

SUPERVISORY APPROACH - ANNEX

(Applies to Isle of Man incorporated deposit taking entities only)

Supervisory Review and Evaluation Process

(“SREP”)

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Appendix I – Glossary

I. Background & Scope

- I.1 The purpose of the Supervisory Review & Evaluation Process (“SREP”) is to ensure that deposit takers (hereinafter referred to as bank or banks as applicable) have sufficient capital to support all material risks to which their business exposes them. It is intended to reinforce the link between risk and capital, so that the bank’s risk management strategy and systems are integrated with its capital planning. As such, it is also encouraging banks to develop and use better risk management techniques.
- I.2 The Commission’s existing supervisory framework (refer to the Commission’s “Supervisory Approach” document, published in January 2007) explains how the Commission risk assesses a bank. The Commission already requires banks to observe a minimum risk asset ratio (“RAR”), the level of which is subject to variation depending on the risk profile of the individual bank.
- I.3 The main innovation under the SREP is the Internal Capital Adequacy Assessment Process or the “ICAAP” which relates risks to the amount of capital a bank holds. The bank has to have an ICAAP and must be able to explain it to the Commission; the Commission has a duty to review the bank’s ICAAP. This review is an integral part of the Commission’s risk assessment of the bank and determination of the bank’s minimum RAR. A separate guidance note on the ICAAP is available from the Commission’s website www.fsc.gov.im.
- I.4 The purpose of this document is to:
 - Outline the principles and key components of the SREP (section 2);
 - Highlight the key features of the Commission’s approach to the SREP (section 3);
 - Provide guidance on how the SREP will be conducted (section 4); and
 - Highlight the Commission’s key considerations when reviewing the ICAAP (section 5).

2. Principles & Key Components of the SREP

- 2.1 The Principles of the SREP are set out in the Basel Committee’s document “International Convergence of Capital Measurement and Capital Standards” and are as follows:-
 - Key Principle 1 requires that banks have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.
 - Key Principle 2 requires supervisors to review and evaluate banks’ internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital

ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

- Key Principle 3 states that supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
- Key Principle 4 states that supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.
- Key Principle 5 states that supervisors must monitor the bank's compliance with the qualifying criteria, where a bank has been given approval to use the advanced approaches to credit and/or operational risk.

2.2 The key components of the SREP are as follows:-

2.2.1 Review of a bank's risk profile

This is part of on-going supervision and is detailed in the "Supervisory Approach". When reviewing a bank's risks, the Commission will assess those factors that may result in an additional capital requirement for the bank, over and above the Pillar I requirement.

2.2.2 Review of a bank's ICAAP

The Commission will review the bank's ICAAP as part of the SREP. The review will include a consideration of the assumptions, methodology, coverage and outcome of the bank's ICAAP, with a view to assessing the adequacy and effectiveness of the ICAAP.

2.2.3 Advanced Approaches to credit and operational risk

There are specific qualifying criteria which must be met before a bank may implement advanced approaches to credit and/or operational risk, and the Commission's approval is required. The SREP will include monitoring by the Commission to ensure that these criteria continue to be met. The criteria are both qualitative (e.g. risk management processes) and more quantitative (e.g. the soundness and integrity of the internal models).

2.2.4 Determination of a bank's minimum RAR and/or other supervisory measures

The Commission will consider what RAR is appropriate under the capital adequacy regime, and will determine the level of capital required in light of the different risk profiles of individual banks. In addition to the capital requirement, the Commission will also consider what other actions may be appropriate such as rectifying any control deficiencies.

2.2.5 Discussion of the SREP results with a bank

The results of the SREP will form the basis of a discussion between the Commission and a bank. This will address any areas of concern raised by the Commission, including those which may lead to an increased RAR and/or other corrective action. A bank's management will be given the opportunity to participate fully in such discussions.

2.2.6 Ongoing monitoring of a bank's capital adequacy

The Commission will monitor the bank by way of analysis of prudential returns, meetings, discussions and on-site inspections. The risk profile of the bank will be updated as appropriate.

3. Key Features of the Commission's approach to the SREP

- 3.1 The minimum RAR is 8% as prescribed in the Financial Services Rule Book 2008, although this may be set at a higher level for individual banks by way of Direction. All banks are required to observe a non-statutory trigger ratio of at least 1% above the bank's minimum RAR. This is intended to provide a cushion to reduce the risk of a bank breaching the minimum requirement and to provide an early warning signal of deterioration in a bank's capital adequacy.
- 3.2 The Commission will endeavour to be as transparent as possible in respect of the SREP, making publicly available the criteria to be used in the review of a bank's ICAAP. Where the Commission sets RARs higher than the minimum, it will explain the rationale for this to a bank.
- 3.3 Pillar 2 does not mean an automatic capital add-on, although this could be one of the outcomes of the ICAAP and/or SREP.
- 3.4 The Commission will adopt a proportionate approach to the SREP. The intensity and depth of the review will take account of the nature and scale of a bank's operations and its track record.
- 3.5 It is expected that a bank will adopt a proportionate approach to the ICAAP and the Commission expects ICAAPs to vary in detail depending on the nature, scale and complexity of individual banks.

- 3.6 The ICAAP will be reviewed annually and the depth of review will depend on the nature and circumstances of a bank as well as on events over the previous year. The results of the review will normally be discussed at the Annual Business Meeting.
- 3.7 The Commission will take stock of significant changes to a bank's risk profile over the past year and assess how these changes affect a bank's plans in the coming year. The Commission will consider the results of any off-site reviews, on-site inspections and any relevant information obtained from prudential returns, meetings, media coverage, routine contacts and other research.
- 3.8 The responsibility for the ICAAP is that of the Board and Senior Management. The SREP does not replicate the role of these bodies.
- 3.9 The Commission expects the ICAAP to be subject to a periodic review which should be annual as a minimum. If there is no material change to the risk profile of a bank, confirmation of this to the Commission will be sufficient. However, where a bank's risk profile has changed to a material extent during the year, the Commission will require a revised ICAAP to be submitted which will be reviewed as part of the SREP.

4. Guidance on the Methodology of the SREP

- 4.1 The "Supervisory Approach" details the inherent risks the Commission will consider when risk assessing a bank and as well as other considerations such as systems and controls and corporate governance which also form part of this process. These are known as "risk groups". Within each risk group there are "risk elements" which provide further detail re the criteria the Commission may use in making its assessment.
- 4.2 Under the SREP, the Commission will evaluate the risks and the extent to which they are mitigated and managed. The review of a bank's ICAAP will be part of the review of the "Financial Soundness" risk group. The outcome of this process will determine if a bank should hold additional capital and if so, how much. The SREP is a combination of on-site and off-site supervision.
- 4.3 Certain inherent risks are within the scope of the minimum capital requirements of Basel II, Pillar I, and so capital has already been allocated to these. However, there are residual risks arising out of some of the above which are not covered under Pillar I and there are other inherent risks which are not covered at all and which must be addressed by the ICAAP and SREP under Pillar 2. All controls are assessed under the SREP.

The following table provides a summary:-

Inherent Risks	Covered under Pillar I	To be addressed under Pillar 2 as part of the SREP
Strategic / Business		√
Operational	√	
Residual operational (i/c legal risk)		√
Reputation		√
Liquidity		√
Credit	√	
Credit concentration risk		√
Market Risk	√	
Interest rate risk		√
Foreign exchange risk	√	
Financial Soundness (including ICAAP assessment)		√
Controls		
Corporate Governance & Management		√
Internal Control Systems		√
Systems & Controls		√

The combination of the capital required under Pillar I and the outcome of the SREP and any capital requirement arising from this will form the minimum RAR for a bank.

4.4 Financial Soundness & ICAAP

4.4.1 The Commission will look at the quality and effectiveness of a bank's ICAAP for managing its capital adequacy in relation to its risk profile. It will look at the quality of capital held by a bank, its access to additional capital and capability to withstand business cycles and/or adverse events on its operations. The Commission will consider whether a bank has strong parental support and whether the parent has the resources to provide support if required.

4.4.2 The Commission will also look at the corporate governance framework around the ICAAP and will pay particular attention to Board and Senior Management oversight and involvement, as well as their responsiveness to any issues raised by the Commission.

4.5 Determination of the minimum RAR

- 4.5.1 Under the SREP the minimum RAR set by the Commission is made up of the statutory minimum of 8% plus a capital add-on to address other risks and uncertainties faced by a bank.
- 4.5.2 It is in principle possible for a bank to be assigned a minimum RAR of 8% (i.e. no capital add-on required) if the Commission is satisfied that a bank has strong systems and controls in place and all material risks are adequately covered by the statutory minimum. The add-on for other banks that do not fall into this category depends on the SREP.
- 4.5.3 As a guideline, banks will be assigned a minimum RAR in line with the following table. The Commission may, however, assign minimum RARs outside of these ranges if it is appropriate to do so. The rationale would be discussed with a bank.

Overall Risk Profile ¹	Minimum RAR
Lower	8% – 10%
Medium	11% - 14%
Higher	>14%

- 4.5.4 The SREP may lead the Commission to conclude that in addition to minimum levels of capital, there will be other ways in which deficiencies can be addressed. The Commission may also temporarily increase the minimum RAR until system and controls deficiencies have been rectified.

4.6 Stress and Scenario Tests

- 4.6.1 The Commission will assess the potential vulnerability of a bank to adverse events or other external factors such as business cycle risk and whether there is a need for a bank to hold additional capital for these risks. In making this assessment, the Commission may review the results of stress tests and scenario analyses and the potential impact on a bank's financial condition. The Commission's aim is to consider to what extent a bank has provided for unexpected events in setting its capital level.

4.7 Ongoing monitoring of capital adequacy

- 4.7.1 A bank is expected to maintain levels of capital consistent with its risk profile and if this declines significantly, it is expected to notify the Commission. Banks are required to operate a trigger ratio which is at least 1% above its minimum RAR. If the RAR falls below this level, the Commission expects to be notified immediately and to be advised of a bank's proposed actions.

¹ This refers to the overall composite risk rating of a bank as referred to in the Commission's published "Supervisory Approach".

5. Review of the ICAAP by the Commission

5.1 The Commission will have regard to:-

- The soundness of the overall ICAAP given the nature and scale of a bank's business activities;
- The degree of management involvement in the process e.g. whether target and actual capital levels are monitored and reviewed by the Board;
- The extent to which the internal capital assessment is used routinely within a bank for decision-making purposes;
- The extent to which a bank has provided for unexpected events in setting capital levels;
- The reasonableness of the outcome of the ICAAP in terms of whether:
 - The amount of capital required as demonstrated by the ICAAP is sufficient to support the risks faced by the bank; and
 - Whether the levels and composition of capital chosen by the bank are comprehensive, relevant to the current operating environment, and appropriate for the nature and scale of the bank's business activities.

5.2 A bank should be able to explain and demonstrate to the Commission:

- How its ICAAP meets supervisory requirements;
- How its material risks are defined, categorised and measured;
- How internal capital targets are chosen and how those targets are consistent with the overall risk profile, current operating environment and future business needs; and
- The reason for any differences between the ICAAP's level of capital and the regulatory requirement.

Appendix 2 – Glossary

“Bank” is the Isle of Man incorporated deposit taker

“SREP” is the supervisory review and evaluation process (in relation to a bank’s ICAAP)