



**Guernsey Financial Services Commission  
Isle of Man Financial Supervision Commission  
Jersey Financial Services Commission**

High level principles on Pillar 2 and revision of supervisory returns.

*June 2007*

## **Introduction - The Pan-Island Approach**

In 1988 the Basel Committee on Banking Supervision (“Basel Committee”) issued a report entitled “International Convergence of Capital Measurement and Capital Standards”. The report was updated in 1997. Its purpose was to secure international convergence of supervisory regulations governing the capital adequacy of international banks. The report has become known in recent years as “Basel I”.

Latterly, the Basel Committee has worked to revise Basel I. The new revised framework was last updated in November 2005 and was re-issued as a “Comprehensive Version” in June 2006. The revised framework is referred to hereafter as “Basel II”.

The Guernsey Financial Services Commission, the Isle of Man Financial Supervision Commission and the Jersey Financial Services Commission have been working together to establish a unified approach, wherever possible, to implementing Basel II. This is not only because a number of banks operate in all three (or two of the three) jurisdictions, but also because their geographical proximity and similar constitutions leave them vulnerable to regulatory arbitrage if a common approach is not reached.

Throughout this publication, the three Commissions are referred to as the “**Tri-Party Group**”, and the three islands as the Crown Dependencies. Any further use of the word “Commission” refers to the relevant individual Commission.

The previous publication of three papers on Basel II demonstrates the unified approach being taken by the islands’ implementation teams. The papers are:

- “National Discretions for the Standardised Approaches to Credit and Operational Risk under the Basel II Capital Framework”, issued in August 2006 and revised in November 2006 (hereafter referred to as the “**Tri-Party National Discretion paper**”),
- “Basel II – External Credit Assessment Institutions’ Ratings and Mapping of Ratings to Risk Weights”, issued in October 2006 and revised in November 2006, and
- “Basel II – Operational Risk” issued in May 2007.

In carrying out this work the Tri-Party group has already arrived at a consensus in three important areas of Basel II implementation across the Crown Dependencies.

This paper outlines how the Tri-Party Group will continue this cooperation. It focuses on two general areas of implementation:

- Pillar 2, and
- Supervisory Returns.

## **Pillar 2**

Each of the Commissions making up the Tri-Party Group has issued or will issue guidance in their own jurisdictions on implementation of Pillar 2 of Basel II. The following outlines areas where a common approach to Pillar 2 implementation will be taken.

### 1. The ICAAP

The Tri-Party Group expects all banks incorporated in their respective jurisdictions to carry out their own Internal Capital Adequacy Assessment Process ("ICAAP"). (Banks established as branches in one or more of the Crown Dependencies are not required to produce an ICAAP for the branch.)

It is recognised that banks operating in the Crown Dependencies are normally subsidiaries of banks operating in another jurisdiction and their parent banks will be required to produce an ICAAP for their home regulator. Banks in the Crown Dependencies may well leverage off expertise in this area at a group level and/or draw on their parent bank's ICAAP and the template(s) used. However the Tri-Party Group requires banks operating in the Crown Dependencies to produce their own ICAAPs which must be relevant to the business carried on (and risks) in their jurisdiction. The ICAAP should demonstrate that the level of capital held by the local subsidiary is adequate given the bank's risk profile.

The primary reason for this decision is that capital is not considered to be freely transferable across borders or between legal entities and therefore it has to be available in the subsidiary where it is needed as a mitigant for particular, local risks.

A second reason is that host regulators are best positioned to understand the particular risks faced by banks in their jurisdictions and this is considered to be a more robust approach than, for example, a purely "top-down" approach of arbitrarily allocating a Pillar 2 capital charge across a banking group based on a measure such as volume of business, balance sheet size or risk weighted assets.

In assessing capital adequacy, bank management need to be mindful of the particular stage of the business cycle in which the bank is operating. Rigorous, forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact the bank should be performed. However, the Tri-Party Group has agreed that, in many cases, such business cycle and strategic stress-testing could be performed on a group or regional basis. In these cases it would be acceptable for a banking group to determine the necessary level of capital to be set aside as a result of business or economic cycle stress-testing at a consolidated or sub-consolidated level and this would then be allocated, pro rata, across the group using a proxy, such as balance sheet size, to decide where such capital should be located.

## 2. Initial Implementation of Basel II and the ICAAP

The Tri-Party Group expects most banks to implement Basel II in 2008. As part of the implementation, it is expected that banks should have drafted an ICAAP and made any necessary provision for risks not captured under Pillar 1. The Commission will review the ICAAP submission and, once this review is completed, issue individual capital guidance to each bank, including a minimum risk asset ratio. The Commission will issue further guidance on the transitional process in due course.

## 3. On-going review of the ICAAP

A bank is expected to review its ICAAP at least annually. If there is no material change to the risk profile of a bank, confirmation of this to the Commission for the years following the submission of the initial ICAAP will be sufficient. The Commission will validate this through its annual Supervisory Review and Evaluation Process ("SREP") (see below). 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. ICAAP format

The Tri-Party Group does not wish to be prescriptive over the format under which an ICAAP may be submitted. However, it is clear that some banks would like guidance on the general shape an ICAAP should take.

Banks' business and risk profiles differ and the ICAAP should be proportionate to the size, nature and complexity of a bank's business. The Tri-Party Group considers that the format shown in the annex to this paper may be convenient for banks as it covers most of the matters which typically would be reviewed by the Commission under the SREP. However, other formats may be acceptable. The Commission will be issuing further guidance on the ICAAP in due course.

## 5. The Supervisory Review and Evaluation Process (SREP)

Although the general supervisory approach of the Commissions in the Crown Dependencies is broadly similar there will always be some level of difference in the reporting and monitoring processes used by any regulator. For this reason it is considered appropriate for the Tri-Party Group to focus only on a high level approach and not a detailed methodology for the SREP. The Tri-Party Group has agreed the following general principles in its approach to the SREP:-

- The Commission will endeavour to be as transparent as possible. Where the Commission sets a capital requirement higher than the minimum level, it will explain the rationale for this to the bank;
- Pillar 2 does not necessarily mean an automatic capital add-on, although this could be one of the outcomes of the SREP;

- The Commission will be assessing the reasonableness of the ICAAP in terms of whether the amount of capital said to be required by the ICAAP is sufficient to support the risks faced by the bank;
- The Commission will adopt a proportionate approach to the SREP. The intensity and depth of the review will take account of the nature, scale and complexity of individual banks, as well as the extent to which the bank's risk profile has changed over the previous year;
- The SREP will normally be an annual process;
- The Commission will, as part of the SREP, take account of any off-site reviews, on-site visits and relevant information already obtained from prudential and statistical returns, meetings, media coverage and other research;
- The ICAAP is the responsibility of the Board and Senior Management. The SREP will not replicate the role of these bodies; and,
- The Commission will review the corporate governance framework around the ICAAP and will pay particular attention to Board and Senior Management oversight and involvement, as well as responses to any issues raised by the Commission during the SREP. It will also examine the extent to which the internal capital assessment is used routinely within the bank for decision making purposes.

### **Supervisory returns**

#### **The way forward**

In May 2007 the Tri-Party Group issued a joint paper on Operational Risk including a proposed common format for reporting forms (and guidance to completing these forms) and calculating operational risk capital charges.

It is intended that in the third quarter of 2007 similar papers will be issued by the Tri-Party Group outlining how banks will report and calculate their capital requirements under Basel II to take account of Credit and Market risk under the Standardised and Simplified Standardised Approaches.

The Tri-Party Group is committed to introducing Basel II-compliant capital returns that have broadly similar format and content across the Crown Dependencies. The May 2007 Operational Risk paper and the forthcoming Credit and Market risk papers will go a long way to achieving this.

With the introduction of Basel II-compliant returns, the Commission will take the opportunity to also review other areas of its prudential returns and the Tri-Party Group is to work together on co-ordinating this review. The aim of this work is to bring the returns, and underlying guidance, in line as closely as possible.

Each Commission will issue its own specific reporting requirements during 2007/8.

Any queries arising from this paper should be addressed in the first instance to the persons below.

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## Annex - ICAAP format

*Below is an outline of a suggested format showing the general areas and headings an ICAAP could take:-*

### ICAAP SUBMISSION - A FORMAT THAT MAY BE USED BY BANKS

XYZ Bank Ltd

#### *Executive Summary*

The purpose of the Executive Summary is to present an overview of the ICAAP methodology and results. This overview would typically include:-

- the purpose of the ICAAP;
- the main findings of the ICAAP such as :-
  - how much and what composition of capital the bank considers it should hold in addition to the Pillar 1 minimum capital requirement; and
  - a description of the bank's overall risk management processes, including comments on its adequacy;
- key financial commentary, including a summary of the bank's balance sheet strength, strategy and future profitability;
- brief descriptions of the capital and dividend plan;
- commentary on the bank's most material risks, why the level of risk is considered acceptable or, if it is not, what mitigating actions are planned; and
- who has carried out the assessment, how it has been challenged, and who has approved it.

#### *Background*

This section would cover the relevant organizational and historical financial data on the bank such as group structure and key data and trends. It would include any conclusions that can be drawn from trends which may have a material impact on the bank's future. It would also give a description of expected changes to the bank's business strategy.

#### *Capital Adequacy*

This section would include a detailed review of the capital adequacy of the bank. It might start with a description of the risk appetite of the bank which would set the context for the ICAAP. Where economic capital models are used this would include details of the assumptions behind those models.

Where scenario analyses or other means are used, then some other description of how the severity of scenario has been chosen would be included.

The ICAAP might include:-

- the date of the ICAAP calculations, together with consideration of any events between this date and the date of submission which would materially impact the ICAAP calculation, together with their effects;
- details of, and rationale for, the time period over which capital has been assessed;
- identification of the major risks faced;
- for each risk an explanation of how the risk has been assessed and any quantitative results of that assessment;
- an explanation of how the risks have been mitigated, including the relevant risk management and control policies and processes;
- a clear articulation of the bank's risk appetite by risk type, for example, a strong appetite, modest appetite or conservative appetite;
- details of any restrictions on management's ability to transfer capital into or out of the bank (for example, contractual, commercial, regulatory or statutory restrictions that apply); and,
- an analysis of significant movements in available capital and capital required since the latest ICAAP (where appropriate) and a comparison of the capital required under Pillar 1 calculations as compared with the overall capital requirement identified by the ICAAP.

#### *Key sensitivities and future scenarios*

This section would detail the sensitivity tests undertaken to key assumptions and factors that have a significant impact on the broader financial condition of the company. Material changes in the financial risks to which the business is exposed would be explored and quantified as far as possible in this section.

Banks that have had advanced approaches (IRB/AMA or IMA) approved should note that this is in addition to any stress testing that might be undertaken for testing or supplementing advanced approach modeling assumptions.

#### *Aggregation*

This section would describe how the results of the bank's various separate risk assessments are brought together and an overall view taken on capital adequacy. This requires a methodology to be used to quantify the amount of capital required to support individual risks so that they can be aggregated into a total figure.

*The challenge process and sign off of the ICAAP*

This section would describe the extent of challenge and testing of the ICAAP that has taken place. It would include the testing and control processes applied to the ICAAP calculations, and the senior management or board review and board sign off procedures.

Details of the reliance placed on group ICAAPs or any external suppliers/consultants would also be detailed here e.g. for generating economic scenarios.

*Use of the ICAAP within the bank*

This would demonstrate the extent to which capital management is embedded within the bank including the extent and use of capital modeling or scenario analysis and stress testing within the bank's capital management policy, e.g. in setting pricing. This would also include a statement of how the submitted ICAAP would be reflected in the bank's capital management policy.