GUERNSEY
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Basel II Implementation Bulletin

October 2006

What is Basel II and why is it important?

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 disclosure and market discipline. Pillar 2 concerns the supervisory review process. This bulletin 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.

Timing of Implementation

As Guernsey is not a Basel Committee member and is not a member of the EU (and therefore not subject to the provisions of the Capital Requirements Directive) there is no formal date by which the Island is expected to have implemented Basel II. Nevertheless the Commission is committed to implementing Basel II and current indications are that it would be well positioned to begin implementing the Standardised Approaches by early 2008 and the Advanced Approaches by early 2009.

To meet these indicative implementation dates the Commission and banks in Guernsey need to agree on which approaches to credit risk and operational risk banks will adopt. This applies to all banks operating in Guernsey as subsidiaries. (Banks operating as branches in Guernsey do not have capital requirements imposed on their Guernsey branches by the Commission. However, it is likely that branches will become involved in providing data and adopting policies and procedures in connection with Basel II implementation as required by their Head Offices as a result of the requirements imposed by their home supervisor.)

Application Process – Advanced Approaches

Under Basel II banks may apply to use the advanced approaches to calculating capital allocations for credit and operational risk. For these more advanced approaches banks are required to calculate (using Basel I methodology) a capital floor following implementation of the Basel II framework. This is so that they can operate a "parallel run" of Basel I and Basel II frameworks for a number of years (see paragraphs 45 to 49 of the new Accord). In addition the Basel II framework requires a number of years of data in order to implement the more advanced approaches (see paragraphs 263 and 264 of the Accord).

As a consequence banks will need to apply to the Commission for permission to use the advanced approaches to credit and/or operational risk within a reasonable timeframe. **Accordingly, the Commission will assume that banks will be implementing the Standardised Approaches to credit and operational risk unless it receives a written application to utilise the advanced approaches by 31 December 2006.**

On the basis of consultations and discussions in prudential meetings, we are not expecting many banks to apply to use the advanced approaches.

Application Process – Other Approaches

Other alternatives to the Standardised Approaches to credit and operational risk are the Alternative Standardised Approach to operational risk (see the Tri Party National Discretions paper issued by the Guernsey, Jersey and Isle of Man Commissions in August 2006 for details on this approach), the Basic Indicator Approach to operational risk and the Simplified Standardised Approach to credit risk**. To assist the Commission in its Basel II implementation planning, banks are requested to confirm, in writing, to the Commission before 31 December 2006 if they wish to seek permission to use one of these three other approaches.**

Approval Process – Advanced Approaches

The Commission will enter into a dialogue with banks wishing to implement approaches other than the Standardised Approaches. (In some cases this dialogue has already begun although no formal applications to adopt advanced, simplified or alternative approaches have yet been received.) This dialogue will include discussions on how appropriate the proposed framework is to the risks facing the bank in Guernsey and what level of understanding the local management has of the model(s) being used. It will also include an ongoing dialogue with the home supervisor of the bank concerned to evaluate their approval process and any conclusions they might have reached in connection with the model.

Throughout 2007, and as applications are made in subsequent years, the Commission will work with banks seeking to implement advanced frameworks until all pre-conditions are met and a conclusion is reached by all parties that it is an appropriate time for the Guernsey bank to implement advanced approaches. This will include a period of parallel running to ensure that there is not a sudden and inappropriate change to banks' minimum capital requirements.

Approval Process – Other Approaches

Before the Commission will approve the use of Simplified Standardised, Alternative Standardised or Basic Indicator Approaches it will need to be satisfied that these approaches are sophisticated enough to capture all of the risks in the bank. If the Commission is not convinced that these approaches are sufficient to capture a bank's risks it may well nevertheless approve the use of that approach but with the proviso that risks not caught in Pillar 1 will need to be addressed in the ICAAP under Pillar 2. (The Commission will issue a Briefing Paper on Pillar 2 in 2006.)

Conclusion

Before 31 December 2006 banks are requested to formally apply to the Commission if they intend to adopt one or more of the following Basel II frameworks:-

1) Credit Risk

   Foundation Internal Ratings – Based Approach (FIRB)
   Advanced Internal Ratings – Based Approach (AIRB)
   Simplified Standardised Approach

2) Operational Risk

   Advanced Measurement Approach (AMA)
   Alternative Standardised Approach
   Basic Indicator Approach

Those banks which have not applied to carry out one or more of the above approaches will be assumed to be adopting the Standardised Approaches to credit and/or operational risk.

Guernsey Financial Services Commission
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