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Basel 2 Implementation in Guernsey

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What is Basel 2?

- Pillar One – Recalibrates credit risk weightings in a more risk-sensitive way. Introduces a charge for operational risk.

- Pillar Two – Covers other risks such as interest rate risk in the banking book; and for risks inadequately covered in pillar 1. Should be based on the bank's own assessment and agreed with the regulator. The key tool here is the Internal Capital Adequacy Assessment Process (ICAAP)

- Pillar Three – Sets out disclosure standards. We would expect these to be operative at the group rather than the subsidiary level though we welcome and will take account of greater disclosure on the Bailiwick in any capital assessment (eg what you say to customers about your island operations)

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What is Basel 2?

- Applies to Banks. For non-banks (eg fund administration and trust companies; and whether or not owned by banks) Basel 2 will only be applied at the request of the firm and after case-by-case agreement with the Commission

- We have said that Basel 2 will directly affect Guernsey subsidiaries. However, Guernsey branches will also be affected in that their risks will need to be reflected in the head office Basel 2 work. Nevertheless the focus of the Commission's work will be on the subs.

Basel 2 – its aims

- To ensure a more efficient allocation of resources through greater risk sensitivity and greater use of a risk/reward matrix.
- It forces banks to consider more deeply operational risk
- It sanctions the use of models where a firm wishes to use them
- It puts the onus for risk assessment on the banks
- It requires all firms to have in place a systematic process for analysing and mitigating material risks. This should create a trade-off/incentive between better controls/less capital
- It requires senior management to think about unlikely (but not impossible) events and to stress-test controls (Think credit crunch)

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Timelines

- In Europe (including the UK and Switzerland) Basel 2 is already in place for some approaches and will go live across-the-board in total in January 2008
- The US will apply Basel 2 in January 2009
- Bermuda will offer Basel 2 sometime in 2008/9
- However, in general, everyday implementation is lagging the above timelines.

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Timelines

- In Guernsey, we want firms to implement properly and we recognise that this will take time. However we would expect all banks to be on Basel 2 by end 2008.

- The GFSC would like some time to see the outturn for several firms so that we can benchmark results.

- We will require all firms to report on both a Basel 1 and Basel 2 or from Q1 2008. Once we have agreed to transition a firm to Basel 2, Basel 1 reporting can stop.

- Transition must include an assessment of pillars one and two – so a bank cannot go onto Basel 2 with only a pillar one assessment.

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Timelines

- The IMF is not pushing for immediate Basel 2 implementation.
- However it is developing separate criteria by which it will judge Basel 2 implementation.
- Although these are unlikely to be ready in time for the Fund visit to Guernsey in December 2008, there is already a new requirement in the Core Principles that considers how both the regulator and banks systematically analyse their risks.
- Basel 2 implementation will therefore inevitably feature as part of the Fund's assessment of Guernsey.

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Past Action by the Commission

- Over the last 2 years the Commission has issued a series of papers, often in tandem with the JFSC and the Isle of Man. These have outlined the nature of the Accord and the proposed methods of implementation in relation to the Crown Dependencies. We have also issued an ICAAP paper.

- The Commission's approach follows international standards.

- The Operational risk return form required for Basel 2 is now available on the website; credit and market are due this week. The 'non-Basel 2 forms' – eg simplifying the balance sheet return – will be available by end year.

- We are piloting with some firms the actual working return forms and these forms will be issued to the banking community in the New Year.

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Future Action by the Commission

- We will be undertaking site visits around ICAAP.
- We are considering whether we can merge the Annual Review work with ICAAP
- We are developing a simple Supervisory Review Evaluation Process (SREP) so that we can consider a firms' own risk assessments along standard lines. This will enable us to evaluate firms with different approaches equally and allow us to allocate our resources better
- We are now moving forward to case-by-case implementation issues with some firms
- Under Pillar two, we will want to see a treatment of the threat posed to the firm from money laundering and assessment of the nature and quality of its controls (new Handbook relevant here)

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What you need to do for Basel 2 now

- Get ready to fill in the new returns for Basel 2.
- Undertake a risk assessment and link this into a capital requirements (hint – concentrate on the material risks and the key controls). This is the ICAAP. It can be based on a model approach or it can be more simple. It is your choice.

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What you need to do for Basel 2 now

- Consider the specific risks in Guernsey without becoming too granular (eg Avian flu yes; roadworks no).
- Utilise the expertise of HO or sister firms as much as possible. Link in your capital assessment with the rest of the group's. Collaborate.
- Expect parallel running with Basel I return (BSL/1)for at least one quarter, depending on when you transition to Basel 2.
- Come to the Commission earlier rather than later with your approach. We welcome discussion and communication. We are open for business.

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What does a good ICAAP look like?

- There is no one solution and the Commission supports an approach that fits best with the business needs of the firm. But the general components might look something like the following:-

- A workshop by senior management to identify material areas of risk eg credit, operational, reputation, fx etc. We would expect many risks to be deemed immaterial – but you must demonstrate this. Less is more.

- Some analysis of the risks and effectiveness of controls by the business heads. Would be helpful at this point to run specific scenarios. But make them meaningful and relevant to you (hint – no asteroids) .

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What does a good ICAAP look like?

- Production of some capital estimates either through a model or not eg putting a number on a concept. This will be a combination of Pillars one and two; taking into account controls. Linked to the desired credit rating of the group and its risk appetite

- An action plan to identify remedial improvements in the control environment and management information to give comfort to management that the key controls work. Think about whether the key controls really work and why you think this (eg indicators around effectiveness are useful) .

- An annual update together with documentary evidence that the process has business relevance (the “Use test”). (Hint – Examples of ‘wins’ help implementation). There is no point doing this just for the regulators

- A third-party assurance process (eg internal audit, consultants). But management should be its own harshest critic.

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Possible Issues

- Attempts by HO to change capital in the subsidiary on the assumption that capital is freely transferable across legal entities and jurisdictions (this is the home/host issue and is an on-going global issue)

- Different risk appetites for the subsidiary and the parent and also for the home and host supervisor

- Need to reconcile legal entity with lines of business

- Uncommitted facilities

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Possible Issues

- Need for closer home/host supervisory contacts
- Technical training for staff across the island
- Banks will need a collaborative approach with the Commission

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Questions and Discussion

- Are you clear in general about the aims of Basel 2?
- Are you broadly clear at a high level about what you now need to do?
- Is there anything that you would from the Commission (realistically)?
- Thank you for coming…and good luck.

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