Guernsey Financial Services Commission

Guidance on the approach to Pillar 2 following the implementation of Basel III-consistent minimum regulatory capital requirements in Guernsey.

February 2017

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The Pillar 2 element of the jurisdiction's Basel-III approach is applied through two processes: banks' risk assessment and identification of capital and other mitigants required to cover these risks (the Internal Capital Adequacy Assessment Process - "ICAAP"), and the process of supervisory review and evaluation of that assessment (the "SREP") by the Commission.

Banks' total regulatory capital Risk Asset Ratio must be maintained above a level calculated by the addition of the Pillar 1 requirement of 8% of Risk Weighted Assets ("RWA"), a 2.5% Capital Conservation Buffer (CCB) and a Pillar 2 add-on. The Pillar 2 add-on is determined through the SREP and represents the amount of additional capital to be held for Pillar 1 risks and for those risks not included in the Pillar 1 charge. The Commission sets a floor of 0.5% for this Pillar 2 add-on but expects banks generally to be well above this minimum.

While the ICAAP should review all risks and the controls over them, the Pillar 2 charge should focus on the two or three key material risks that merit capital mitigation. The assumption should be that these risks continue even when relevant controls are effective.

For all risks, in the event that the Commission considers that key controls have, or are likely to fail, then the Commission has the option of increasing the Pillar 2 charge until matters have been put right.

For the avoidance of doubt, the CCB is an additional regulatory capital charge that acts as a buffer to assist a bank in formal recovery mode – subject to agreement with the Commission. In practice however, no bank would normally wish to enter upon such a process and thereby eat into its CCB.

It is the Commission's expectation, therefore, that in preparing and presenting the ICAAP, banks will identify their capital needs on the following basis:

Pillar 1	***8% of RWA***
Plus Capital Conservation Buffer	***2.5% of RWA***
Pillar 2	***X% of RWA (bank risk specific, aggregate minimum of 0.5% of RWA)***
Total	***At least 11% of RWA***

Banks are reminded that the ultimate responsibility for identifying risks remains with the Board of Directors and that the ICAAP should be regularly updated to reflect changes within the business.

A Pillar 2 Working Sheet, illustrating the suggested format for the presentation of the Pillar 2 add-on calculation to the Commission, accompanies this guidance. Banks may find it useful to complete the Working Sheet or may choose to adopt the calculation format in their own workings.