



**Guernsey Financial Services Commission
Isle of Man Financial Supervision Commission
Jersey Financial Services Commission**

Consultation Paper

National Discretions for the Standardised Approaches to Credit
and Operational Risk under the Basel II Capital Framework

May 2006

Introduction

In 1988 the Basel Committee on Banking Supervision (“Basel Committee”) issued a report entitled “International Convergence of Capital Measurement and Capital Standards” (“the 1988 Accord”). The report was updated in 1997. Its purpose was to secure international convergence of supervisory regulations governing the capital adequacy of international banks. The 1988 Accord laid down the template for capital adequacy in banks and has become known in recent years as “Basel I”. Latterly the Basel Committee has worked to revise the 1988 Accord. Its aim was to develop a framework that would further strengthen the soundness and stability of the international banking system and would align economic capital with regulatory capital while maintaining sufficient consistency such that capital adequacy regulation would not be a significant source of competitive inequality among internationally active banks. The new framework, most recently updated in November 2005, has sought to arrive at significantly more risk-sensitive capital requirements. The revised framework has the same title as the 1988 Accord but is known more commonly as “Basel II”.

Basel II comprises three pillars. Pillar 3 sets out measures designed to allow enhanced market discipline. Pillar 2 sets out the supervisory review process. This paper deals with Pillar 1, which contains a number of options for calculating banks’ minimum capital charge for Credit, Operational and Market risk. These options range from relatively simple methodologies to more complex approaches that utilise banks’ own quantitative risk assessments. In providing a wide range of approaches, Basel II introduces regulatory capital requirements that capture risks more fully and are sensitive to the differing complexity of international banks. The simplest approach – the Simplified Standardised Approach – is set out in Annex 11 to Basel II and includes rules for both Credit and Operational Risk.

The Pan-Island Approach

The Guernsey Financial Services Commission, Isle of Man Financial Supervision Commission and the Jersey Financial Services Commission have been working together to minimise, wherever possible, differences in their approaches to implementing Basel II. This is not only because a number of banks operate in all three (or two of the three) jurisdictions, but also because their geographical proximity and similar constitutions leave them vulnerable to regulatory arbitrage if a common approach is not reached. The paper draws together work carried out by each island’s Basel II implementation teams and reflects the position taken by all three Commissions following meetings of their representatives. Throughout the paper, the three Commissions are referred to as the Tri-party Group, and the three islands as the Crown Dependencies. Any further use of the word “Commission” refers to the relevant individual Commission.

This consultation paper focuses on the Standardised Approaches to Credit Risk and Operational Risk. It is the Tri-Party Group’s understanding that the vast majority of banks in the Crown Dependencies will be adopting these approaches, including the Simplified Standardised Approach for credit risk, or the Basic Indicator approach for Operational Risk.

NB: This paper does not address national discretions for the advanced approaches to both credit and operational risk (FIRB, AIRB and AMA). Consideration of the advanced approaches will be based on models developed outside the Crown Dependencies validated by the relevant home regulator, and therefore the national discretions of the relevant home regulator are likely to be adopted

National Discretions

The Basel Committee have included in the Basel II framework a number of areas where supervisors have discretion to tailor the requirements to best suit their particular markets and prudential approaches. These are referred to as National Discretions. The attached Appendix lists the National Discretions available under the Simplified Standardised and Standardised Approaches to Credit Risk along with the options proposed for consultation by the Crown Dependencies.

Within the Appendix there are a number of areas (in *bold italics*) where banks are specifically asked to comment on the proposed approach. These are:-

- i) Claims in the Regulatory Retail Portfolio (paragraphs 69 and 70);
- ii) Claims secured by residential property (paragraphs 72 and 73);
- iii) Venture capital and private equity investments (paragraph 80);
- iv) Credit Risk Mitigation techniques (own haircuts) (paragraph 154).

Banks are particularly encouraged to provide feedback on these issues but are invited to comment on any of the proposals.

National Discretions for the Standardised Approach to Operational Risk

The basic indicator and standardised approaches to Operational Risk use gross income¹ as the risk indicator. The Tri-Party Group is aware that many banks will use this option, but recognises that for some banks gross income may not be the most appropriate indicator to use when calculating the operational risk capital charge under Basel II.

Footnote 104 of Basel II gives supervisors the discretion to allow the Alternative Standardised Approach (“ASA”) to Operational Risk where banks are able to satisfy their supervisor that this alternative approach provides an improved basis of calculation. Once a bank has been allowed to use the ASA it would not be allowed to revert to the Standardised Approach without the permission of its supervisor.

¹ Under the basic indicator approach the capital charge is 15% of average annual gross income over the previous three years. Under the standardised approach a bank’s activities are divided into eight business lines and factors ranging between 12% and 18% are applied to gross income for each line.

The Tri-Party Group is minded to permit banks to use the ASA for Operational Risk. It is proposed that, for the ASA to be permitted in the Crown Dependencies, banks will be required to aggregate retail and commercial banking business lines and calculate the capital charge using the proportion of loans and advances (multiplied by a fixed factor of 0.035 as stated in footnote 104) as the exposure indicator. The capital charge for these lines will be 15% of this amount. The gross income for the other six business lines is aggregated and a factor of 18% then applied.

Banks are invited to provide comments on whether or not they would find this version of the ASA an appropriate alternative to the Standardised and Basic Indicator Approaches to operational risk.

Consultation

Banks are invited to provide any comments to their relevant Commission on the proposals contained in this consultation document. Where a bank is incorporated in one Crown Dependency and has branches in another Crown Dependency they are invited to send a group response to the Commission of the jurisdiction in which they are incorporated.

Comments should be in writing to the contact persons listed below and should be forwarded by 16 June 2006.

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National Discretions for the Standardised Approach to Credit Risk

Basel II paragraph reference (November 2005 version)	Summary of the Basel II National Discretion	Proposed Approach
Claims on sovereigns		
54 (3 under Simplified Standardised)	Apply a lower risk-weight to GBP claims on Crown Dependency governments when denominated and funded in GBP	Yes
54 (3 under Simplified Standardised)	Recognise the lower risk-weights of other supervisory authorities for domestic currency sovereign exposures funded in that currency	Yes, for exposures to Crown Dependency governments and the UK in GBP
55	Allow the recognition of export credit agencies' country risk scores for risk-weighting claims on sovereigns	Yes, use consensus risk scores of ECAs participating in the "Arrangement on officially supported export credits" - see www.oecd.org
201	Apply a lower risk-weight to claims (and portions of claims) guaranteed by the sovereign (or central bank) when denominated and funded in domestic currency	Yes
Claims on non-central government public sector entities (PSEs)		
57	Claims on domestic PSEs to be risk-weighted using option one or option two for claims on banks	Option 1
58 (7 under Simplified Standardised)	Claims on domestic PSEs may be treated as claims on the sovereign in the jurisdiction the PSE is established	Yes, if there is an explicit guarantee (no recognition of implicit guarantees)
Claims on banks		
60 – 64	Claims on banks may be risk-weighted one category less favourable than claims on the sovereign (option one) or based on the bank's own external credit assessment ² (option two)	Option 2 for Banks choosing the Standardised Approach. The simplified standardised approach is equivalent to Option 1, see para 8 of Annex 11
64 (9 under Simplified Standardised)	Allow a preferential risk-weight for claims on banks with an original maturity of three months or less that are denominated and funded in the domestic currency	Only under simplified standardised approach
Claims on corporates		
67	Increase the standard risk-weight for unrated claims when a higher risk-weight is warranted by the default experience of the jurisdiction	No, not warranted by the default experience in the Crown Dependencies

² The Tri-party Group will be responsible for determining whether an external credit assessment institution (ECAI) meets the criteria listed in paragraph 90 and will publish the process for recognising ECAIs in due course

Basel II paragraph reference (November 2005 version)	Summary of the Basel II National Discretion	Proposed Approach
Claims on corporates (continued)		
68	Allow all corporate claims to be risk-weighted at 100% without regard to external ratings	Yes on a bank-by bank basis, subject to the relevant Commission’s approval in writing
Claims in the regulatory retail portfolio		
69 (12 under Simplified Standardised)	Claims that qualify under criteria as laid down under Basel II (subject to discretion re para 70 below) may be considered as retail claims in a regulatory retail portfolio and may be risk weighted at 75% (except for past due loans)	<p>The Tri-Party Group is minded to offer a risk weighting of 75% for claims in the regulatory retail portfolio that meet the four Basel II criteria (orientation, product, granularity (see para 70) and low value)</p> <p><i>Comments are invited on whether banks plan to use the proposed 75% risk weight for claims in the “regulatory retail portfolio”. These comments should include reference to the ability of banks to be able to comply with the four criteria on an ongoing basis, including cost implications</i></p>
70 (13 under Simplified Standardised)	Set a numerical limit on the regulatory retail portfolio so that no aggregate exposure to one counterpart exceeds 0.2% of the overall regulatory retail portfolio	<i>Comments are invited on whether a numerical limit of 0.2% is appropriate to ensure granularity/diversification</i>
71 (14 under Simplified Standardised)	Increase risk-weights for regulatory retail exposures	Use 75% (see 69 above) given the low default rates in the Crown Dependencies. If a bank cannot meet the four criteria, a default weighting of 100% will apply
Claims secured by residential property		
72 – 73 (15 and 16 under Simplified Standardised)	Increase the preferential risk-weight (i.e. 35%) for claims secured by mortgages on residential properties (occupied by the borrower or rented) subject to LTV criteria	<p>For claims secured by residential properties with loan-to-value ratios of up to 80% use a risk weight of 35%. For higher LTVs use a risk weight of 75 % for the portion above 80% LTV. LTVs should be assessed on an ongoing basis, making use of indices where appropriate</p> <p><i>Comments are invited on whether the cut off LTV above is reasonable for the market in the Tri-Party Area</i></p> <p><i>Comments are also invited on the proposed methodology of apportioning risk weights on individual loans with LTVs above 80% and whether banks’ systems will be capable of monitoring LTVs to enable this methodology</i></p>

Basel II paragraph reference (November 2005 version)	Summary of the Basel II National Discretion	Proposed Approach
Claims secured by commercial real estate		
Footnote 29 to paragraph 74	Allow certain commercial property loans to be risk-weighted at 50% (subject to conditions)	No
Past due loans		
75 and 78 (18 and 21 under Simplified Standardised)	Allow the risk-weight for the unsecured portion of a past due loan, net of specific provisions, to be reduced to 50% when specific provisions are more than 50% of the claim (20% for mortgage loans)	Yes, but guidance would be given that, in such cases, banks would be close to liquidating the claim and would not be intending to make further material provisions
Footnote 30 to paragraph 75 (footnote 204 to 18 under Simplified Standardised)	Treat non-past due loans extended to counterparties subject to a 150% risk-weight the same way as past due loans (ie where specific provisions are more than 50% of the claim, risk weight the unprovided portion the claim at 50%)	Yes, but guidance would be given that, in such cases, banks must assess the provision on the basis of expected liquidation proceeds and not expect to make any further material provisions
Footnote 31 to paragraph 76 (footnote 205 to 19 under Simplified Standardised)	Allow a transitional period of three years for the recognition of a wider range of collateral for higher risk (past due) loans	No
77 (20 under Simplified Standardised)	Allow a 100% risk-weight for past due loans that are secured by other forms of collateral where provisions are greater than 15% of the outstanding amount of the loan	No
Other categories		
80 (22 under Simplified Standardised)	Apply a risk-weight of 150% or higher to other assets (e.g. venture capital and private equity investments)	<i>Comments are invited on the proposal that exposures to venture capital and private equity investments should be weighted at 150%</i>
Footnote 32 to paragraph 81 (footnote 206 to 23 under Simplified Standardised)	Allow gold bullion held in banks' own vaults or on an allocated basis to the extent it is backed by bullion liabilities to be risk-weighted at 0%	Yes
Footnote 32 to paragraph 81 (footnote 206 to 23 under Simplified Standardised)	Allow cash items in the process of collection to be risk-weighted at 20%	Yes

Basel II paragraph reference (November 2005 version)	Summary of the Basel II National Discretion	Proposed Approach
Use of external ratings		
Footnote 35 to paragraph 102	Allow the use of a borrower's domestic currency rating for an exposure in foreign currency if the exposure is to a multilateral development bank	Yes
108	Allow a bank to use unsolicited ratings in the same way as solicited ratings	No
Credit risk mitigation techniques		
154	Banks may calculate haircuts using their own internal estimates of market price volatility and foreign exchange volatility	<i>Comments are invited on whether banks in the Crown Dependencies would make use of this discretion. The Tri-party Group's initial conclusion is that the haircuts specified in the Basel II rules on the comprehensive approach to credit risk mitigation are sufficient for banks using the Standardised Approach</i>
170	Allow a zero haircut for certain types of repurchase and reverse repurchase agreements where the counterparty is a core market participant	Yes
171	Definition of core market participants	Follow the definition in the Basel II paper
172	Recognise other supervisors' preferential treatment with regard to haircuts for repurchase and reverse repurchase agreements	No