Guernsey Financial Services Commission

Banking Division

ICAAP – Taking Stock

Industry Presentation – 20 October 2011

Introduction by Philip Marr

Thank you for attending our second Engagement with Industry Seminar and I hope you appreciated and benefited from the morning session at St James. I was certainly listening intently to what the guest speaker, Angela Knight, Chief Executive of the British Bankers Association had to say, in particular, her thoughts on the future of regulation in the UK context, especially since last month the UK Government received the so-called Vickers Report by the Independent Commission on Banking. Some of you in the room will have attended our ICAAP workshop earlier in the year so we do not need to go over all of that ground but we did think it would be worthwhile initially to “take stock” of the ICAAP process. This primarily affects subsidiaries but there are some messages for the branch bankers among you. I will share the slides with my colleagues: in the first instance; George Bartlett will talk on the ICAAP process and will be followed by me on the same subject, then Andrea Sarchet-Luff will talk about upstreaming and Eamonn Finnerty will outline our thoughts on outsourcing. I will then come back and give you a roundup of how I see the regulatory horizon for the banking industry as it affects bankers in Guernsey. I will be hoping to dispel any notion you may have gained that there is a huge raft of regulation heading towards you. In banking we are not usually directly affected by European legislation although we can be indirectly affected by it. Our immediate focus is on the recommendations of the Basel Committee on Banking Supervisors and I will concentrate on what we know has already come out from the Basel Committee of which the Basel III element is fully in the public domain. I will also give an impression of the direction of travel of the revised Basel Core Principles.

I will hand over to George to start the presentations.

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Background *[GB]*

- ICAAP is a product of Basel II
- We are approaching a third cycle. Inevitably it has been a learning curve
- We currently have 17 subsidiaries who will be required to do an ICAAP during 2012

1.

Since the introduction of Basel II Guernsey subsidiaries have completed two ICAAP cycles. The implementation of the ICAAP and the SREP has been a steep learning curve but the industry has made significant progress.

As we head in to the third cycle of ICAAPs this is a good opportunity to take stock and touch upon some considerations as you prepare for your next submission.

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Recap Objectives *[GB]*

- Capital adequacy – no longer a statistical snapshot, it's a process
- Forward looking capital planning – an important decision making tool
- Survival (1) Ability to repay depositors
- Survival (2) Capacity to generate profits typically for group.

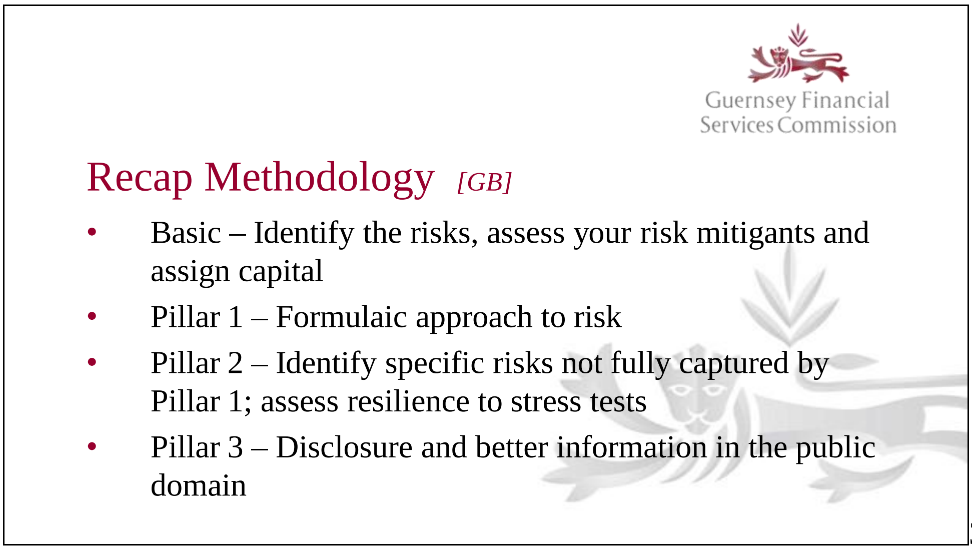
2.

There has always been a need for Guernsey banks to assess how much economic capital is required for the business. Basel I attempted to capture Credit Risk and Market Risk under a formulaic framework, but it wasn't until Basel II that the comprehensive assessment of all risks for which capital is needed in a business became a more formalised process – with the regulator as a participant.

In assessing your regulatory capital there is also an expectation that your analysis is forward looking. This is turn makes the ICAAP an important decision making tool.

In thinking about the objectives of the ICAAP we encourage you to consider what it means to your different stakeholders:

- The regulator (as a stakeholder) is interested in ensuring there is enough capital to support your business model.
- The banking regulator also endeavours to reflect the interests of another critical stakeholder namely the depositors.
- The other important stakeholder - your shareholders – (typically your parent bank) are interested that you have a viable business in the face of your risk environment and that the bank is delivering an acceptable return on their investment (i.e. an acceptable ROE).



3.

In our review of your ICAAPs the best examples have always followed this basic principle:

Identify the risks in your business, assess your risk mitigants, what is the residual risk from this assessment? How much capital do you need?

I will take the opportunity to recap the three Pillars of Basel II and will give you our view in some detail.

Pillar 1 is the formulaic, automated, indivisible portion of your capital assessment. For confirmation there can be no substitution for Pillar 2 capital in place of Pillar 1 charges, and RWAs under Pillar 1 have a fixed charge of 8%.

Pillar 2 is the full assessment of the risks in your business, regardless of whether capital is set against them or not. For information, the analysis of your non capital risk mitigants may include:

- Discussion of your firm’s view on the adequacy of the risk management process, and:
- Stress testing and scenario planning.

From this analysis, appropriate capital, if any, must be considered for each risk. Analysis of capital should also include your firm's capital plan over a specific period (e.g. profitability/capital assessment over next three years).

Pillar 3 exists so firms disclose better information in the public domain to allow markets to differentiate between banks.

The Commission does not require firms to produce Pillar 3 disclosure forms like your parent companies do. However, we do review them when looking at your ICAAP, so we recommend that you at least reference them when drafting your submission. That said, the locally produced financial statements of Guernsey banks which address the component risks of the business could be regarded as being part of Pillar 3.

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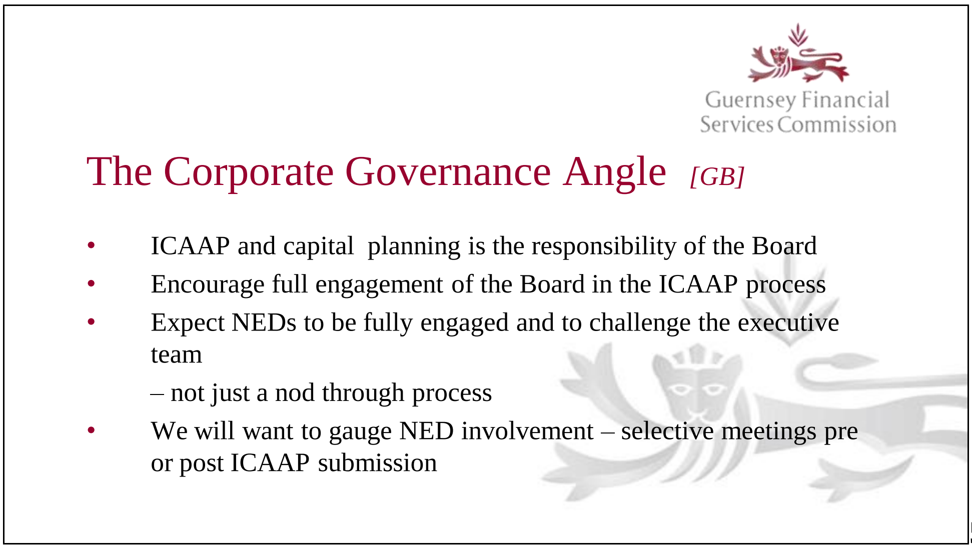
Basel II was drafted with home supervisors in mind, and as a host supervisor the Commission has needed to consider the costs and benefits of the ICAAPs in our jurisdiction.

Our fundamental view is that Pillar 2 has shown that it is an invaluable tool in considering risks specific to our sector. It also puts the local entity into focus.

But the assessment of Pillar 2 risks is a moving target, and indeed our view on certain risks has evolved.

The Commission anticipated concentration risk to be a significant factor in Guernsey ICAAPs, this has been confirmed. This took on greater significance as issues emerged during the 2007 – 2008 financial crisis.

Reputation risk is an issue we are looking for more consideration around, and I will discuss that shortly.

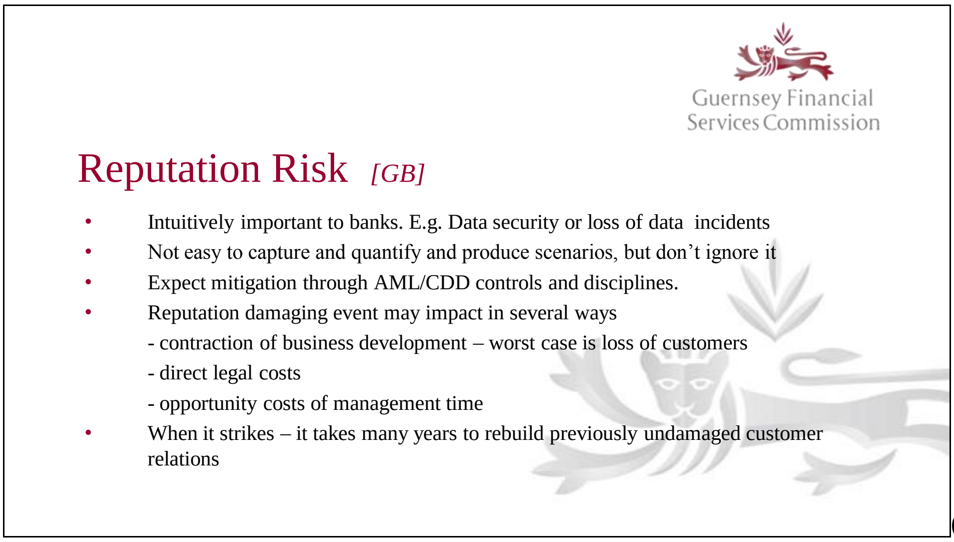


5.

The ICAAP and capital planning is the responsibility of the Board, and the Commission encourages full Board and NED engagement in the ICAAP process.

Over the past two years the Commission has been conducting dialogue with NEDs on a selective basis. This has been of mutual benefit as we are able to get an insight into the dynamics of the Board, and the NEDs are able to open a channel with the Commission and use us as a sounding board if appropriate.

For the third cycle of ICAAPs we will be continuing this dialogue by requesting to speak with NEDs separately on a selective basis as part of the SREP meeting process.



6.

Managing reputation is, of course, intuitively important for banks. Indeed upholding your reputation is a central tenet of your business management which goes towards maintaining the confidence of customers in your bank.

The ICAAP has shown, however, that it is not easy to capture Reputation Risk, particularly quantifying how much capital is needed to support it, but this doesn't mean you should ignore it in the ICAAP.

Many firms consider the reputational impact of the failure of AML/CDD controls in the ICAAP. The following framework is also used by licensees to estimate the cost of Reputation Risk:

- Contraction of business development – worst case is loss of customers.
- Direct legal costs.
- We also want you to consider the opportunity costs of management time i.e. the opportunities lost as damage limitation, efforts divert the executive team from building the business .

As Reputation Risk may occur from the failure of other risks identified in your risk framework, (particularly Operational Risk) it is good practice to consider what the cost would be to manage the materialisation of these risks from a reputational perspective.

The bottom line is that the ICAAP should demonstrate that management of Reputation Risk is pro-active and not reactive. For example, when reviewing the ICAAP we look to see, if there is a crisis management plan in place; we consider if the executive team can manage its resources if reputation risk materialises, and we ask how does the business monitor threats to reputation?

I will hand over to Philip for slides 7 to 10

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Credit Risk & Concentration Risk *[PM]*

- Credit risk is the main driver of Pillar 1 capital requirements
- Because subsidiary banks have relatively small capital bases so this throws up concentration risks – addressed through Pillar 2
- Concentration risks can appear as single name exposures or sectoral concentrations
- Andrea Sarchet-Luff will develop some of the issues surrounding concentration risk and so-called large exposures

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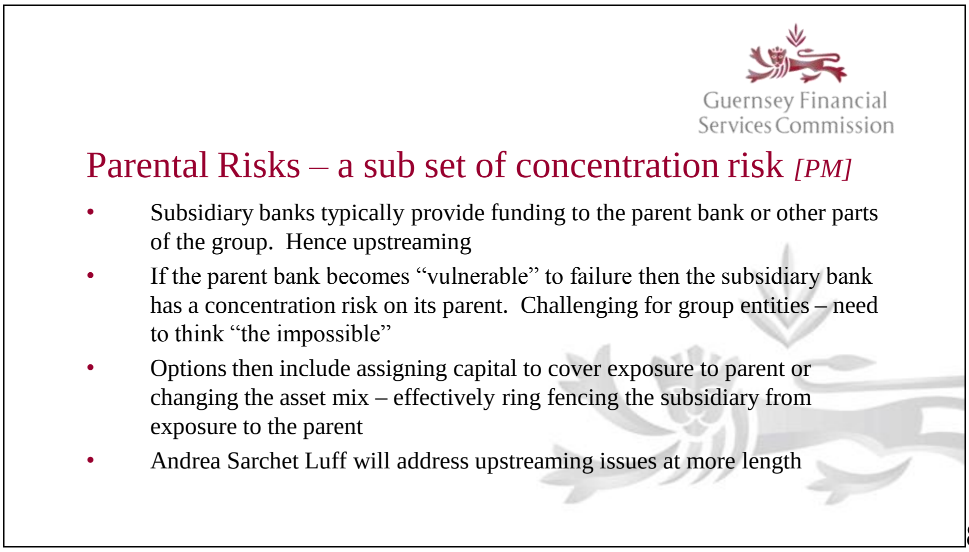
Credit risk is the main driver of Pillar 1 through the RWAs – the risk weighted assets. Credit RWAs can be generated by loans to individuals, mortgages, loans to corporates, placements with banks and holdings of securities.

Because our subsidiary banks have relatively small capital bases but nevertheless can generate relatively “chunky” loans so this throws up concentration risks – measured by the size of individual loans compared to capital base – and this is addressed in Pillar 2 not in Pillar 1.

In the ICAAP we can deal with concentration risk at several levels: as single name exposures: as sectoral concentrations, e.g. natural resource sector or property sector; or as sub sectoral concentrations – e.g. pockets of exposure to properties in Central London.



8.

Because our banks are liability driven the economic model has typically been one of funding chasing earning assets. A very frequent solution has been of subsidiary banks providing funding to the parent bank or other parts of the group which are long on earning assets but short on funding. It is a convention to call funding to the parent bank "upstreaming". That was a fine economic model in benign economic times.

However if the parent bank – for whatever reason – becomes "vulnerable" to the failure of the parent's economic model or has known structural weaknesses – which would be manifested in, for example, a Moody's or Fitch downgrade then the subsidiary bank acquires a concentration risk on its parent. Clearly over the last few years this has been a challenging process for group entities and especially so for career bankers. We recognise that it is not a comfortable or easy process to think "the impossible" and contemplate the downgrade or potential failure of a parent.

At the sharp end in discussions with management teams and boards we have to consider a range of options to mitigate this: from assigning capital to cover the exposure to a vulnerable parent to substantially changing the asset mix of the subsidiary. In extreme cases we may have to contemplate effectively ring fencing the subsidiary from exposure to the parent or reducing that exposure to a minimum.

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Operational Risk *[PM]*

- On paper should be easy to identify specific “add-ons”
- Common sense tests are useful to benchmark relative importance of capital to support Operational Risks.
  – also to counter under-estimation in the potential scale of losses
- Outsourcing will frequently be employed in subsidiary banks
- Project risk should not be ignored including integration of systems
  – delays on projects may be unavoidable but may have costs
- Key man risk – not well articulated: a function of size of team

9.

Before I make a few points about Operational Risk (Op Risk) may I remind you – in case you have forgotten - that Op Risk is calculated in Pillar 1 under the standardised approach to Basel II in a very rudimentary way. It is calculated by using “gross revenues” under both the basic indicator and the standardised approaches as a crude proxy for Op Risk. It is crude because those proxy indicators are not themselves risk sensitive.

That said, identifying Op Risk add-ons under Pillar 2 should be relatively straight forward if you truly “know your business.” Reminders and recaps for today are that since outsourcing is a fundamental part of nearly all Guernsey banks in the Crown Dependencies then risks to the delivery of outsourcing arrangements should be factored in to the ICAAPs.

Similarly project risk should not be forgotten especially when you are engaged in the integration or replacement of systems and banking platforms: delays on projects may be unavoidable but they may have consequential costs.

One risk which we would ask you to consider in the next round is “key man” risk. So far it has not been well articulated. It may be a function of the size of teams and if you really do have “strength in depth” then you may effectively mitigate it. However it may be productive to review this aspect of your business.

From time to time we apply common sense tests as a benchmark to measure Op Risk i.e. the relative importance of the capital supporting Op Risk compared with the total capital supporting identified risks. Our consultant on ICAAP risk (Edward Sankey) whom many of you saw at the industry seminar reminded me that it is a useful test to counter the under-estimation of the potential scale of losses. To be fair he was thinking of the sheer scale of losses identified by UBS in their recent unauthorised/uncontrolled ETF position taking scandal. Since we only have very limited dealing rooms here it is not a directly relevant example but I think the principle is made.

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ICAAP Open Questions *[PM]*

- If you get smarter can you manage with less capital and report better results
- “Maybe - but not necessarily” since it depends on the economic environment and your business plans and risks in your target market and what cushions are built in to the ICAAP.
- Arguably we should we take account of how much diversification there is in the parent
- Finally, don’t forget ICAAP is a living process
- In a post crisis world ICAAP will be considered in parallel with liquidity management and crisis management.

10.

All this talk about making ICAAPs smarter begs the question – can you manage with less capital and still report better results? Clearly getting ICAAPs smarter must go hand in hand with improved risk control and an improved risk culture. Even then the answer is not a clearcut ‘yes’ – it is a ‘maybe’ – but not necessarily since it depends on the interaction of the economic environment and economic outlook, your business plans and the prevailing risks in your target market and how they all align with the cushions or buffers built into the ICAAP. As supervisors we would also wish to take account of how diversified the business lines of the parent bank are.

Finally as we said in the ICAAP seminar don’t forget that the ICAAP is a living process which is dynamic – it is not a snapshot document which sits on the shelf. In the current still uncertain economic environment of the post crisis world the ICAAP won’t be considered in a vacuum; it will be considered in parallel with liquidity management and indeed crisis management.

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Regulatory Horizons (1) – Basel III *[PM]*

Micro prudential and macro prudential

- Purpose: to tighten system wide measures
- Raising the quality of capital
- Raising minimum capital requirements
- Harmonised leverage ratio
- Improving risk management, supervison and market discipline
- Global liquidity standards – LCR and NSFR
- Capital conservation and counter cyclical buffers
- Measures to reduce systemic risk – macro element
- Challenges – consistent implementation; timescale

11.

I have returned to give you a brief overview of what is on the regulatory horizon for bankers. I will address first of all what is already in the public domain which is the list of measures which go together to make up the Basel III package. I will outline those proposals which are a mixture of micro prudential and macro prudential measures.

The backdrop to Basel III is to learn the lessons of the 2008 crisis and so strengthen the resilience of the system that it could never happen again. Whether that wish is likely to be fulfilled is still a matter of debate. Basel certainly thinks that while this package may not guarantee the recurrence of a crisis it would, if these measures were implemented, prevent a repeat of a crisis of the same depth or amplitude. Its purpose is also to make the global system more robust in order to reduce contagion or prevent the transmission of national crises.

A first step has been the raising of the quality of capital in the system. The test for quality capital usually called "Tier 1" is that it is fully able to absorb losses. One of the lessons of the crisis was that it was discovered that significant elements of reported regulatory capital was in fact "goodwill" which was not able to support losses. Clearly convertible capital has to be totally transparent as to the trigger event which converts it into pure risk capital.

Raising the minimum capital requirements has been a public debate throughout the summer and Basel has published a timeline for the achievement of enhanced capital levels to make banks more resilient to shocks and able to absorb impairment on their vulnerable asset portfolios. Indeed, you know very well that a lot of talk in the financial press recently has been about banks' ability to absorb impairments to Greek sovereign debt.

The harmonised leverage ratio has been introduced as a secondary capital safety net: it does not measure the riskiness of assets but acts as a cap on gross balance sheet size. As a long serving bank supervisor I can tell you that leverage or gearing ratios were the capital adequacy tool that was employed before the advent of Basel I. Incidentally we understand that Basel has seen evidence that leverage ratios were a very good statistical predictor of the failure of banks during the 2008 crisis.

The other vital elements in learning the lessons from the 2008 Banking Crisis is to ensure that banks have a much more robust approach to liquidity management. Basel III has proposed two global liquidity standards: one with a short term time horizon and the other with a longer term horizon. The short term measure – the Liquidity Coverage Ratio (“LCR”) is about liquidity management designed to survive the next 30 days. We essentially replicate that theme in our liquidity management approach. The UK Liquidity regime employs a Basel III “plus” approach and focuses on survival over 90 days. The longer term measure is about banks reducing their reliance on wholesale funding sources so the Net Stable Funding Ratio (“NSFR”) is an incentive to banks to tap individual, retail and sticky funding sources rather than volatile contractual based wholesale funding.

On top of the capital adequacy ratios and quality requirements. Basel III introduces a dynamic element to capital adequacy. This links capital to the state of the national and global economy and at any time the current position in the economic cycle. If the economic outlook is getting worse and there are known issues about to crystallise then Basel believes it makes sense to conserve capital and, for example, not pay out dividends from reserves.

Whilst an economy growing “too quickly” is a problem the western nations are not currently worrying about, nevertheless, Basel believes it would be useful to be able to apply the brakes when markets and asset prices are accelerating too fast, or they have got out of touch with reality. The brakes could be applied using a variety of tools but in the mortgage market this could include applying maximum loan to value ratios (LTVs) in the event that house prices started spiralling.

Measures to reduce systemic risk have included first steps to address the difficult question of how you deal with banks that are “too big to fail”. These now have their own label – “SIFIs” – which stands for systemically important financial institutions. Post crisis the G20 nations are trying to move to a position where banks are NOT “too big to fail” and that taxpayers do not have to “pick up the tab” for rescuing nationally important banks. We have, of course, already seen the UK’s approach to this in the ICB Report but globally this remains a very difficult issue because big banks are nearly all active internationally but banks are only rescued nationally and not using tried and tested cross border arrangements.

There is still some debate as to whether the Basel III list of measures was too ambitious or too conservative. However, the main challenges are seen as being whether national supervisors can implement the measures consistently and not dilute their effectiveness. The timescale for full implementation is seen as too far off in (2019) which thereby dilutes its value to the global system: some commentators would like the whole Basel III exercise implemented sooner rather than later.

We shall watch that space.

Regulatory Horizons (2)
Revised Basel Core Principles *[PM]*

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- FSB request review as a response to the crisis – last review 2006
- Not a complete rewrite – more an update but 29 core principles are proposed against 25 core principles
- Addresses macro prudential issues, financial stability and requirement for stress testing
- Two new core principles added; corporate governance and disclosure and transparency: these address crisis preparedness, bank resolution and colleges as part of home/host relationship
- When finalised we will review whether we need more powers – e.g. to increase capital and provisions and to change composition of board.

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For our last piece of presentation I want to give a brief outline of some of the issues in the current revision of the Basel 25 Core Principles (CPs). We understand it is not a complete re-write, more a refreshing of the CPs to take on board the lessons of the crisis. Hence a new CP will address corporate governance, disclosure and transparency and a further CP will address crisis preparedness, bank resolution methodologies and colleges of supervisors as part of continuing home/host relationships. We expect some firm proposals to be published around the end of the year for consultation in the first half of 2012. We understand that the final total may be 29 CPs but that will result from some current "additional criteria" being uplifted to "essential criteria" and some current "essential criteria" being upgraded to full core principle status.

When finalised the Commission will review whether it is necessary to fully comply with all the new provisions and consider whether or not we may need more powers.

Philip Marr
Director of Banking