

EXPLANATORY MEMORANDUM TO
THE CAPITAL REQUIREMENTS REGULATIONS 2006

2006 No. 3221

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. **Description**

2.1 These Regulations implement, in part, Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (recast) (the Banking Consolidation Directive) and Directive 2006/49/EC of the European Parliament and of the Council on the capital adequacy of investment firms and credit institutions (recast) (the Capital Adequacy Directive). The Regulations make provision for applications by pan-European groups for permission to calculate their capital requirements in line with new methods allowed by the Banking Consolidation Directive, for cooperation between the Financial Services Authority (FSA) and competent authorities of other Member States and for the FSA to recognise external credit assessment institutions so that the credit ratings which these institutions make may be used by banks and other FSA authorised firms to calculate their capital requirements.

3. **Matters of special interest to the Joint Committee on Statutory Instruments**

3.1 None

4. **Legislative Background**

4.1 The Banking Consolidation Directive and Capital Adequacy Directive introduce a new framework for the prudential supervision of the capital held by banks and other financial services firms in the European Union which reflects new standards agreed internationally in the Basel Committee on Banking Supervision in 2004. Most of the changes made by these Directives can be implemented directly by the FSA in its rules (which are made under powers conferred in the Financial Services and Markets Act 2000 (FSMA)). These Regulations (which are made under powers conferred by section 2(2) of the European Communities Act 1972) are needed to confer new powers and impose new duties on the FSA itself, and for connected purposes.

4.2 The proposals for the Directives were considered in Explanatory Memorandum on European Community Legislation 11545/04. The European Scrutiny Committee of the House of Commons considered the Explanatory Memorandum on 20 October 2004 and recommended a debate which took place on 8 November 2004.

5. **Extent**

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Economic Secretary to the Treasury has made the following statement regarding Human Rights:

In my view the provisions of the Capital Requirements Regulations 2006 are compatible with the Convention rights.

7. Policy background

7.1 The policy objective behind the Banking Consolidation Directive and the Capital Adequacy Directive is to modernise and update the European legal framework relating to the prudential supervision of the capital held by banks and other financial institutions in line with the internationally agreed recommendations from the Basel Committee on Banking Supervision. The Directives (which are usually called the Capital Requirements Directive (CRD)) form a key part of the EU Financial Services Action Plan (FSAP) for developing a single market in financial services.

7.2 The Treasury considered that the best way to implement the recast Directives would be to follow, so far as possible, a 'copy-out' approach – an approach in which the legal framework is copied more or less directly from EC law into national legislation. A copy-out approach helps to ensure that the United Kingdom does not 'gold-plate' European legislation and avoids costly burdens on UK industry. The Treasury consulted on this basis and the Treasury's approach was supported by market participants involved in the pre-consultation exercise and the FSA, and by the respondents to the formal consultation exercise which was launched at the end of February 2006. A summary of the responses to formal consultation was published on the Treasury's website (hm-treasury.gov.uk) in July 2006.

7.3 The only departure from the copy-out approach is the addition of specific provisions to facilitate the revocation and variation of applications for model recognition by financial groups, for example when there are mergers or acquisitions. These provisions go beyond the text of the Directives which are silent on the issue of variations made by the consolidated and relevant supervisors on their own initiative. The Treasury understands that the governments of other Member States take the view that own initiative variations by the consolidated supervisors are envisaged by the Directives and therefore the Regulations make provision to enable the FSA to revoke and vary applications made to it, and to participate in discussions on these points with competent authorities in other Member States. These additional powers arise out of the obligations imposed by the Directive and do no more than the minimum necessary to enable the FSA to fulfil its role as a consolidated or relevant supervisor.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

9. Contact

Gillian Hood at HM Treasury Tel: 020 7270 5219 or e-mail: gillian.hood@hm-treasury.x.gsi.gov.uk can answer any queries regarding the instrument.

1

INTRODUCTION

THE GROUP RELIEF FOR OVERSEAS LOSSES (MODIFICATION OF THE CORPORATION TAX ACTS FOR NON-RESIDENT INSURANCE COMPANIES) REGULATIONS 2006

TITLE OF THE DIRECTIVE

1.1 Directive 2006/48/EC of 14 June 2006 of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions and Council Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions. These Directives are commonly referred to as the Capital Requirements Directive (CRD).

PURPOSE AND INTENDED EFFECT

1.2 This section sets out:

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

OBJECTIVE OF THE CRD

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

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

1.5 The CRD, when implemented, will:

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

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

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

IMPLEMENTATION TIMETABLE

1.8 Finance Ministers reached agreement on the European Parliament's legislative resolution on the CRD on 11 October 2005. The Commission's proposal was therefore agreed in a single reading under the co-decision procedure. Co-decision is the legislative process whereby the Commission proposes draft legislation and the Council and the European Parliament have equal rights to examine and propose amendments to the Commission's proposal. Council formally adopted the Directive in June 2006, following the translation of the Directive into all EU languages through what is known as the jurists-linguists process.

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

RATIONALE FOR INTERVENTION BY THE UK GOVERNMENT

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

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

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

1.12 Once a Directive is adopted, each Member State must: a) give effect in national law to the rights and obligations created by the Directive; and b) ensure that the Directive is implemented in a transparent manner. Failure to implement the Directive properly runs the risk of the UK being infringed and fined by the Commission. This is the 'do nothing' option. The UK has been supportive of the Commission making use of its powers to infract.

1.13 Intervention is also important in order for the UK Government to fulfil its other international obligations. Many of the requirements in the CRD stem from agreed international Basel 2 recommendations. The latter are global financial standards and are used by the IMF and

World Bank in their Financial Sector Assessment Programme of countries. Compliance with Basel recommendations is important to reassure other Governments and financial institutions that the UK has a sound, stable and competitive banking system.

2

REGULATORY IMPACT ASSESSMENT (RIA)

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

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

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

CONSULTATION

2.3 The two areas for which HM Treasury are responsible for transposing were previously considered in the HM Treasury publication: Transposition of the Capital Requirements Directive: Consultation and Partial Regulatory Impact Assessment. The consultation ran from 26th February 2006 to 23rd May 2006 and received responses from the British Bankers Association (BBA), London Investment Bankers Association (LIBA) and the Investment Management Association (IMA). The BBA and LIBA together represent more than 300 banks and investment firms doing business in London and elsewhere in the UK, while the IMA is the trade body for the UK's £2 trillion asset management industry. Responses were also received from Moody's Investor Services, Fitch Ratings and the Dominion Bond Rating Service.

2.4 In the consultation, HM Treasury offered a range of proposed options and made initial recommendations. As outlined in the summary of responses, all of the respondents were content with HM Treasury's recommended options and felt that the RIA helpfully benchmarked the likely costs of the alternative options. These options are discussed in more detail below.

IMPLEMENTATION OPTIONS: GROUP MODEL RECOGNITION

2.5 Article 129(2) imposes obligations on the FSA which must be given effect to in domestic law under existing provisions of Financial Services and Markets Act are not appropriate for the effective transposition of this Directive provision. HM Treasury therefore needed to consider how best to provide for this.

2.6 Provision is needed to require the FSA to:

- co-operate with the other relevant competent authorities to come to a joint decision;
- make a decision and comply with the relevant obligations if it is the consolidated supervisor; and

- implement the decision, whether that decision was made jointly by the FSA as consolidated supervisor, or by another competent authority as consolidated supervisor.

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

2.8 To this end, four options were considered.

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

2.9 Costs, benefits, risks, compliance, enforcement and competition issues have been considered for all options for decision-making and consultation purposes. A summary table of these costs and benefits can be found at the end of the chapter, along with the final recommended option.

Option 1: do nothing

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

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

Option 2: copy out

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

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

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

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

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

2.15 The Directive does not stipulate how competent authorities should undertake their responsibilities under Article 129(2) in situations where, for example, a new member joins a group or a group makes changes to their risk models. The FSA and other member states take the view that own initiative variations by the consolidated and relevant supervisors are intended, although not explicit in the directive text.

2.16 In order to enable variations or revocations to be made to an Article 129(2) decision, HM Treasury must provide suitable powers to the FSA in its implementing legislation. However, it would not be proportionate to require that all changes to underlying models go through the Article 129(2) procedure. As a result, this option does not define what constitutes a variation, but would leave this issue to the FSA and the other competent authorities party to an Article 129(2) decision. This discretionary approach for the FSA will minimize unnecessary administrative burdens on firms as well as providing for a degree of useful flexibility.

2.17 As this option builds on Option 2, the principal cost involved is also the cost of applying for a joint application under Article 129(2). However, there is the risk of differences between the UK's and other Member States' implementation of this article. Inconsistent Member State implementation could impact on the attractiveness of the UK as a place to do business as well as having negative implications for the development of a Single Market in financial services. However, firms have indicated in their responses to the HM Treasury consultation that this would not impact on the attractiveness of the UK as a place to do business.

Option 4: detailed legislative framework

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

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

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

SMALL FIRMS IMPACT TEST

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

COMPETITION ASSESSMENT

2.21 Consultation responses received confirm HM Treasury's view that Article 129(2) will not have significant competition impacts. The provision provides EU groups with an option to make a group application for the advanced approaches to measuring Pillar 1 capital requirements, and therefore does not impose any obligations on industry that might have an adverse effect on competition.

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

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

ENFORCEMENT SANCTIONS AND MONITORING

2.24 All enforcement, including any sanctions, monitoring and inspections is the responsibility of the FSA under the Financial Services and Markets Act 2000.

2.25 Details on how the FSA intends to enforce the procedures under Article 129(2) are included in the consultation paper CP06/3 and followed up in the feedback statement issued in July 2006.

IMPLEMENTATION AND DELIVERY PLAN

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

2.27 The Treasury will transpose Article 129(2) into domestic law via regulations by the transposition deadline of 1 January 2007. It is the responsibility of the FSA to implement this provision into its handbook text by the 1 January 2008 when the advanced approaches that are the subject of Article 129(2) become active.

POST IMPLEMENTATION REVIEW

2.28 The Government would expect at a minimum to carry out a review of this legislation after 5 years. This would allow for sufficient time for the effects of any legislation to be realised and understood.

SUMMARY AND RECOMMENDATION

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

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

2.30 Based on the costs and benefits outlined in the summary table below, and following extensive consultation, HM Treasury has decided to transpose Article 129(2) using Option 3 – copy out, but with additional provisions for variation and revocation of a group application.

Option	Total benefit per annum: economic, environmental, social	Total cost per annum: - economic, environmental, social - policy and administrative
1	<ul style="list-style-type: none"> o No transposition or implementation costs incurred. 	<ul style="list-style-type: none"> o Costs of not recognising new and continuing developments in financial products or advances in risk measurement and management practices. o Costs from forfeiting the deregulatory opportunities offered by Directive implementation; o Cost of infraction proceedings against UK; o Costs of UK inability to fulfil international obligations.
2	<ul style="list-style-type: none"> o Straightforward process maintaining level playing field amongst EU firms 	<ul style="list-style-type: none"> o Cost of application process o Costs relating to inability of FSA to vary or revoke an application
3	<ul style="list-style-type: none"> o Straightforward process, maintaining level playing field amongst EU firms o Allows supervisor to vary or revoke group model recognition when necessary. 	<p>In addition to costs of Option 2:</p> <ul style="list-style-type: none"> o Differences between the UK's and other Member States' implementation could impact on the attractiveness of the UK as a place to do business.
4	<ul style="list-style-type: none"> o Greater legal clarity, minimising uncertainties regarding compliance. 	<ul style="list-style-type: none"> o Overly prescriptive legislation for dynamic markets can quickly become out-of-date, with potentially negative consequences for business and the attractiveness and competitive position of the UK as an international financial centre.

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

2.31 It is only following recognition that ratings issued by an ECAI can:

1. be used as external credit assessments by authorised credit institutions and affected investment firms opting to use the standardised approach for measuring credit risk under Pillar 1; and
2. have the potential to be used as external credit assessments by firms for capital adequacy purposes in other Member States without further direct recognition.

2.32 As the relevant articles impose obligations on the FSA which must be given effect, and because existing provisions of FSMA would not adequately transpose these Directive provisions, HM Treasury has considered how best to provide for this.

2.33 Four implementation options have been considered.

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

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

Option 1: do nothing

2.35 As with all proposals for legislation, HM Treasury considered the option of making no changes. The implications of this are the following;

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

Option 2: copy out

2.36 This option involves copying out the provisions of the Directive directly into UK legislation. This option implies a light touch, high level, principles based UK legislative framework, enabling HM Treasury to meet its requirements in EU law, while giving the FSA flexibility in its approach. This option is in line with UK Government policy which is not to be superequivalent, that is not to impose additional requirements on UK firms above those specified in the CRD, unless these are shown to be rigorously justified by cost-benefit analysis.

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

2.38 There is also a risk that UK legislation is not clear enough with respect to how ECAIs are granted recognition and the process for dealing with negative recognition decisions. However, this risk is mitigated by the Committee of European Banking Supervisors (CEBS) proposed guidance regarding the recognition process. CEBS published

its guidelines for the recognition of ECAIs in a consultation document on 29 June 2005. The paper set out CEBS' proposed common approach to the recognition of eligible ECAIs and covered: the recognition process; the implementation of the CRD recognition criteria; and the criteria for the 'mapping' of external credit assessments to the CRD risk weights. All of this work by CEBS will encourage greater harmonisation of supervisory approach across the EU.

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

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

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

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

2.42 This option involves copying out the provisions of the Directive directly into UK legislation but with an additional specific provision for an appeals process: the Financial Services and Markets Tribunal. Option 2 does not include an express appeals mechanism, but the option of judicial review would be available. Judicial review involves the High Court considering whether the decision met the standards of administrative decision making. If the required standard had not been met, the Court would usually order the decision maker to retake the decision. However, in judicial review, the Court does not usually impose its own decision on the decision maker.

2.43 This option would still imply light-touch, high level, principles based UK legislative framework, enabling HM Treasury to meet its requirements while ensuring that ECAIs have the opportunity to challenge negative recognition decisions via the tribunal mechanism.

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

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

2.46 However, there are additional costs associated with the inbuilt appeals process.

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

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

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

Option 4: detailed legislative framework

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

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

2.51 This option would therefore provide for greater legal clarity than is provided for by the original Directive text and therefore by Options 2 and 3. Providing detailed provisions within UK legislation could minimise any uncertainties regarding compliance with Directive requirements for both the FSA and credit rating agencies.

2.52 However, this option would contradict the international consensus that rating agencies’ practices and business models are best captured through a high-level, principles-based approach, rather than through prescriptive legislation.

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

consequences for the attractiveness and competitive position of the UK as an international financial centre.

SMALL FIRMS IMPACT TEST

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

COMPETITION ASSESSMENT

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

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

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

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

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

ENFORCEMENT SANCTIONS AND MONITORING

2.60 All enforcement, including any sanctions, monitoring and inspections is the responsibility of the FSA as specified in the Financial Services and Markets Act 2000.

2.61 Details on how the FSA intends to enforce the ECAI recognition process are included in the consultation paper CP06/3 and followed up in the feedback statement issued in July 2006.

IMPLEMENTATION AND DELIVERY PLAN

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

2.63 The Treasury will transpose the ECAI recognition process into domestic law via regulations by the transposition deadline of 1 January 2007. It is then the responsibility of the FSA to implement and enforce this provision from the 1 January 2007.

POST IMPLEMENTATION REVIEW

2.64 The Government would also expect at a minimum to carry out a review of this legislation after 5 years. This would allow for sufficient time for the effects of any legislation to be realised and understood.

SUMMARY AND RECOMMENDATION

2.65 It is only following recognition that ratings issued by an ECAI can:

1. be used as external credit assessments by authorised credit institutions and affected investment firms opting to use the standardised approach for measuring credit risk under Pillar 1; and
2. have the potential to be used as external credit assessments by firms for capital adequacy purposes in other Member States without further direct recognition.

2.66 As the relevant articles impose obligations on the FSA which must be given effect, and because existing provisions of FSMA would not adequately transpose these Directive provisions, HM Treasury needs to consider how best to provide for this.

2.67 Based on the costs and benefits outlined in the summary table below and following extensive consultation, HM Treasury has chosen Option 2 as the most appropriate implementation option for ECAI recognition.

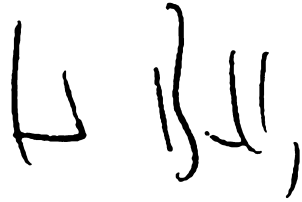
Option	Total benefit per annum: economic, environmental, social	Total cost per annum: - economic, environmental, social - policy and administrative
1	o No transposition or implementation costs	o Costs of not recognising new and continuing developments in financial products or advances

	<p>incurred.</p>	<p>in risk measurement and management practices.</p> <ul style="list-style-type: none"> o Costs from forfeiting the deregulatory opportunities offered by Directive implementation; Cost of infraction proceedings against UK; Costs of UK inability to fulfil international obligations.
2	<ul style="list-style-type: none"> o Lack of risk of UK legislation inadequately implementing the Directive. o No risk of more burdensome UK implementation vis-à-vis other Member States. o Allows CEBS' guidance to be used in ensuring consistent implementation of CRD across Member States and therefore the creation of the Single Market in financial services. o Straightforward for ECAIs in other Member States to understand the UK legislative position. 	<ul style="list-style-type: none"> o Principle costs arise from cost of applying for ECAI recognition. Estimated from £50,000 to £250,000 for the initial application and £12,500 to £200,000 for ongoing compliance.
3	<ul style="list-style-type: none"> o Gives an ECAI the right to challenge a negative recognition decision in a specialist court which would examine the merits of the case. 	<p>In addition to costs of Option 2:</p> <ul style="list-style-type: none"> o Cost of pursuing the tribunal appeal mechanism to dispute a negative decision. o ECAI contesting a negative recognition decision in the tribunal could in turn result in the FSA requesting more detailed information from ECAIs and performing more detailed analysis before reaching a recognition decision. This would increase compliance costs for ECAIs as well as costs for the FSA. o Costs to firms of UK having different regime to rest of EU,
4	<ul style="list-style-type: none"> o Greater legal clarity, minimising uncertainties regarding compliance. 	<p>In addition to costs of Option 2:</p> <ul style="list-style-type: none"> o Overly prescriptive legislation could compromise the independence of rating agencies and stifle innovation. o Risk that overly prescriptive legislation for dynamic markets quickly becomes out of date, with potentially unintended and negative consequences for the attractiveness and competitive position of the UK as an international financial centre.

MINISTERIAL SIGN OFF

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs'.

Signed by the responsible minister

A handwritten signature in black ink, appearing to read 'G. Hood', written over a horizontal line.

Economic Secretary to the Treasury

November 2006

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