GUERNSEY FINANCIAL SERVICES COMMISSION

Implementation of Basel II in Guernsey

Introduction

This paper summarizes the key points in the first year (Year 1) of the implementation of Basel II in Guernsey.

Section I considers the impact of regulatory capital in the Bailiwick both in absolute terms and in terms of regulatory ratios.

Section 2 sets out the main risks that Guernsey banks face as identified in Pillar 2. It outlines the several methodologies adopted by Guernsey banks in assessing and allocating regulatory capital. It identifies the key benefits captured by banks and makes recommendations on how banks can capture further benefits in the second year (Year 2).

Section 3 summarizes the results of a third party assessment of the banks' experience and the Commission's handling of the implementation process. It also sets out the Commission's underlying approach to Year 2.

Section 4 concludes.

This paper is addressed primarily to the Guernsey banking sector.

Scope

During the last three quarters of 2009, 19 banks out of 22 in Guernsey were transitioned from Basel I to Basel II. The residual 3 banks – none of which is amongst the very largest banks in Guernsey - will be transitioned shortly. All the calculations below exclude these banks either for Basel I or Basel II.

All 19 banks chose the simpler Pillar 1 approaches for credit and operational risk. Even in Pillar 2, only one bank chose to use a capital model. This was understandable given the size of most Guernsey banks, the limited data sets, the specialized nature of business and the fact that this was the first year of Basel II.

Comparisons between Basel I and Basel II stretch over 9 months of the transition period. While this does not materially affect the outcomes, it will have had some effect on the comparative Risk Asset Ratios (RARs).

For clarity, an 'average' cited in the text below is based on the sum of all Risk Weighted Averages (RWAs) of the 19 subsidiary banks. This means that the larger banks will have a more significant impact on the average than the smaller banks.

Again for clarity, the conventional terminology for Basel II is to use the Pillar 1 charge as an indicator of base capital – that is the imposed 8% RAR becomes 100% of the capital requirement. Any "add-on" in Pillar 2 is then expressed as an uplift to the 100%. That is to say, that a 10% RAR equates to an Individual Capital Guidance (ICG) of 125%.

At the time of the transition, under Basel I the average RAR was 10.6%, RWAs were £10.4bn and absolute regulatory capital was £1.1bn.

Section 1 – Quantitative Impact

Pillar 1

RWAs rose from £10.4 under in Basel I to £11.7bn under Pillar 1 Basel II. This increase was largely because of the inclusion of committed facilities and an increase in the credit conversion factor for some third party exposures.

However, for capital purposes, the increase in RWAs was outweighed by the notional fall in the RAR to 8% from 10.6%. This meant that absolute regulatory capital fell from £1.1bn under Basel I to £0.9bn under Basel II in Pillar 1; a fall of £0.2bn.

Within Pillar 1 and using an average, the main risk component was credit risk at 94%. Operational risk accounted for 6%. Market risk and settlement risk were negligible.

Pillar 2

In quantitative terms, all banks were required by the Commission to apply "add-ons" in Pillar 2 such that no bank had, as a minimum, less regulatory absolute capital under Basel II than under Basel I.

Unlike the simplified approach to Pillar 1, the setting of Pillar 2 regulatory capital is less rigid. In this case several factors affected the level of Basel II regulatory capital. These were:

1. The outturn of Pillar 1 for each bank and whether this created a need for a large Pillar 2 add-on so as to maintain the absolute level of minimum regulatory capital
2. The Commission's desire to normalize historic RARs some of which had got out of line with the up to date risk profile of the bank; allowing outliers only where it was strictly necessary
3. The identification of risks and the consequent allocation of capital as a result of the Supervisory Review Evaluation Process (SREP) discussion for each bank; this sometimes led to an increase in absolute capital

In the event, Pillar 2 added £0.3bn to total regulatory capital – compared to the reduction of £0.2bn capital to £0.9bn in Pillar 1. Total regulatory capital therefore rose to £1.2bn. However, the average RAR fell to 10.3% compared to 10.6% for Basel 1. Given the number of variables involved (not least the 9 month transition period), this change is of limited significance.

The average regulatory ICG is 132%. Only three banks have an ICG below 125%. The highest ICG is 178%.

Pillar 2 re-balanced the capital coverage of risk away from counterparty exposure. If Pillar 2 capital is added to Pillar 1 operational risk, then the main risk components covered by capital are: credit risk 78% and operational (or 'other') risks 22%. Given that Guernsey banks are exposed to material operational risks, this result seems more appropriate than for Pillar 1 where the operational risk charge was very low.

Actual Capital

Under Basel I, actual capital was £2bn compared to regulatory capital of £1.1bn – representing an uplift of 82%.

Under Basel II, actual capital remained at £2bn but regulatory capital rose to £1.2bn – an uplift of 66%. The gap therefore between actual and regulatory capital has narrowed as a result of Basel 2 but remains significant.

The up lift between Pillar 1 at 8% and actual capital in Basel II is substantial as the actual average ICG is 220%.

Section 2 – Qualitative Factors

The following analyses the qualitative rather than the quantitative outturn of Basel 2. Pillar 2, unlike Pillar 1, allowed a more detailed exploration of the risks faced by Guernsey banks, especially as Pillar 1 focuses more on counterparty risk.

Within Pillar 2, the main add-ons covered the following risks:

1. *Credit concentration*

The main counterparty risk is usually on the parent. In addition, several banks have loan portfolios that can be highly concentrated in distinct geographical areas such as central London.

2. *Outsourcing*

Many banks outsource key activities either outside or within the group – such as credit risk monitoring.

3. *Custody*

Several banks run custody operations where there is a risk of a rare but significant loss; especially given the extent of manual work-around that would sometimes be necessary

4. *AML/CFT and reputational risk*

This was a commonly acknowledged risk for the jurisdiction but there were differing views as to whether capital should be allocated to it. Several banks devised innovative approaches for capital allocation here – see below. Some banks took capital charges for mis-selling.

5. *Governance and risk management*

In a few cases, the Commission concluded on the basis of the ICAAP that the quality of corporate governance and risk management in the firm had not been proven to meet minimum standards. A capital add-on was therefore applied.

Overall, the Pillar 2 process led to both bank management and the Commission better understanding material Pillar 2 risks. For 2010, the above risks should continue to be the object of attention from both the Commission and banks.

<u>The Quality of the ICAAPs</u>

The quality of the ICAAPs varied significantly. After iteration with the Commission, most banks met minimum requirements although only one exceeded them. The Commission expects many more banks to exceed minimum requirements in Year 2 and none to fall below.

Even for those banks meeting minimum standards, the executive's approach to the process was sometimes less than optimal and the board's involvement was limited. In our view there was limited or no useful expert support from the wider group in some cases. Parts of the ICAAP itself were difficult to read; some numbers did not add up and sometimes major risks were dismissed out-of-hand.

In other cases management had thought about the risks in the business and had articulated these in clear terms. Such ICAAPs included scenarios and stress testing; together with innovative approaches to capital estimation. Weaknesses in the control structure were identified with concrete action being taken to address these weaknesses.

Only one ICAAP reflected the additional risks arising from significant developments in the near future and few banks produced ICAAPs that linked capital and control requirements to their business strategy or to the economic cycle.

Some firms tried to apply an aggregate add-on for Pillar 2 without considering specific risks. However, several banks used better approaches. In order to disseminate good practice, examples of these are set out below:

i. Use of historical data

One bank used a concentration risk statistical approach developed by its parent. Based on historical data, the added risks of losses on a loan were estimated based on a concentration on clients, sector (eg property purchase, retail loan,) etc.

One bank assessed the potential loss from reputation risk by looking at how shareholder value had been affected by an event elsewhere that cast group management in a poor light, and relating this to group income. It applied this relationship to its own income.

One bank estimated the scale of future undrawn uncommitted facilities by looking at the fluctuations in drawings in previous years, including the 2008/09 financial crisis when client drawings were very high.

ii. Constructing formulae to represent how losses could eventuate

In estimating the losses from transactions one approach was based on the number of transactions in a period of time. The range of transaction values, the frequency of errors in transactions, and the effect of a bunching of transactions around certain moments, i.e. month end settlements were taken into account. This led to a simple equation to estimate the average losses.

The vulnerability of an upstreaming bank to its parent was assessed by measuring the effect of a severe downgrade on the RWA, i.e. from a 20% capital charge to 50%. In another case, a percentage was added on to the RWA of the upstreamed sum as a prudent uplift to reflect the vulnerability of the bank to loss of parental support.

The extra credit risk factor to apply to a set of loans that were under challenge was estimated by considering the discount that would be applied to the book if the bank tried to sell them.

To estimate the effect of reputational risk, assumptions were made of the proportion of clients who would leave and the duration of this effect, and the impact on income was assessed to provide a capital add-on.

iii. Assessments of average and extreme losses

To estimate the capital charge for extreme interbank losses for a bank that had suffered a large loss in the financial crisis, the biggest loss was taken, the frequency of such an event estimated and the loss of value, i.e. net of recoverable value was used:

(Initial RWA of the Loan * loss of value %) / 40 years

On other occasions, more than one assessment of losses was done to understand the sensitivity of the losses to specific factors in the scenario and a representative value obtained.

iv. Using scenario analysis techniques

To look at residual risk on property backed loans, different scenarios of large falls in prices were postulated, and the shortfall between asset value and loan was summed. These risk weighted assessments of potential losses were added to provide the assessment of residual credit risk

In another case of looking at the possible losses from the interbank book, scenarios were assessed of the major counterparty failing, or a country wide default.

v. Administered banks

For administered banks, one bank used the standardized approach to operational risk to calculate a proxy figure for outsourcing, based on the average 3 year-revenue paid to the managing bank. A 12% beta was taken to produce the Pillar 2 add-on. Another bank used the same methodology (one of several standard operational risk proxies under Basel II) but a beta of 15%. For the same risk another bank applied a Pillar 2 add-on of 1% of risk weighted assets to cover a loss of service and the costs of transferring to another provider of managed bank services. Yet another approach was to consider the cost associated with making alternative outsourced arrangements within a six month timeframe.

Benefits of the ICAAP

In addition to the continuing development of risk management, examples of the actions now underway in banks as a result of their ICAAPs are:

- Improvements in documentation
- Improvement of, and more involvement in, intra-group product development
- More intensive review of credit facilities to determine the real extent of commitment of undrawn facilities.
- Consideration of the extent of the risk exposure to activities taking place elsewhere in the group, and the Guernsey bank's control of them

There is more scope for banks to use ICAAPs to reduce costs, re-balance risk/reward, improve controls and better align future business strategy.

Way forward

We have suggested banks should usefully consider the following key points in Year 2 of the ICAAP:

1. Consider the ICAAP as much a business as a regulatory tool and therefore seek to extract business benefit from it; including forward-looking assessments.
2. Ensure that the board is involved in the identification and mitigation of the material risks
3. Use intra-group risk management support more usefully
4. Use simple but sound methodologies for allocating Pillar 2 capital; using internal and external data; basic impact/probability analysis; future business forecasts; and scenarios
5. Use stress testing (e.g. from the IMF) and reverse stress testing – i.e. what would it take to exhaust capital?

Section 3 – Regulatory Review

The SREP

The Commission engaged an independent consultant to seek feedback on a non-attributable basis on the ICAAP/SREP from eight banks out of a list of nine provided by the Commission as representative of the banks in Guernsey.

The key findings were:

- The most concern was expressed about the early development phase, where most would have appreciated more guidance from the Commission

- The key aspect for the banks in terms of interaction with the Commission was the SREP meeting. Reviews were unanimously positive

- Most felt that the process had been a good learning experience and it had assisted with internal understanding of the various risk categories

- Most respondents looking forward would very much appreciate a steady course from the Commission, with as few changes as possible to the ICAAP process

- Most respondents would very much appreciate any feedback the Commission feels able to provide (via the offices of the Association of Guernsey Banks)

- Most respondents were accepting of the Commission's findings with regard to the final ICG

- Most respondents felt that their experience with the Commission had been more beneficial and constructive than their experiences with other regulators

The views of the banks are summarized below:

_	**Banks**	A	B	C	D	E	F	G	H	**Blended**
Aspect										
ICAAP Development										
Preparation of Report										
SREP										
Issues Arising										
Overall										

Favourable
Mildly Favourable
Neutral
Mildly unfavourable
Unfavourable

The recommendations from the independent consultant are set out below – together with the Commission's responses:

- Provide feedback to the banks on this exercise and what the Commission has learned. *[This paper responds to this point.]*

- Make clear statements regarding the basis for RAR figures, if possible, even if that involves acceptance of a "political floor" for the jurisdiction. *[The Commission in*

Year 2 of the SREP will implement a minimum ICG floor of 125%, unless there are particular reasons for exceptions. The Commission will generally not allow a reduction in regulatory ICGs for Year 2; though it may in the future. On Pillar 2 the Commission is unlikely to reduce the absolute amount of capital required, irrespective of any contraction in the balance sheet)

- Make clear expression of thoughts on the possibility of, and the Commission's appetite for, greater coordination with other jurisdictions. *[The Commission will continue to liaise with other regulators and to deepen the contact; for example it has requested bilateral discussion with all home supervisors on the Guernsey ICG and will feed relevant comments into the Year 2 SREP]*

- Formulate a view concerning the level of guidance the Commission is able and willing to provide as balanced against the requirement to exhibit flexibility with regard to different business models. *[The Commission recognises that a good balance between guidance and innovation is difficult to reach at all times and that each bank may have different views on the correct balance. This paper does contain several outlines of how banks approached Pillar 2 and this should be useful. However generally the Commission will default if in doubt to a position that avoids detailed prescriptive rules)*

At the request of the banks and in order to limit change, the Commission will not make material changes to the SREP for Year 2. It will seek to use SREP material from Year 1 to reduce the internal work required for Year 2; and to continue to clarify the SREP process for banks.

Section 4 - Conclusion

In Guernsey, the transition from Basel I to Basel II has resulted in a small rise in absolute regulatory capital. For credit risk, undrawn committed and uncommitted facilities – which are relatively widespread in Guernsey - now explicitly require regulatory capital. A series of risks – many of them operational in nature - have been identified and regulatory capital allocated to them in Pillar 2. Several assessment and allocation methodologies have been developed by banks.

In terms of RAR and ICG, as well as actual capital levels, the banking sector remains in line with international standards both on average and for each bank.

Looking forward, most banks still need to make further efforts to identify their material risks as well as assessing the effectiveness of the mitigation around them. Risk management analysis needs to be improved (including being made more forward-looking), and more dedicated resource and effort needs to be given to the ICAAP. Boards need to be more involved in the process and to take additional steps to improve their assurance over the executive's management of risk.

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