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

Basel II – Credit Risk

November 2007

Introduction

In 1988 the Basel Committee on Banking Supervision ("Basel Committee") issued a report entitled "International Convergence of Capital Measurement and Capital Standards". The report was updated in 1997. Its purpose was to secure international convergence of supervisory regulations governing the capital adequacy of international banks. The report has become known in recent years as "Basel I".

Latterly, the Basel Committee has worked to revise Basel I. The new revised framework was last updated in November 2005 and was re-issued as a "Comprehensive Version" in June 2006. The revised framework is referred to hereafter as "Basel II".

Basel II builds on and enhances the Basel I requirement for holding capital to cover credit risk and prescribes three methods for calculating required levels, each progressing in sophistication and risk sensitivity. These are:

- The Simplified Standardised Approach ("SSA");
- The Standardised Approach ("SAC"); and
- The Internal Ratings-Based Approach ("IRB").

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 four previous papers reflects this unified approach and brings together work carried out by each island's Basel II implementation teams. The papers were:

- "*National Discretions for the Standardised Approaches to Credit and Operational Risk under the Basel II Capital Framework*", issued in August 2006 and revised in November 2006;
- "*Basel II – External Credit Assessment Institutions' Ratings and Mapping of Ratings to Risk Weights*", issued in October 2006 and revised in November 2006;
- "*Basel II – Operational Risk*" issued in May 2007; and
- "*High level principles on Pillar 2 and revision of supervisory returns*" issued in June 2007.

This paper builds further on the co-operation between the islands and is one of a series of Tri-Party publications of detailed guidance for the implementation of the Basel II framework.

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 Tri-party Group understands that the vast majority of banks in the Crown Dependencies will initially be adopting either the SSA or SAC to calculate the credit risk capital charges under Basel II. The schedule to this paper provides detailed guidance to the prudential reporting under these, rather than the IRB, which will be developed on a bespoke basis with individual banks.

An overview of credit risk

The three methods for calculating credit risk capital charges vary in complexity and risk sensitivity. The approach of the Basel Committee has been to encourage banks to move along the spectrum of available approaches as they develop more sophisticated credit risk measurement systems and practices. However, qualifying criteria have to be met for banks wishing to adopt the IRB. For banks in the Crown Dependencies it may be the case that (based on the risk profile and type of business conducted by the bank) the SSA or SAC will continue to be a appropriate for calculating a credit risk capital charge under Pillar 1.

Internationally active banking groups and banks with significant credit exposures are generally expected to use an approach that is more sophisticated than the SAC (or SSA) and that is appropriate for the risk profile of the bank. A banking group may be permitted by its home regulator to use the SSA or SAC for some parts of its operations and IRB for others provided certain minimum criteria are met, as established under Basel II.

Once a bank has been approved for a certain type of approach, it must not revert to a simpler approach without Commission approval. However, if the Commission determines that a bank using a more advanced approach no longer meets the qualifying criteria for that approach, it may require the bank to revert to a simpler approach for some or all of its operations, until it meets conditions specified by the Commission.

The Commission encourages banks to comply with the Basel Committee's guidance entitled "*Principles for the Management of Credit Risk, September 2000*", *"Sound Credit Risk Assessment and Valuation for Loans, June 2006"* and any relevant current and future guidance on credit risk that may be published by the Basel Committee or the Commission.

Standardised Approach and Simplified Standardised Approach

Overview

Banks using the SSA and SAC must calculate their capital requirements for credit risk in a standardised manner, supported by external credit assessments where appropriate (in the case of the SSA, this is limited to the consensus country risk scores of export credit agencies participating in the "Arrangement on Officially Supported Export Credits" published on the OECD website).

In determining the risk weights to apply to assets under these approaches the Tri Party Group have exercised their "national discretions" to establish that banks using the SAC may use external credit assessments published by the following rating agencies:-

- Fitch Ratings;
- Standard & Poor's Ratings Services; and
- Moody's Investors Service.

The SSA is different from the SAC in that it only provides a limited spectrum of weightings for asset classes. It is therefore simpler but less risk-sensitive.

Any perceived inadequacy of capital held for credit risk would need to be addressed in the ICAAP and SREP processes under Pillar 2 of Basel II.

Detailed Reporting Requirements and Guidance

Schedule 1 provides template prudential reporting forms and associated guidance/completion notes which have been agreed by the Tri-party Group for the SAC and the SSA. The Commission will incorporate these (subject to any final changes in format and referencing) into a set of Basel II compliant prudential reporting forms in time for Basel II implementation.

Qualifying Criteria

No specific qualifying criteria have been established but the SSA may generally be considered applicable to those banks with relatively straightforward credit risks.

Mapping

Schedule 1 includes principles and guidance for assigning eligible external credit assessments to the risk weights available under the standardised risk weighting framework i.e. deciding which assessment categories correspond to which risk weights. This mirrors the previously published guidance contained in the Tri-Party Group paper:- "*Basel II – External Credit Assessment Institutions' Ratings and Mapping of Ratings to Risk Weights*", issued in October 2006 and revised in November 2006.

The Internal Ratings-Based Approach ("IRB")

Overview

It would not be an effective use of the Commission's resources to develop the capability to validate a bank's IRB models (including hybrid IRB approaches comprising both a group IRB and a capital allocation method for individual entities).

Some banks in the Crown Dependencies will wish to utilise models developed at group level. In such cases, the Commission will need to be satisfied that the following criteria can be met before approving the use of the IRB approach:

- The models to be used adequately reflect the local bank's risk profile;
- Ongoing adequate validation and support from the home/lead supervisor will be available;
- The output generated will be adequate to enable the Commission to carry out its continuing responsibility to assess capital adequacy; and
- The local bank has adequate knowledge and resources available locally to enable it to effectively implement and maintain the IRB approach.

The Commission will not be in a position to approve the use of the IRB by a bank to calculate credit risk capital charges, unless it is satisfied with the above conditions. Approval of the IRB approach will normally only be given once the home supervisor has approved the group models involved. It will be done on a case by case basis.

The Commission will also have due regard to the Basel Committee document "*Home-Host information sharing for effective Basel II implementation" (June 2006*) when assessing applications for approval of use of the IRB approach.

Even though advanced approaches are primarily developed at group level, local management will be expected to understand and manage their bank's risk profile and ensure that it is adequately capitalised. A bank should therefore have, or have access to, adequate information that is directly relevant to it, and be able to make this information available to the Commission when requested. Examples of such information may include:

- Local procedures for measuring credit risk;
- Evidence of how the local bank's internal credit risk measurement system is integrated into its day-to-day risk management process;
- Pillar 2 assessment of risks which are not captured in the bank's IRB approach under Pillar 1; and
- How group systems and processes will be applied locally.

<u>Liaison</u>

The Commission encourages banks that wish to adopt the IRB approach to keep it informed of progress in the home regulator approval process. This will assist the Commission in its dialogue with home supervisors.

<u>Detailed Reporting Requirements and Guidance</u>

The Commission will require banks utilising the IRB approach to complete a set of Basel II-compliant prudential reporting forms which will include capital (and risk weighted asset equivalent) figures for the credit risk charge on a quarterly basis. Individual reporting requirements will be agreed as part of the approval process.

<u>Qualifying Criteria</u>

Basel II lays out minimum requirements for entry and ongoing use of the IRB approach. The minimum requirements are set out in detail under twelve sections of the accord (as set out in "*H. Minimum Requirements for IRB Approach*" within "*III. Credit Risk – The Internal Ratings-Based Approach*", within "*Part 2: The First Pillar – Minimum Capital Requirements*"), which are:-

- Composition of minimum requirements;
- Compliance with minimum requirements;
- Rating system design;
- Risk rating system operations;
- Corporate governance and oversight;
- Use of internal ratings;
- Risk quantification;

- Validation of internal estimates;
- Supervisory Loss Given Default and Exposure at Default estimates;
- Requirements for recognition of leasing;
- Calculation of capital charges for equity exposures; and
- Disclosure requirements.

If a banking group wishes to adopt the IRB approach it must meet these qualitative and quantitative criteria as established under Basel II. This will be assessed as part of the home / lead supervisor's validation that, as previously stated, forms part of the Commission's considerations.

Any queries relating to the information contained in this paper should be addressed in the first instance to the persons below, as appropriate to the place of incorporation of the bank concerned.

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Schedule 1 – Reporting Forms, Guidance/Completion Credit Risk Capital Calculations under the Simplified Standardised and Standardised Approaches

Reporting Forms:

Part A: SSA Forms

http://www.gfsc.gg/UserFiles/File/Banking/Part%20A%20-%20SSA%20Forms.pdf

Part B: SAC Forms

http://www.gfsc.gg/UserFiles/File/Banking/Part%20B%20-%20SAC%20Forms.pdf

Guidance / Completion Notes:

Part C: SSA Completion Guidance

http://www.gfsc.gg/UserFiles/File/Banking/Part%20C%20-%20SSA%20Completion%20guidance.pdf

Part D: SAC Completion Guidance

http://www.gfsc.gg/UserFiles/File/Banking/Part%20D%20-%20SAC%20Completion%20guidance.pdf