



Isle of Man Financial Supervision Commission

Basel II – Implementation - Update

September 2006

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1. Introduction

1.1 Overview

In 1988 the Basel Committee on Banking Supervision (“Basel Committee”) issued a report entitled “International Convergence of Capital Measurement and Capital Standards” (“the 1988 Accord”). The report was updated in 1997. Its purpose was to secure international convergence of supervisory regulations governing the capital adequacy of international banks. The 1988 Accord laid down the template for capital adequacy in banks and has become known in recent years as “Basel I”. Basel I required banks to maintain capital commensurate with their level of exposure to credit risk and market risks. Latterly the Basel Committee has worked to revise the 1988 Accord. Its aim was to develop a framework that would further strengthen the soundness and stability of the international banking system and would align economic capital with regulatory capital while maintaining sufficient consistency such that capital adequacy regulation would not be a significant source of competitive inequality among internationally active banks. The new framework, updated in November 2005 and re-issued as a “Comprehensive Version” in June 2006, has sought to arrive at significantly more risk-sensitive capital requirements. The revised framework has the same title as the 1988 Accord but is known more commonly as “Basel II”.

Basel II comprises three “Pillars”:

- Pillar 1, which contains a number of options for calculating banks’ **minimum capital charge** for credit, operational and market risk. These options range from relatively simple methodologies to more complex approaches that utilise banks’ own quantitative risk assessments. In providing a wide range of approaches, Basel II introduces regulatory capital requirements that capture risks more fully and are sensitive to the differing complexity of international banks;
- Pillar 2, which concerns the supervisory review process and assessment of capital adequacy; and,
- Pillar 3, which concerns measures designed to promote enhanced market discipline at the top consolidated level of a banking group. The Commission considers that disclosure requirements under Pillar 3 are not directly applicable to locally incorporated banks and does not intend setting additional general disclosure requirements.

The Commission published its approach to Basel II adoption in February 2006 and consulted upon the National Discretions for the standardised approaches to credit and operational risk in May/June 2006. A final list of National Discretions was published in August 2006 in cooperation with the GFSC and JFSC. This paper explains further the Commission’s plans for implementation of Basel II for locally incorporated banks.

1.2 Adoption timescale

Regulators throughout the world plan to adopt Basel II, but there are differences in terms of what is being implemented and when it is being implemented. The EU has issued the Capital Requirements Directive (“CRD”) which all regulators of member states must implement. Although this encouraged adoption from 1st January 2007, the

CRD contains a qualification that, where a bank has committed to the standardised approach by 1st January 2008 it can continue to report under Basel I during 2007.

The Isle of Man is not part of the EU and is not under any legal obligation to require locally incorporated banks to report under Basel II from 1st January 2007 or 1st January 2008 (with commitment).

However, the Commission understands that locally incorporated banks which are subsidiaries of banks in countries requiring Basel II reporting in 2007 may wish to begin similar reporting to the Commission, whether under standardised or more advanced approaches (re parallel runs). With this in mind the Commission intends to have available the necessary reporting forms and guidance during 2007 but may require these banks to also continue reporting under Basel I. It is the Commission's intention that it will require locally incorporated banks to report under Basel II with effect from 1st January 2008 for the standardised approaches, with some degree of flexibility on a case by case basis for later adoption (*it has generally been indicated to the Commission by banks that 1st January 2008 is the preferred date for the commencement of reporting under Basel II*).

The timeframe for reporting under advanced approaches for credit and operational risk will be dealt with on an individual bank basis as this is primarily driven by the requirements of the group and the home regulator.

The Commission does not intend to require locally incorporated banks reporting under the standardised approaches with effect from 1st January 2008 to also report under Basel I rules (i.e. no formal parallel run is planned but the Commission will have due regard to the impact on a bank's capital adequacy position compared to Basel I). For banks adopting the advanced approaches (including FIRB) to credit risk, reporting under Basel II is subject to capital floors measured under Basel I in any case, and dual reporting is normally required by the home regulator before approval is given to waive the adoption of the standardised approaches.

1.3 Legislation

Basel II will require the Commission to make some changes to the Banking (General Practice) Regulatory Code 2005, as amended ("the Code"). It is expected that these changes will be minor and will focus on capital, risk management, and reporting forms (which are specified in the schedule to the Code). In addition, the Commission anticipates that guidance notes will be utilised to supplement the Code to ensure compliance with Basel II principles contained within Pillar 1 and Pillar 2.

1.4 Implementation

There are a number of areas where different approaches may be adopted and National Discretions applied.

Once the framework is more developed and guidance in place, banks should first discuss and explain their proposed approaches to Basel II compliance so that the Commission can understand the methodology being applied and how appropriate the approaches will be to the nature of business conducted and systems in operation.

2. Capital and Consolidation

2.1 Capital

The Basel Committee has not recommended any fundamental changes to the definition of capital. However, the Commission is aware that there are minor changes included under Basel II for tier 1 and tier 2 capital with respect to capital deductions (and apportionment thereof), and for the inclusion of general/collective provisions in tier 2 capital in respect of banks adopting advanced approaches to credit risk (FIRB and AIRB). These minor changes in the definitions of regulatory capital will be captured within the reporting forms and guidance under Basel II.

There are also changes in aspects of tier 3 (innovative) capital in respect of a bank's trading book (market risk). Under Basel I the Commission did not recognise tier 3 capital, due to the nature of business being undertaken in the Isle of Man and the lack of material trading book activity. The Commission will consider its position on this as part of the wider aspects of Basel II implementation and consultation.

2.2 The minimum risk asset ratio (capital adequacy ratio)

The current statutory minimum risk asset ratio set by the Commission for locally incorporated banks is 10% for Basel I reporting, against a minimum Basel I capital adequacy ratio of 8%. Some banks have been set a higher risk asset ratio to take into account additional risks specific to them.

The minimum capital adequacy ratio prescribed under Basel II is 8% of total risk weighted assets. The capital rules under Basel II, Pillar 1 generally cover the following inherent risks in a bank:

- Credit risk - counterparty default risk, transaction risk (credit risk mitigation);
- Market risk – trading risk, FX risk; and,
- Operational (and legal) risk – risk of losses from internal operations and external events.

Note that the Commission's current reporting forms apply a capital charge to interest rate risk in the banking book. This may be included under pillar 1 of Basel II, or be assessed under Pillar 2 only.

Capital required to capture the additional risks inherent in the banking system (applied to each individual bank), and risks unique to each bank, should be captured under the key principles of Basel II, Pillar 2. This includes risks such as credit concentration risk, interest rate risk in the banking book (see above note), reputation and strategic risk. Supervisors may therefore set higher minimum capital levels on a bank by bank basis. Supervisors are free to apply a higher statutory minimum to all banks, such as the current 10% but the rationale for this should be clear and transparent.

Basel II is a more risk sensitive framework than Basel I and should encourage bank management, and supervisors, to be more focused in assessing risks in banks and linking those risks to capital adequacy. By implementing international capital standards (*in addition to other international standards such as Anti Money Laundering*) and developing a transparent and effective supervisory review process to

assess capital adequacy (as part of an overall risk assessment process) it may be disproportionate to automatically apply a 10% statutory minimum risk asset ratio. Further, the fact that many locally incorporated banks are part of banking groups based in jurisdictions in which the 8% minimum is applied is a key consideration.

The Commission has therefore agreed that the statutory minimum risk asset ratio will be changed from 10% to 8% under Basel II. Of course, banks may still be set risk asset ratios higher than the statutory minimum, as is currently the case, but the reason for this will be explained to the bank concerned. Higher risk asset ratios are set by means of a Direction. In addition the use of trigger ratios will remain.

2.3 Consolidation

Where an Isle of Man incorporated bank has subsidiaries, two treatments could be used to account for them – consolidation or deduction. The Commission considers that the treatments will be applied as follows:

- In quarterly prudential reporting a bank should show all investments in subsidiaries as deductions from capital, in order for the Commission to assess the capital adequacy of a bank pre consolidation;
- All lending of a capital nature is deducted from capital;
- An additional consolidated return would be produced where there are material investments in banking subsidiaries or other material subsidiaries conducting business similar to a bank (e.g. leasing). Such subsidiaries would be consolidated. Immaterial subsidiaries would not be consolidated but shown as investments deducted from capital; and,
- Guidance regarding materiality will be partly based on capital required to support the subsidiaries' risks.

The Commission considers that this will not have a significant impact on Isle of Man incorporated banks and is broadly consistent with the current framework.

3. Pillar 1 – Standardised Approaches (including simplified)

3.1 Credit risk

The Commission published its final list of National Discretions under the standardised approach and simplified standardised approach to credit risk in August 2006. This paper expands on some of the key aspects of the National Discretions.

3.1.1 Sovereign exposures (standardised and simplified standardised approaches)

The Commission is assigning a risk weighting of zero to sterling claims on, and guaranteed by, the Isle of Man Government (*for the purposes of capital adequacy, the Isle of Man Government is considered to be a sovereign state*). The Commission is also recognising the lower risk weighting (of zero) being applied by other supervisory authorities to sterling claims on their sovereigns, namely Guernsey, Jersey and the United Kingdom (*also see section 6*).

The rationale for assigning a risk weight of zero for exposures to the Isle of Man Government was based on the fact that it has been rated by an ECAI as AAA, which would most likely result in a risk weighting of zero being applied under the standardised approach in any case. Further, the Commission has taken into account the impact on banks adopting the simplified standardised approach with regard to the assessment of exposures to locally incorporated banks, which is based on the rating of the sovereign.

The decision to apply a risk weighting of zero to such exposures is subject to review, for example if an ECAI assigns a sovereign rating of less than AA- (Standard & Poors, or equivalent) to the Isle of Man Government, or if a consensus risk score of ECAs is published other than 0 or 1.

For other sovereign exposures the risk weightings will be derived as defined in Basel II based on the ECAI rating or consensus ECA score. This will be formally clarified under the mapping process of ECAIs to be published shortly.

3.1.2 Bank exposures

a) Standardised Approach

The Commission is requiring banks to use option 2, in which the risk weighting is based on the rating of the bank to whom they are exposed. It is intended that this will be based on the rating of the legal entity, not that of the group (exposures to unrated banks are risk weighted at 50%, or 20% for exposures less than 3 months). Risk weightings will range from 20% to 150%, with preferential risk weights being applied to short term exposures (those below 3 months) unless the counterparty is rated below BBB- (Standard & Poors, or equivalent). The risk ratings and risk weightings will be formally clarified under the mapping process of ECAIs to be published shortly.

This is more risk sensitive than Basel I which essentially applied a 20% risk weight to exposures to Zone A banks and Zone B banks less than 1 year, and 100% to exposures to Zone B banks over 1 year.

b) Simplified Standardised Approach

Exposures to banks are linked to the rating of the sovereign of incorporation. By exercising the National Discretion on the treatment of the rating of the Isle of Man Government re sovereign exposures, the risk weight that will be applied to short term (less than 3 months) sterling exposures to locally incorporated banks will be 20% (being one category less favourable), irrespective of any ECA consensus risk score.

The Commission may look at extending this to include exposures greater than 3 months and take into account other currencies.

3.1.3 Corporate exposures*a) Standardised Approach*

Similar to bank exposures, the risk weighting is based on the rating of the corporate entity that the exposure is to. Risk weightings will range from 20% to 150%, with unrated corporate exposures being weighted at 100%, which is effectively the same as Basel I. The risk ratings and risk weightings will be formally clarified under the mapping process of ECAIs to be published shortly.

The Commission may also allow a bank to risk weight all its corporate claims at 100% without regard to external ratings. A bank will not be allowed to “cherry pick” exposures (i.e. it must either use ratings wherever available, or not at all). Commission approval will be required before a bank is allowed to utilise this simpler methodology.

b) Simplified Standardised Approach

All corporate claims will be risk weighted at 100%. There is no regard taken to external ratings.

3.1.4 Retail exposures (standardised and simplified standardised approaches)

The Commission will allow exposures contained within a bank’s regulatory retail portfolio to be risk weighted at 75% irrespective of where the lending is based (e.g. within, or outside, the Isle of Man). This will be subject to the four criteria of orientation, product, granularity and value being met.

If the Commission feels that a bank has significant retail exposures which pose an increased risk (for example credit concentration risk) of default then it will assess this under Pillar 2 of Basel II (*also see sections 6 and 7*), or alternatively may consider that the granularity criterion is not met.

Further guidance on the criteria will be published following any necessary consultation, with granularity being assessed on a bank by bank basis. The Commission will work with the GFSC and JFSC with regard to this, and be minded of the UK FSA definitions where appropriate.

If a bank cannot demonstrate that it has a portfolio that meets the four criteria then the exposures will be risk weighted at 100%.

3.1.5 Mortgage exposures (loans secured against residential property)

The Commission will apply a 35% risk weighting to lending fully secured against residential property irrespective of the location of the property. This weighting will be applied for loan to value (“LTV”) ratios of up to 80%. For higher LTVs (up to 100%) a risk weighting of 75% will apply to the portion of the loan above 80% LTV. This helps to avoid what is commonly referred to as the “cliff effect”.

If a bank does not hold information on its systems regarding LTVs for individual exposures, a risk weighting of 50% will apply to the whole of those exposures. This is the same as Basel I.

If the Commission feels that a bank has significant mortgage exposures which pose an increased risk (for example credit concentration risk) of default then it will assess this under Pillar 2 of Basel II (*also see sections 6 and 7*).

Further guidance on what loans can be included within the definition of mortgage exposures, together with revaluation of loan portfolios, will be published following any necessary consultation. The Commission will work with the GFSC and JFSC with regard to this, and be minded of the UK FSA definitions where appropriate.

3.1.6 Venture capital, and private equity, investments

The Commission will apply a 150% risk weighting to venture capital, and private equity, investments. Further guidance on what exposures will attract this increased risk weighting will be published following any necessary consultation. This will also address the treatment for indirect exposures (e.g. through providing liquidity lines to funds that invest in venture capital or certain investments). The Commission will work with the GFSC and JFSC with regard to this.

3.1.7 OTC derivatives – counterparty credit risk

Basel II, Pillar 1 applies capital charges for counterparty credit risk in respect of OTC derivatives. The Commission proposes to adopt the simplest options as set down by Annex 4 of Basel II, and in respect of OTC derivatives will apply the “current exposure method”. This is very similar to the Basel I rules on credit conversion factors used to calculate capital charges, as captured in the new reporting forms that accompany the Code. The credit conversion factors under the current exposure method for Basel II are shown in *appendix 1*.

3.2 Operational risk

Three approaches will be allowed for banks, being the:

- Basic indicator approach;
- Standardised approach; or,
- Alternative standardised approach.

3.2.1 Basic indicator approach (“BIA”)

The BIA is simply a requirement to allocate an amount of capital equal to 15% of gross income to offset operational risks, averaged over the previous 3 years. This figure is converted to a risk weighted asset amount by multiplying it by the reciprocal of the statutory minimum capital under Basel II, Pillar 1 (i.e. 12.5). Gross income is net interest income plus net non interest income, gross of operational costs and exceptional items.

3.2.2 Standardised approach (“SA”)

The SA requires banks to allocate income by business line and allocate capital ranging from 12% to 18% of gross income, depending on the nature of the business line. The definition of gross income and methodology for converting the overall capital charge to a risk weighted asset equivalent is the same as for the BIA. *Appendix 2* contains detail regarding what activities comprise each business line and the weightings allocated.

3.2.3 Alternative standardised approach (“ASA”)

The National Discretions allow banks, subject to approval by the Commission, to adopt a different approach to the SA, known as the ASA. For some banks the SA (which uses gross income as the indicator) may not be the most appropriate method to use. The ASA may provide an improved basis of calculation with the retail and commercial banking business lines being aggregated, and the capital charge being based on the value of the loan portfolio. The charge is calculated by multiplying the total loans and advances by a factor of 0.035 and applying a 15% capital charge. The other six business lines are aggregated and are treated as per the SA, but a standard 18% capital charge is to be used. The methodology for converting the overall capital charge to a risk weighted asset equivalent is the same as for the SA and BIA.

Basel II outlines minimum criteria that a bank must comply with to be allowed to adopt the approaches above, and the Commission will have due regard to this when developing guidance.

3.3 External Credit Assessment Institutions (“ECAIs”)

The standardised approach to credit risk attempts to improve risk weighting sensitivity by making use of rating assessments by eligible ECAIs, for sovereign, bank, securities firms, and corporate exposures. Basel II uses illustrative ratings of Standard & Poors as an example of mapping ratings to risk weights. The Commission will publish a list of eligible ECAIs in due course, in conjunction with the GFSC and JFSC. This is expected to include Moody’s, Standard & Poors and Fitch, with due regard being taken of the work performed by CEBS. The Commission will not allow the use of unsolicited ratings. The Commission will also publish guidance to assist banks in the nomination of ECAIs that they propose to use.

As outlined in the final list of National Discretions (August 2006) the Commission will also allow the use of the OECD consensus risk scores of Export Credit Agencies

(“ECAs”) participating in the “Arrangement on Officially Supported Export Credits”, which is available from the OECD website (www.oecd.org).

3.4 Credit risk mitigation

Basel II contains two approaches to credit risk mitigation, the simple approach and the comprehensive approach.

3.4.1 Simple approach

In this approach the risk weighting of the collateral instrument (being lower than the counterparty risk weighting) collateralising or partially collateralising the exposure is substituted for the risk weighting of the counterparty. This method is similar to that applied under Basel I.

Eligible collateral, subject to certain criteria, will include cash (including CDs and similar instruments), gold, certain debt securities, certain main index equities and certain undertakings for collective investment schemes. This is more wide ranging than Basel I. Certain guarantees, credit derivatives and on-balance sheet netting are also allowable subject to conditions, including legal certainty.

Banks adopting the simplified standardised approach to credit risk can only use the simple approach to credit risk mitigation.

3.4.2 Comprehensive approach (this does not apply to banks adopting the simplified standardised approach to credit risk)

In this approach the collateral effectively offsets the exposure. Haircuts are applied to deal with the quality of the collateral and the nature of the exposure. After these are applied the adjusted exposure is reduced by the adjusted collateral and remainder (being effectively the unsecured portion) is weighted as per the exposure. This could allow for nil exposure providing sufficient collateral is in place.

In addition to the eligible collateral allowed under the simple approach, the comprehensive approach also allows the use of other listed equities and some additional collective investment schemes.

A National Discretion applied allows banks to calculate haircuts using their own internal estimates of market price volatility and foreign exchange volatility, rather than the calculations as prescribed under Basel II. Any bank proposing to utilise this National Discretion should obtain the Commission’s approval, in a similar manner to the approach adopted for advanced methodologies (*also see section 4*). The Commission will also have due regard to banks that apply haircuts as set under the National Discretions of their relevant home regulator (*also see section 6*).

4. Pillar 1 – Advanced Approaches

It would not be cost effective for the Commission to be in a position to validate advanced approaches as a stand-alone body regarding approval, or on an ongoing basis.

The Commission is allowing banks to apply to use advanced approaches (for credit and operational risk) providing:

- The process adequately reflects the local bank’s risk profile;
- The outputs will be adequate for the Commission’s assessment purposes; and,
- The availability of ongoing validation and support from the home / lead supervisor will be in place.

The Commission will not be in a position to waive the requirement of a bank to report under the standardised approaches, unless it is satisfied with the above three conditions. Approval of advanced approaches will normally only be given once the home supervisor has approved a group model. It will be done on a case by case basis.

The Commission will also have due regard to the Basel Committee document published in June 2006 titled “Home-Host information sharing for effective Basel II implementation” when assessing applications for approval of the use of advanced approaches.

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, Basel II implementation material that is directly relevant to it, and be able to make available this information to the Commission when requested. Examples of information may include:

- Plans at a local level for measuring credit, market and operational risks;
- How the group approach to Pillar 2 will be applied locally to meet any requirements; and,
- Adjustments made to group systems and processes for application in the local market.

The Commission encourages banks that wish to adopt advanced approaches (credit or operational risk) to keep the Commission informed of any key developments within its group timeframe for approval by home regulators. This will assist the Commission in its dialogue with home supervisors.

5. Reporting Forms and Guidance

5.1 Concepts and format

The Commission will work with the GFSC and JFSC in developing a common reporting framework for Basel II reporting of capital adequacy. This does not mean that the suite of prudential returns for banks across the three islands will be identical, as each island will prescribe its own reports in respect of, for example, liquidity, interest rate risk in the banking book, and other supplementary information.

5.2 Impact on existing reporting forms

Elements of the current prudential reporting forms will change under Basel II, based mostly on the capital and risk weighting sections of the forms (the current SR-1 and SR-2A). The Commission will consult upon changes to the reporting forms and is working with the GFSC and JFSC to try and standardise the capital reporting under Basel II.

The Commission expects to have reporting forms available for reporting under Basel II during 2007, if this is needed by a bank. However, it is likely that such reporting will be on a voluntary basis. The Commission will not necessarily be in a position to make such forms part of the secondary legislation until more formal adoption.

5.3 Liquidity, interest rate risk and market risk (forms SR-3A, SR-3B and SR-4)

The Commission, in consultation with the industry, overhauled the reporting requirements with respect to liquidity risk, interest rate risk and market risk (FX and OTC derivatives re counterparty credit risk) in the banking book as part of the introduction of the Code. This takes effect for the 30th September 2006 prudential returns. It is not the Commission's intention to make any changes to these reporting forms, with the exception of reviewing the risk weightings associated therein.

5.4 Other forms (memorandum items SR-2C / large exposures SR-2B)

The Commission does not propose to make any significant changes to the information being requested under the existing forms SR-2C and SR-2B. The risk asset ratio calculation contained within SR-2C will be provided elsewhere.

5.5 Guidance notes

The Commission will publish guidance notes (similar to the current BGN2.0, or any subsequent revisions thereto) in relation to the completion of Basel II reporting forms, together with associated definitions of, for example, asset classifications (e.g. loans secured by residential property). Any guidance will be issued for consultation, most likely in conjunction with the GFSC and JFSC.

6. Equivalent Regulator Concept

In the National Discretions (published August 2006) the Commission stated that it will recognise the lower risk weights of certain other supervisory authorities for domestic currency sovereign exposures funded in that currency, being the other Crown Dependencies and the UK. The Commission also referred that, with respect to credit risk mitigation techniques, haircuts set out under the National Discretions of the relevant home regulator will be considered.

The above gives rise to the concept of equivalent regulators, which effectively means that the Commission will be able to consider certain jurisdictions to have equivalent Basel II requirements.

The Commission is also aware that the risk weightings (standardised and simplified standardised approaches) of 75% for exposures in the regulatory retail portfolio and 35%/75% for exposures secured on residential property, have been based on an assessment of the local markets in the Crown Dependencies, but will be applied for lending outside the Isle of Man by local banks. If a bank has such exposures to a jurisdiction that may not be deemed to be equivalent (for example that jurisdiction may apply a higher risk weighting based on the knowledge of their country) the Commission will expect banks to take this into account when assessing their risks and capital levels under Pillar 2. To assist in this risk assessment the Commission may publish a list of equivalent regulators in due course.

The concept may also be extended to consolidated reporting, such that a local bank may have a material subsidiary in another jurisdiction that applies different risk weightings from the Commission. The Commission may, in such circumstances, consider that consolidated reporting could partly be based on the other regulators' requirements. This concept could also apply to assessing the risk weighting of assets in overseas branches of locally incorporated banks, especially if such branches were in jurisdictions that would be "non-equivalent".

7. Pillar 2

7.1 Overview

Pillar 2 is concerned with the supervisory review process and the assessment of banks' capital adequacy. The supervisory review process is intended not only to ensure that banks have adequate capital to support all the risks in their business but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. Effectively banks face eight broad inherent risks, being:

- Credit risk;
- Operational risk;
- Market risk;
- Liquidity risk;
- Interest rate risk;
- Strategic risk;
- Reputation risk; and,
- Legal risk.

The supervisory review process is intended to recognise the responsibility of bank management in developing an internal capital assessment process and setting capital targets that are commensurate with a bank's risk profile and control environment. Bank management will continue to bear responsibility for ensuring a bank has adequate capital to support its risks beyond the minimum requirements of Pillar 1. However, Basel II also recognises that increased capital is not the only option for addressing increased risks.

The Commission intends using the key aspects and principles of Pillar 2 to review risks considered under Pillar 1 that are not fully captured under that process (e.g. credit concentration risk, and other residual risks), factors not taken into account by Pillar 1 (e.g. strategic risk, reputation risk, interest rate risk in the banking book – *but see section 2.2*), and external factors (e.g. business cycle events). The Code and related guidance (especially around credit risk, large exposures, liquidity, interest rate risk in the banking book and foreign exchange risk) already issued by the Commission will be relevant to the Pillar 2 processes.

In matters of developing the Pillar 2 regime (including any reference to ICAAP or CAAP methods) the Commission will consult where necessary, and will have due regard to the level of complexity in local banks and the relationships with their larger groups, together with guidance already issued.

7.2 The four key principles of supervisory review

Basel II outlines four key principles, which are briefly explained below. Further guidance will be issued where necessary, and with appropriate consultation, to expand on these.

7.2.1 Principle 1

Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels

Banks will be expected to have processes commensurate with their risks, policies and procedures. The five main features of a rigorous process are:

- Board and senior management oversight;
- Sound capital assessment;
- Assessment of risks (which would normally cover the eight inherent risks);
- Monitoring and reporting; and,
- Internal control review.

7.2.2 Principle 2

Supervisors should 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

The Commission intends to develop a framework designed to enhance its existing risk based approach to supervision in order to better link risks inherent in banks to capital adequacy (in addition to those risks captured under Pillar 1), which would also include an assessment of banks' risk management and controls. Consideration of principle 1 will obviously form part of the supervisory review. Supervisory review can include such things as on-site visits, desk-based review, discussions with management, review of external audit work, and regular periodic reporting.

7.2.3 Principle 3

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

The Commission already provides guidance to banks on the use and application of trigger ratios for monitoring of capital levels. It also has the ability to require banks to hold capital in excess of the statutory minimum risk asset ratio by issuing recommendations / directions to banks.

7.2.4 Principle 4

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.

The Commission already closely monitors banks' capital ratios, utilising trigger ratios as early warning indicators of any deterioration in capital levels. The Commission is able to increase a bank's capital ratio if required, and can utilise other powers to require banks to, for example, restrict the payment of dividends. In some cases the

Commission would simply discuss the matter with management and ensure robust monitoring and reporting is in place, together with any necessary contingency arrangements.

7.3 Other aspects of the supervisory review process

7.3.1 Supervisory transparency and accountability

The Commission intends to make publicly available the criteria it will use in the review of banks' capital adequacy (i.e. its supervisory approach and risk assessment process), together with its broad methodology for requiring banks to hold minimum capital in excess of the agreed statutory minimum of 8% under Basel II.

7.3.2 Cross border communication and cooperation

The Commission is predominantly the host supervisor for locally incorporated banks and is responsible for the supervision of banks operating in the Isle of Man. As host supervisor, the Commission may accept methods and approval processes used by a bank at the group level, providing they adequately meet the Commission's requirements.

7.3.3 Securitisation and supervisory review

Basel II includes a section on the supervisory review process for securitisation. The Commission does not intend at this stage to provide detailed guidance due to the low levels of securitisation undertaken in the Isle of Man, and the requirements of Pillar 1, which will include risk transfer.

8. Glossary

GFSC	Guernsey Financial Services Commission
JFSC	Jersey Financial Services Commission
FIRB	Foundation Internal Ratings Based
AIRB	Advanced Internal Ratings Based
OECD	Organisation for Economic Cooperation and Development
ICAAP / CAAP	Internal Capital Adequacy Assessment Process (or Planning) / Capital Adequacy Assessment Process (or Planning)
Zone A	Means countries which are full members of the OECD and those members which have concluded special lending arrangements with the International Monetary Fund (“IMF”) associated with the IMF’s General Agreement to Borrow, provided they have not rescheduled their external sovereign debt to official or private sector creditors in the previous five years. The Isle of Man, Jersey, Guernsey, Gibraltar and Bermuda should also be regarded as being within Zone A.
Zone B	Means all countries which are not in Zone A
UK FSA	United Kingdom Financial Services Authority
CEBS	Committee of European Banking Supervisors

Any queries relating to the information contained in this paper should be addressed in the first instance to one of the persons below.

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9. Appendices**Appendix 1 – OTC Derivatives – credit conversion factors – current exposure method**

	Interest Rate	FX and Gold	Equities	Precious Metals (excl Gold)	Other Commodities
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
Between 1 and 5 years	0.5%	5.0%	8.0%	7.0%	12.0%
Over 5 years	1.5%	7.5%	10.0%	8.0%	15.0%

Appendix 2 – Standardised Approach to Operational Risk – Mapping of Business Lines

Business Line	Major Business Segments	Activity Groups	Charge as % of gross income	Gross income definition
Corporate Finance	Corporate Finance	Mergers and Acquisitions, Underwriting, Privatisations, Securitisation, Research, Debt (Government / High Yield), Equity, Syndications, IPO, Secondary Private Placements	18	Net fees / commissions earned in each business line.
	Municipal/Government Finance			
	Merchant Banking			
	Advisory Services			
Trading & Sales	Sales	Fixed income, equity, foreign exchanges, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage	18	Profits / losses on instruments held for trading purposes, net of funding cost. Fees from wholesale broking.
	Market Making			
	Proprietary Positions			
	Treasury			
Retail Banking	Retail Banking	Retail lending and deposits, banking services, trust and estates	12	Net interest income on loans and advances to retail customers and small businesses treated as retail. Fees related to traditional retail activities. Net income from swaps and derivatives held to hedge the retail banking book. Income on purchased retail receivable.
	Private Banking	Private lending and deposits, banking services, trust and estates, investment advice		
	Card Services	Merchant / Commercial / Corporate cards, private labels and retail		

Commercial Banking	Commercial Banking	Project finance, real estate, export finance, trade finance, factoring, leasing, lends, guarantees, bills of exchange	15	<p>Net interest income on loans and advances to corporate, inter-bank and sovereign customers.</p> <p>Income on purchased corporate receivable.</p> <p>Fees related to traditional commercial banking activities including commitments, guarantees, bills of exchange.</p> <p>Net interest income on securities held in the banking book.</p> <p>Profits/losses on swaps and derivatives held to hedge the commercial banking book.</p>
Payment & Settlement	External Clients	Payments and collections, fund transfer, clearing and settlement	18	<p>Net fees / commissions earned.</p> <p>Fees to cover provision of payments / settlement facilities for wholesale counterparties.</p>
Agency Services	Custody	Escrow, Depository receipts, Securities lending (customers), Corporate actions	15	Net fees / commissions earned in each business.
	Corporate Agency	Issuer and paying agents, Agency services		
	Corporate Trust			
Asset Management	Discretionary Fund Management	Pooled, segregated, retail, institutional, closed, open, private equity	12	Net fees / commissions earned in each business.

	Non-Discretionary Fund Management	Pooled, segregated, retail, institution, closed, open		
Retail Brokerage	Retail Brokerage	Execution and full service	12	Net fees / commissions earned in each business.