prove that it is marking conservatively? It may be possible to mark to an extreme of possible values (e.g. correlation at +/-100%) or write off a portion of the trade (options). However, neither of these approaches is valid – the firm should aim to mark at its best estimate of fair value (to generate the right PV and risk), and apply reserves around uncertainty. This would result in a conservative outcome but is not marking 'conservatively' as required by the rule.

It would be helpful therefore if the rules were to clearly state what the expectation is for documenting how conservatively mark to model valuations have been performed and for this to reflect practice. The substance should simply be a) achieve best mid estimate of the unobservable and b) specifically identify the range or uncertainty in the unobservable.
Model risk

We support the requirement for firms to take model risk into consideration when making valuation adjustments. This formalises best practice adopted voluntarily.

Valuation adjustments

We support the requirement for firms to consider whether valuations for fair value positions should be adjusted to reflect a “prudent value”. However, the reference to positions is unhelpful. Uncertainties may be better considered at the portfolio level where uncertainties offset (though positions may not). Considering some of the un-observable factors at the position level may be both excessively time consuming and lend a spurious level of accuracy to the resulting analysis.

Regarding liquidity adjustments, we note that, if a firm has appropriate bid-offer reserves, then valuations should already be at ‘prudent’ values.

Cost benefit analysis

We agree that firms are already meeting these requirements and, therefore, will not incur significant additional costs. However, we would like to highlight that significant divergence from audited financial statements is undesirable as it is operationally intensive and potentially confusing if it results in “two sets of accounts”, although we accept that any convergence may require some movement in position from both the accounting and regulatory community.
Response to Chapter 8- Pillar 2 & 3

Q46: Do you believe that our approach to implementing Pillar 3 remains appropriate?

We support the decision to retain the existing implementation approach, i.e. straight copy-out without the provision of additional guidance. In reaching this view, we recall that the original purpose of Pillar 3 was to encourage market discipline and that the disclosures were therefore intended to be made by the market for the market. Interpretation of the requirements should, in our view, remain the responsibility of banks, in communication with their stakeholders; which of course includes regulatory authorities. Further, we fear that interpretation or guidance could lead to confusion and fragmentation in how these, global requirements, are applied. For this reason we believe that the industry is best placed to develop and promulgate any guidance, should it be deemed necessary.

In formulating our opinion, we recall the considerable volume of work undertaken by the industry to prepare for the first time publication of Pillar 3 disclosures in 2009. This work focused - both in the UK and across the EU - on interpreting the requirements of Pillar 3 with a view to increasing the utility of Pillar 3 disclosures for the market. The CP rightly notes that the analysis of initial Pillar 3 disclosures undertaken by CEBS in June 2009 found that this industry work had been successful in that it resulted in the provision of information to market participants that allowed them to better assess banks’ risk profiles and capital adequacy. This industry work continues in preparation for disclosures relating to the 2009 year-end and will go forward to assessment of these new requirements ahead of 2010 disclosures.

Q47: Do you have any comments on our approach to implementing the changes to public disclosure requirements?

We believe the assessment of the implementation costs associated with the package of amendments to be a reasonable estimate. It is too early as yet to assess the success of Pillar 3 disclosures. Our experience to date has been that market participants have shown limited interest in the disclosures. We would anticipate this to change, however, as trend information begins to become available and the markets’ understanding of the disclosures improves. To this end, we have engaged in a number of market education events – both on an industry basis and through CEBS – to seek to explain the purpose of Pillar 3 to market participants and to understand their information needs. We believe this is entirely in keeping with the Basel Committee’s original intention for Pillar 3.

We note that the revised framework extends the scope of the disclosure requirements beyond information specifically linked to the computation of minimum capital requirements under Pillar 1. Pillar 3 should not, in our view, become the location for catch all risk disclosures relating to an institution’s activities. Institutions already devote considerable space within their Annual Report and Accounts to communicating their risk profiles and the processes and procedures used to mitigate these. Duplication of these disclosures in Pillar 3 documents is both unnecessary and risks obscuring the disclosures made with regard to Pillar 1.

In terms of the technicalities of the transposition, we note that there are certain areas where the FSA proposes to introduce requirements over and above those contained in the Directive. Most notably in relation to VaR Model disclosures under BIPRU 11.5.13, where separate disclosures are required in relation to the All Price Risk Measure, and in relation to disclosures on SSPEs under BIPRU 11.5.17 (4a), where it would appear that there is a requirement to disclose a list of the entities that the firm manages or advises and that invest in either the securitisation positions that the firm has securitised or in the SSPEs that the firm sponsors.
We also note an error in BIPRU 11.5.17 (3a) which states: '...including how the behaviour of the underlying assets impacts re-securitisation positions...' whereas the Directive reads: '...including how the behaviour of the underlying assets impacts securitisation positions...' (p.8, 14ca).

Finally we observe that BIPRU 11.5.17 (6B) requires ‘an explanation of significant changes to any of the quantitative disclosures in BIPRU 11.5.17 R (14) to BIPRU 11.5.17R (17) since the last reporting period.’ However, the proposed handbook text does not include subsection 16 or 17 only 14 and 15.

We would welcome clarification of each of these points.
Response to Chapter 9 –Technical amendments

The industry welcomes the technical amendments which in large part will simplify and confirm existing capital treatments in the CRD.

**Q48: Do you agree with our proposed approach to implementing the CRD technical amendments?**

The Associations generally support the changes proposed to the FSA handbook text, but note the following:

**Internal ratings based approach (IRB)**

**Requirements to be satisfied for use of guarantees by IRB firms [paras. 9.11-9.13]:** The Basel Committee is currently looking into this issue and the industry therefore would welcome a globally aligned solution. We therefore urge the FSA to delay rulebook changes. In addition as regards points 9.19 and 9.20 the industry assumes that “EU Member” states was intended to read EEA member states but confirmation is requested.

**Credit risk mitigation (CRM)**

Conversion factors [9.38 – 9.43]: The industry maintains that conversion factors should apply after calculation of the exposure values. Members would like to therefore suggest changing the FSA proposed handbook text to better align with industry best practices and the original intentions of the CRD text which also align to Basel requirements. We believe that the intent of the CRD amendment was to ensure that when a firm determines the proportion of an off-balance sheet exposure covered by a credit risk mitigant that they look at the value of the exposure before the application of the credit conversion factor. The original credit conversion factor should however continue to apply to both covered and uncovered portion (if any) in the capital calculations.

The following example using the Standardised Approach for simplicity explains:

Assume a firm had an undrawn credit facility of 100 with an original maturity of 11 months, to a corporate customer with Fitch rating of BBB+

**Unsecured** this would result in:

\[ \text{RWA} = 100 \times 20\% \text{ (CCF)} \times 100\% \text{ (CQS3)} = 20 \]

**Secured**

Now assume that a firm had 100 of collateral provided by a Fitch rated A+ corporate

\[ \text{RWA} = 100 \times 100\% \text{ (CCF)} \times 50\% \text{ (CQS2)} = 50 \] (The 100% CCF is the FSA interpretation)

Which is inappropriate as the capital requirements increases as a result of the higher CCF applied.

The appropriate approach compliant with the CRD would be the following:

Compare the collateral with the off-balance sheet amount. In the above example both 100 therefore fully covered:
Therefore,

\[ RWA = 100 \times 20 \text{ (original CCF)} \times 50\% \text{ (CQS2 - the protection provider)} = 10 \text{ (we believe that the intention was that the 100\% CCF is only used for the determination of coverage).} \]

If the collateral provided was lower than 100 then you would have a covered piece which would attract the risk weight of protection provider and an uncovered piece with the risk weight of the original obligor (both parts would still attract the same conversion factor).

This approach is backed up by the CRD Transposition Working Group - Question 483, the answer to which suggests:

"The approach to credit risk mitigation techniques and conversion factors explicitly laid down in the Financial Collateral Comprehensive Method (e.g., firms apply CRM techniques to the original exposure before taking into account conversion factors)…"

Life insurance policies [9.48 - 9.49]: Members have significant concerns over the practical implications for the equivalence assessment of third country guarantee schemes on an ongoing case by case basis. The industry urges the FSA to consider a general periodic equivalence assessment for major third country insurance companies and to publish a list of eligible insurance firms. Firms that operate globally must have the immediate and assured capability to utilise 'third country insurance companies' both from a practical and legal perspective. In some instances, it will be the requirement of local legislation / regulation to predominantly use national firms for this.

**Operational Risk**

9.52 Limits to capital alleviation from risk transfer mechanisms [9.52]: The industry urges the FSA to review jointly with CEBS and Basel the 20% limit as it may have the unintended consequence of creating a ‘disincentive’ to mitigate risk. Given the current inexperience with the limit we propose a periodic review of this limit to determine whether the theoretical limit has any detrimental impact on risk transfer practices.

New business line for mapping exceptional institution-wide loss events [9.53]:
Standardised approach calculation [9.54]:

9.53; In referencing 'new business line 'corporate items' we assume the FSA also intends this to cover corporate function related losses? Can the FSA clarify what it foresees as being 'exceptional circumstances'?

**Detailed Comments on Draft Handbook Text in Appendix 7**

| 4.2.29 | We note that this handbook amendment is not covered in Chapter 9 |

- ENDS -