

# Isle of Man Financial Supervision Commission

## Approach to Basel II Adoption

17<sup>th</sup> February 2006



Financial Supervision Commission BARRANTEE OASEIRYS

The Commission's approach to Basel II adoption is proposed to be both pragmatic and flexible taking into account the different needs of locally incorporated banks.

Detailed information about Basel II can be found on the website of the Bank For International Settlements – [www.bis.org](http://www.bis.org). The Commission refers you to the paper by the Basel Committee on Banking Supervision titled “International Convergence of Capital Measurement and Capital Standards – a revised framework – updated November 2005” as a starting reference point.

### The Commission's Basic Approach to Pillar I

The proposed basic approach is as follows:

- Banks will be expected to adopt Basel II;
- The Standardised Approach to credit risk will be the norm, which can include adoption of the Simplified Standardised Approach subject to this being appropriate for a bank's risk profile;
- The Basic Indicator Approach for operational risk will be the minimum requirement;
- The Standardised Approach for operational risk will be acceptable for a bank that can demonstrate adequate segregation and reporting of income streams and appropriate oversight to comply with the Basel II requirements;
- Basel I will ultimately cease to be the basis for prudential reporting, although no end date has been agreed.

The Commission is currently flexible with regard to the commencement date for prudential reporting under Basel II for the basic approaches above, but will require all banks to have committed to adopting Basel II prior to 1<sup>st</sup> January 2007. Prudential reporting under the basic approaches is likely to be introduced during 2007. The Commission recognises that some banks will be in a position to report under Basel II with effect from 1<sup>st</sup> January 2007 either for their own needs or for that of the group of which they are a part, and the Commission will aim to have appropriate reports for use if required for the March 2007 prudential returns.

The Commission may also consider the use of the Alternative Standardised Approach for operational risk in appropriate circumstances and may encourage its use if this more accurately reflects the risk profile of a bank.

### The Commission's Approach to Advanced Models

The Commission also recognises that some banks may wish to adopt a more advanced approach for either credit risk, operational risk, or both, which will often be for group requirements. Banks may apply to use the Advanced Approaches and this will require the Commission's agreement, which will include the Commission being satisfied with:

- The process adequately reflecting the bank's risk profile;
- The outputs being adequate for the Commission's assessment of capital;

- Local management having an appropriate level of understanding (refer to section on Pillar II), and;
- The availability of appropriate validation and support from the home supervisor.

The timescale for adoption of Advanced Approaches will be agreed on an individual basis and will most likely be driven by adoption at group level. The Commission encourages banks wishing to adopt advanced approaches to enter into dialogue as early as possible.

### National Discretions

The Commission has been working with its counterparts in Jersey and Guernsey on a number of aspects of Basel II adoption, and this will continue into 2006. One of the key aspects to ensure a smooth process to the introduction of prudential reporting under the basic approach is the agreement of National Discretions for the Standardised Approach to credit risk.

The Commission expects to be in a position to publish to the industry (for consultation) its proposed National Discretions in relation to the Standardised Approach for credit risk in late April 2006. At present the Commission has identified 4 key areas where industry feedback will be most important during the consultation phase, which are:

- The risk weighting to be attached to the Isle of Man Government (taking into account its AAA rating);
- The option to be exercised with respect to the risk weighting of exposures to banks (using the sovereign rating or the credit rating of the counterparty bank);
- The use of the preferential risk weighting of 35% for lending fully secured by mortgages on residential property, and associated LTV criteria, and;
- Whether to adopt the reduced risk weighting of 75% for certain retail exposures, subject to diversification criteria.

The Commission will consult on all National Discretions during 2006.

### Pillar II

Pillar II requires banks to assess whether the credit and operational risk capital requirements established under Pillar I provide sufficient cover for all risks faced by the bank, taking into account the nature and complexity of its business. Banks will be expected to have appropriate regard to Pillar II in respect of capital adequacy planning.

The Commission does not consider that locally incorporated banks have trading books and thus does not provide a framework for the capital adequacy charge associated with trading book risk.

For all locally incorporated banks the Commission may apply a capital charge to interest rate risk in the banking book, consistent with Pillar II. The Commission has already implemented such a charge for Basel I in the revised Banking Code to come into operation from 1<sup>st</sup> July 2006.

### Pillar III

The Commission considers that disclosure requirements under Pillar III are not applicable to the majority of locally incorporated banks and does not intend to set additional general disclosure requirements. Pillar III applies at the top consolidated level of a banking group only.

### Working with Industry

The Commission's general approach will be to discuss Basel II adoption with individual locally incorporated banks during 2006. The Commission will also hold workshops as appropriate, in liaison with the Association of Licensed Banks.