



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

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

August 2006
(Revised November 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, updated in November 2005 and re-issued as a “Comprehensive Version” in June 2006, 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 concerns measures designed to promote enhanced market discipline. Pillar 2 concerns the supervisory review process. This paper focuses on 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.

NB: 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, the Isle of Man Financial Supervision Commission and the Jersey Financial Services Commission have been working together to establish a unified approach, wherever possible, 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 publication of the National Discretions brings together work carried out by each island’s Basel II implementation teams and reflects the position taken by all three Commissions following the consultation exercise of May/June 2006. Throughout this publication, 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.

The published list of National Discretions 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 publication 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 and which will be validated by the relevant home regulator, and therefore the national discretions of the relevant home regulator are likely to be adopted in those cases.

National Discretions

The Basel Committee has 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 chosen by the Crown Dependencies, taking into account feedback received to the May 2006 consultation paper. Further guidance supplementing the National Discretions will be published as part of Pillar 1 preparation and implementation across the Crown Dependencies.

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.

The Tri-Party Group will permit banks to use the ASA for operational risk, subject to the qualifications in the preceding paragraph. For the ASA permitted in the Crown Dependencies, banks will be required to aggregate retail and commercial banking business lines and calculate the capital charge using the amount of loans and advances (multiplied by a fixed factor of 0.035 as stated in footnote 104) as the exposure indicator, instead of gross income. 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.

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.

Any queries relating to the National Discretions should be addressed in the first instance to the persons below as appropriate to the place of incorporation of the bank.

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National Discretions for the Standardised Approach to Credit Risk

| Basel II paragraph reference (June 2006 version) | Summary of the Basel II National Discretion | 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 – allocate a risk weighting of zero |
| 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; apply a zero risk weight |
| 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 |

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 (June 2006 version) | Summary of the Basel II National Discretion | 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 |
| 68 | Allow all corporate claims to be risk-weighted at 100% without regard to external ratings | Yes, available as an option 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) | A 75% risk weighting will be allowed for claims in the regulatory retail portfolio that meet the four Basel II criteria (orientation, product, granularity (see para 70) and low value) |
| 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 | No – granularity will be assessed on a bank by bank basis |
| 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 | For claims secured by residential properties with loan-to-value ratios of up to 80% a risk weight of 35% will apply. For higher LTVs a risk weight of 75 % for the <i>portion above</i> 80% LTV will apply |
| | | If a bank does not hold information regarding LTVs for individual exposures, a risk weighting of 50% will apply to the whole of those exposures |
| | | LTVs should be assessed on a regular basis, making use of relevant indices and market information where appropriate |

| Basel II paragraph reference (June 2006 version) | Summary of the Basel II National Discretion | Approach |
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| 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 will 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 will 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) | A 150% risk weight will apply for venture capital and private equity <i>investments</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 (June 2006 version) | Summary of the Basel II National Discretion | Approach |
|--|--|--|
| Use of external ratings | | |
| Footnote 37 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 Yes |
| Credit risk mitigation techniques | | |
| 154 | Banks may calculate haircuts using their own internal estimates of market price volatility and foreign exchange volatility | Yes on a bank-by bank basis, subject to the relevant Commission's approval in writing, taking into account the Basel II criteria. In particular, haircuts set out under the national discretions of the relevant home regulator will be considered. |
| 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 |