# GUERNSEY FINANCIAL SERVICES COMMISSION
# ISLE OF MAN FINANCIAL SUPERVISION COMMISSION
# JERSEY FINANCIAL SERVICES COMMISSION

# DISCUSSION PAPER ON: BASEL III

Issued: 12 September 2012

## GLOSSARY OF TERMS

The following table sets out a glossary of terms used in this paper.

| | |
|---|---|
| Additional Tier 1 capital | Items permitted within Tier 1 capital, other than CET1 capital |
| Basel 2.5 | "*Enhancements to the Basel II framework*", issued in July 2009 by the Basel Committee |
| Basel Committee | Basel Committee on Banking Supervision |
| Basel II | "*International Convergence of Capital Measurement and Capital Standards*", re-issued in comprehensive form in June 2006 by the Basel Committee |
| Basel III | collectively, a series of documents issued by the Basel Committee that either revise Basel II or establish new international standards regarding the financial management of international banks |
| Basel III capital adequacy standard | "*A global regulatory framework for more resilient banks and banking systems*", issued in December 2010 by the Basel Committee and revised in June 2011 |
| Basel III liquidity standard | "*Basel III: International framework for liquidity risk measurement, standards and monitoring*", issued in December 2010 by the Basel Committee |
| Capital FAQ | *Basel III definition of capital - Frequently asked questions*", issued in December 2011 by the Basel Committee |
| CCP Requirements Paper | "*Capital requirements for bank exposures to central counterparties*", issued in July 2012 by the Basel Committee |
| CDs | Crown Dependencies – Guernsey, Isle of Man and Jersey |
| CET1 | Common Equity Tier 1 capital |
| Countercyclical Guidelines Paper | "*Guidance for national authorities operating the countercyclical capital buffer*", issued in December 2010 by the Basel Committee |
| CRD IV | EU proposals to introduce Basel III requirements |
| D-SIFI | domestic SIFI |
| DCS | depositor compensation scheme |
| GFSC | Guernsey Financial Services Commission |
| G-SIFI | global SIFI |
| G-SIFI Requirements Paper | "*Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*", issued in November 2011 by the Basel Committee |
| ICAAP | Internal Capital Adequacy Assessment Process |
| ICB | Independent Commission on Banking |
| ICB Report | "*Final Report*" issued in September 2011 by the ICB |
| IOMFSC | Isle of Man Financial Supervision Commission |
| JFSC | Jersey Financial Services Commission |
| LCR | Liquidity Coverage Ratio |
| Liquidity Principles | "*Principles for Sound Liquidity Risk Management and Supervision*", issued in September 2008 by the Basel Committee |
| NSFR | Net Stable Funding Ratio |
| PLAC | Primary loss absorbing capacity |
| RWAs | Risk Weighted Assets |
| SIFI | systemically important financial institution |

| | |
|---|---|
| Tri-Party Group | comprises the GFSC, IOMFSC and JFSC |
| White Paper | "*Banking reform: delivering stability and supporting a sustainable economy*", published in June 2012 by HM Treasury |

## CONTENTS

# INTRODUCTION

## 1 Background

1.1 In 2005, the Basel Committee on Banking Supervision ("**Basel Committee**") issued a revised framework intended to secure international convergence of supervisory regulations governing the capital adequacy of international banks. This document, "*International Convergence of Capital Measurement and Capital Standards*", re-issued in comprehensive form in June 2006, has become known as "**Basel II**".

1.2 The Guernsey Financial Services Commission ("**GFSC**"), the Isle of Man Financial Supervision Commission ("**IOMFSC**") and the Jersey Financial Services Commission ("**JFSC**"), jointly the "**Tri-party Group**", worked together to establish a unified approach, reflecting our similar responsibilities as host supervisors, wherever possible, to implementing Basel II during the period 2005 to 2008.

1.3 Latterly, the Basel Committee has worked to revise Basel II. This work has resulted in a number of documents being issued that either revise Basel II or establish new international standards regarding the financial wellbeing of international banks. Collectively, this initiative is described by the Basel Committee as "**Basel III"** and it encompasses both capital adequacy and liquidity measures. This paper focuses on six documents in particular (in chronological order):

1.3.1 "*Enhancements to the Basel II framework*", issued July 2009[1], referred to herein and widely known as "**Basel 2.5**";

1.3.2 "*Basel III: International framework for liquidity risk measurement, standards and monitoring*", issued December 2010[2], referred to herein as the "**Basel III liquidity standard**";

1.3.3 "*A global regulatory framework for more resilient banks and banking systems*", issued December 2010 and revised June 2011[3], referred to herein as the "**Basel III capital adequacy standard**";

1.3.4 "*Guidance for national authorities operating the countercyclical capital buffer*", issued December 2010[4], referred to herein as the "**Countercyclical Guidelines Paper**";

1.3.5 "*Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*", issued November 2011[5], referred to herein as the "**G-SIFI Requirements Paper**"; and

1.3.6 "*Capital requirements for bank exposures to central counterparties*", issued July 2012[6] referred to herein as the "**CCP Requirements Paper**".

[1] http://www.bis.org/publ/bcbs157.htm
[2] http://www.bis.org/publ/bcbs188.htm
[3] http://www.bis.org/publ/bcbs189.htm
[4] http://www.bis.org/publ/bcbs187.htm
[5] http://www.bis.org/publ/bcbs207.htm
[6] http://www.bis.org/publ/bcbs227.htm

1.4 The Tri-Party Group is distributing this paper to all banks that are incorporated in the Crown Dependencies ("**CDs**") – Guernsey, Isle of Man and Jersey - to provide information on Basel III and an indication of the Group's initial views and in order to solicit feedback. A period of three months to 12 December 2012 has been set aside for this and banks are asked to submit feedback to their supervisor but be aware that the content of feedback will be made available to the other CD supervisors on a no-names basis.

1.5 The regulation of branches in the CDs does not include requirements in respect of capital or liquidity ratios, with responsibility for such prudential matters being the responsibility, on a whole company basis, of the home supervisor. No change is seen in this area as a result of Basel III.

1.6 The aim, once feedback has been received, will be to establish, where appropriate, a joint implementation path, which is expected to entail further consultation prior to the implementation of any specific proposals.

1.7 The considerations divide into those relating to liquidity and those relating to capital adequacy.

1.8 The Basel III liquidity standard consists of rules for the establishment of:

1.8.1 a Liquidity Coverage Ratio ("LCR") – a minimum ratio requirement for short term liquidity;

1.8.2 a Net Stable Funding Ratio ("NSFR") – a minimum ratio requirement for longer term liquidity; and

1.8.3 a set of standardised reporting requirements relating to liquidity.

1.9 The capital adequacy standards and proposals can be divided into six areas:

1.9.1 Revised definitions of capital, including the establishment of new minimum capital ratios for Common Equity Tier 1 ("**CET1**") capital and Tier 1 capital in relation to risk weighted assets ("**RWAs**"), in addition to the Basel II requirement for total regulatory capital to exceed 8% of RWAs;

1.9.2 Measures that may or will add to the above requirements, which can be sub-divided into: a systemically important financial institution ("**SIFI**") capital increment, a capital conservation buffer and a counter-cyclical capital buffer.

1.9.3 Measures that address counterparty credit risk ("**CCR**") and other RWA related aspects;

1.9.4 The introduction of a leverage ratio;

1.9.5 Measures intended to reduce the current pro-cyclical impact of Basel II; and

1.9.6 Pillar 2 related developments.

1.10 The EU is currently consulting on its implementation of Basel III, in a set of proposals known as "**CRD IV**". This, of itself, may lead to a majority of locally incorporated banks being part of groups subject to consolidated supervisory requirements that incorporate much of Basel III.

1.11 This paper is divided into sections covering liquidity and capital adequacy, where the main features are explained, and references are provided to the underlying Basel Committee papers. The initial thoughts of the Tri-Party Group are also provided and questions are raised in order to prompt initial feedback on these matters.

## 2 Overview

2.1 The Basel III capital adequacy and liquidity standards are stated to be applicable to all internationally active banks on a consolidated basis, but may also be used by supervisors for domestic banks and for any subset of entities that form part of an internationally active bank where this would ensure greater consistency and apply a level playing field between domestic and cross-border banks. This mirrors the language for Basel II, which has previously been adopted in the CDs.

2.2 No bank incorporated in the CDs falls within this scope in its own right but most form part of banking groups that do so at the consolidated level, and will therefore at least indirectly become subject to Basel III, as implemented by respective home supervisors.

2.3 Therefore, rather than considering Basel III as a block of standards that must be implemented, individual elements are considered separately in this paper on their own merits. The Tri-party Group aims to ultimately implement changes where they are appropriate locally.

2.4 In considering whether any aspect is appropriate, an assumption has been made that aspects of Basel III that identify and address shortcomings in Pillars 1 and 2, as already adopted in the CDs (e.g. capital quality and RWA measures), should be implemented, unless a counter-argument can be made. Pillar 3 has not been adopted and therefore related proposals are not considered herein.

2.5 CRD IV is relevant to the majority of CD incorporated banks, as most are part of groups that are headquartered within the EU. Other UK and international developments are also referred to herein where they highlight matters that are relevant to the consideration of Basel III.

## LIQUIDITY STANDARD

### 3 General

3.1 The Basel III liquidity standard specifies two minimum requirements that complement the stress testing approach to liquidity that the Basel Committee established in its paper *"Principles for Sound Liquidity Risk Management and Supervision"*, issued September 2008 *("***Liquidity Principles***")*.

3.2 Current regulation of liquidity differs between the CDs but the core requirement (for banks incorporated in the CDs) in each case is that the cumulative contractual net outflow to one week is required to be zero or better, with a small net outflow permitted to one month by the GFSC and JFSC, whereas the IOMFSC require this also to be zero or better. All three supervisors permit marketable assets to be reflected on a sale, rather than maturity, basis and allow adjustments to be made to flows, in particular contractual deposit outflows, to reflect likely behaviour. Reporting forms are similar in layout.

3.3 The main difference is that the IOMFSC and JFSC have a bank-by-bank approach to determining appropriate behavioural adjustments, whereas the GFSC has advised all banks of standard adjustments.

3.4 Many home supervisors of local banking groups have stated that they intend to implement the Basel III liquidity standard, with the most detailed pronouncements being in respect of the LCR standard. However, in many cases, details are not finalised and are not always fully in line with Basel III. The related EU proposal forms part of CRD IV. The FSA has already implemented a stress test based approach, in line with the Liquidity Principles, and it is unclear how this will be changed, if at all, when the CRD IV requirements are finalised.

3.5 The Tri-Party Group considers that the Liquidity Principles represent international best practice and that focus should be on developing, where necessary, local liquidity requirements that are based on a stress testing approach. Whilst standardised minimum ratios may be useful as a complementary measure, the ratios specified within the Basel III liquidity standard (LCR and NSFR) are not calibrated for the local market.

3.6 In carrying out future work in this area, the Basel III liquidity standard will be considered as a source of guidance that is relevant in places.

3.7 Feedback is sought from industry on three general areas:

**3.7.1 Do you expect to be part of a group that is subject to consolidated supervision of liquidity by a supervisor that has adopted the Basel III liquidity standard? If so, are there any specific aspects that should be considered locally?**

**3.7.2 Would further alignment of the liquidity regimes across the CDs be beneficial to banks?**

**3.7.3 Are there any specific changes to the current regime that you would like to see?**

3.8 The rest of this section provides an overview of the Basel III liquidity standard and seeks feedback on specific aspects. Questions are asked in order to obtain the views of

Industry and do not represent an indication that any decision has been taken to pursue specific proposals.

## 4 LCR

4.1 The LCR is a standardised minimum ratio with only very limited flexibility provided to local supervisors. It is intended for internationally active banks at a fully consolidated level, where it will complement their internal stress test based management of liquidity.

4.2 The LCR requires that sufficient liquid assets (see below) are held to meet predicted outflows to one month, although up to 75% of this can be offset by predicted inflows (such as money due from other banks on a contractual basis). Predicted flows are determined by applying a set of standard assumptions to contractual outflows, subject to limited national discretions. Commencement of reporting is required by 2012 and adoption by 1 January 2015 (at a consolidated level). The Tri-Party Group is aware that the Basel Committee will shortly be publishing a further paper on some potential changes to the parameters that make up the LCR.

4.3 In contrast, local regulations in Jersey and Guernsey permit a small net outflow to one month and, in all three jurisdictions, predicted inflows can fully offset predicted outflows (i.e. they are not capped at 75% of predicted outflows).

**4.3.1 For Guernsey and Jersey incorporated banks only, what issues would arise for your bank if the local requirement for the one month liquidity mismatch was amended to remove the allowance of a small net outflow to one month, in line with Basel III and IOMFSC?**

4.4 Liquid assets are tightly defined in the Basel III liquidity standard. In summary, a majority are required to be in the form of 0% weighted sovereign debt, although a portion may be highly rated quasi-sovereign issues (such as issues by certain public sector entities), corporate issues (non-bank) or covered bonds (not issued by the holding bank). Detailed criteria are also established regarding required marketability and operational criteria. Liquid assets do **not** however include normal interbank exposures (including amounts due from group) although these are allowable as inflows.

4.4.1 **Do you envisage using marketable assets as part of liquidity management?**

4.4.2 **If so, please consider whether these would meet the criteria set out in Basel III. Please also explain the criteria that you currently use to determine marketability, including any restrictions in respect of concentration risk**.

4.5 Minimum outflow assumptions in Basel III vary depending on the type of counterparty and the nature of the relationship. The limited national discretions available either permit or require authorities to carry out assessments of local conditions before setting or varying certain standard assumptions for local banks.

4.6 For example, the standard outflow assumptions for retail depositors and SMEs depend on how "sticky" the funds are, with "stable" funds receiving a 5% outflow assumption but being limited to those deposits fully covered by a depositor compensation scheme ("**DCS**") (and other restrictions). Some latitude is available to local supervisors to establish detailed parameters and outflow assumptions for other types of retail deposits.

4.7 Deposits from non-financial corporates and sovereigns attract a 75% outflow assumption. All other outflows applied are contractual (100%), unless the funds are held in respect of operational relationships, in which case a 25% outflow assumption applies. This would typically result in a 100% outflow assumption for funding from other financial institutions (including banks, securities firms and insurance companies, including Swiss style fiduciary deposits), deposits placed in a fiduciary capacity by a financial institution, conduits, special purpose vehicles and affiliated entities of the bank.

**4.7.1 Do you consider that deposit behaviour should be assessed centrally or on a bank by bank basis?**

**4.7.2 Do you consider that there are specific criteria that should be established (beyond the generic designation of retail and corporate deposits) to identify "sticky" deposits, such as size and nature of relationship? If so, should these be established across the CDs, by each supervisor or on a bank-by-bank basis?**

**4.7.3 Would the Basel III LCR measure be appropriate for your bank?**

## 5 NSFR

5.1 The NSFR is a longer term measure that is intended for internationally active banks at a fully consolidated level. Unlike the LCR, it has no parallel in the current regulation of banks in the CDs. It requires available stable funding to exceed required stable funding. This is essentially an issue at the consolidated level to encourage banks to avoid placing reliance on wholesale funding.

5.2 "Available stable funding" is limited to capital, funding with a maturity over one year and a proportion of shorter term deposits, with different levels permitted for retail/SME deposits and wholesale deposits (but not those from financial institutions or fiduciaries).

5.3 "Required stable funding" is an amount required to fund long term lending (over one year) plus a proportion of shorter term lending. Liquid assets do not give rise to any related requirement.

5.4 The Tri-Party group considers that, in keeping with the Liquidity Principles, banks should manage their liquidity over both short and long timescales but that the NSFR is not generally appropriate for entities that manage their liquidity on a group-wide basis, as is typically the case in the CDs.

**5.4.1 Do you use similar liquidity ratio calculations within your current approach to longer term liquidity management? If so, please provide a brief summary and highlight key differences to the NSFR standard.**

## 6 Reporting

6.1 The Basel III liquidity standard calls for significant additional reporting to supervisors, including that required to determine the two ratios (LCR and NSFR) but also significant supporting data, involving liquid assets, funding concentration by product/instrument/counterparty, contractual and stressed flows and data by currency (primarily for the LCR). The standard suggests that certain reports (those relating to the LCR) are made monthly and should be capable of being made weekly.

6.2 Currently, reporting requirements are similar across the CDs, consisting of reports on maturity mismatches and concentration of funding, but with differing formats.

**6.2.1 Would it be helpful if reporting requirements were closely aligned across the CDs?**

**6.2.2 Would it be useful to align the reporting of liquidity data / metrics more closely to the Basel III liquidity standard requirements and/or to requirements specified by other bodies?**

**6.2.3 Would a requirement to provide data on liquid assets present any specific issues?**

**6.2.4 Would reporting data on a currency by currency basis be problematic? If so, how could this be limited to provide data on material liquidity mismatches whilst minimising the cost of implementation?**

**6.2.5 What problems would a move to require that banks be able to make more regular submission of liquidity data present (for specific reports and only where considered to be necessary)? In particular, does your current daily internal reporting provide sufficient data to enable completion of the current regulatory templates?**

## CAPITAL: STANDARD AND PROPOSALS

### 7 General

7.1 The Basel III capital standard, and the related documents, provide both a revised standard and proposals to be developed in respect of capital adequacy.

7.2 A brief summary of current regulatory capital adequacy requirements in the CDs is:

7.2.1 The framework for determining RWAs under the standardised approach is closely aligned across the CDs;

7.2.2 The definitions of regulatory capital specified by the Tri-Party Group are closely aligned, save that the JFSC permits banks to use Tier 3 capital where the bank has a trading book capital requirement;

7.2.3 The use of advanced approaches is permitted by the Tri-Party Group, but in practice almost all banks have adopted the standardised or simplified standardised approaches;

7.2.4 The Tri-Party Group apply requirements for individual banks to hold more capital to address unmitigated Pillar 2 risks; but

7.2.5 The JFSC applies a general minimum RAR of 10%, whilst the GFSC and IOMFSC adopt an equivalent minimum requirement.

7.3 Many home supervisors have stated that they intend to implement the Basel III capital standard and several have already adopted Basel 2.5. However, in many cases, details are yet to be finalised and are not always fully in line with Basel III or only fully address parts of the proposals. As stated in the introduction, Basel III requirements only fully apply at the consolidated level and as a result are not all directly applicable at the subsidiary level.

7.4 The EU proposals in this respect form part of CRD IV. However, the UK government is considering a course that would either supplement or supplant the CRD IV proposals, with a regime that requires separation of retail and investment banking and require higher minimum capital ratios. This is addressed later in references to the ICB.

7.5 Feedback is sought from industry on three general areas:

**7.5.1 Do you expect to be part of a group that is subject to consolidated supervision of capital requirements by a supervisor that has adopted the Basel III capital standard? If so, are there any specific aspects that should be considered locally?**

**7.5.2 Would further alignment of the regimes in the CDs be beneficial and, if so, in which areas?**

**7.5.3 Are there any specific changes to current local capital adequacy requirements that you would like to see?**

7.6 The rest of this section provides an overview of the Basel III capital standard plus related documents and seeks feedback on specific aspects. Questions are asked in order to obtain the views of industry and do not represent an indication that any decision has been taken to pursue specific proposals.

## 8 Definitions of capital

8.1 The Basel III capital standard specifies criteria for CET1 capital that start from a base of common share capital (and related share premium reserves) plus retained earnings, after excluding certain items. The principal exclusions are deferred tax assets that depend upon future profitability and certain minority interests arising on consolidation of subsidiaries (the amount that can still be recognised is that required by Basel III in respect of the subsidiary).

8.2 It also tightens up rules for adjustments applied by many supervisors, including those within the Tri-Party Group. In particular, pension deficits and fair-value losses on available-for-sale bonds may not be set-aside when calculating CET1 capital.

8.3 Rules in Basel I/II require deductions to be made from total regulatory capital or in some cases tier 1 capital. Rules now require most deductions to be made from CET1 capital. Goodwill and most investments in the capital of other banks must be deducted.

8.4 For a small group of items previously treated as deductions, including significant investments in commercial entities, the revised standard instead requires that such items are treated as exposures with a 1250% risk weight. This has a similar impact on the total capital requirement for such items, where a minimum of 8% applies, but has a less severe impact on the CET1 capital requirement.

8.5 The new exclusions and tighter rules for adjustments regarding CET1 have a knock-on impact on total Tier 1 capital and total capital because the affected items are eliminated from regulatory capital.

**8.5.1 Would the application of CET1 capital stated in the Basel III capital standard have a significant impact on your current capital or on capital planning (also see section 9, capital minima)?**

8.6 The requirements for items that are permitted within Tier 1 capital, other than CET1 capital ("**Additional Tier 1 capital**"), and Tier 2 capital provide a more robust (and detailed) set of definitions that are considered to be in keeping with the spirit of the original Basel I/Basel II guidance. Tier 3 capital is no longer permitted.

*8.7* The Basel Committee has issued a further paper "*Basel III definition of capital - Frequently asked questions*", issued December 2011[7] ("**Capital FAQ**") that clarifies and expands the definitions in the standard. For example, in respect of the requirements for Additional Tier 1 capital, it states that: "*Additional Tier 1 instruments accounted for as liabilities should at least comply with the following minimum standards:*

*8.7.1 The trigger level for write-down/conversion must be at least 5.125% Common Equity Tier 1 (CET1).*

[7] http://www.bis.org/publ/bcbs211.htm

8.7.2 *The write-down/conversion must generate CET1 under the relevant accounting standards and the instrument will only receive recognition in Additional Tier 1 up to the minimum level of CET1 generated by a full write-down/conversion of the instrument.*

8.7.3 *The aggregate amount to be written-down/converted for all such instruments on breaching the trigger level must be at least the amount needed to immediately return the bank's CET1 ratio to the trigger level or, if this is not possible, the full principal value of the instruments."*

8.8 The standard also requires that capital provided to subsidiaries is deducted from the same category – i.e. CET1 capital is deducted from CET1 capital and so on. It is not clear how this will be implemented by the supervisors of parent companies, particularly where the capital is transformed via the use of intermediate holding companies.

**8.8.1 Would the specifications of additional issued Tier 1 and Tier 2 capital stated in the Basel III capital standard have a significant impact on your bank's total available regulatory capital or on capital planning?**

**8.8.2 Would the removal of Tier 3 capital have a significant impact on your bank's total available regulatory capital or on capital planning?**

**8.8.3 Are there any impediments, legal or otherwise, to issuing capital that meets the criteria set in the Capital FAQ?**

8.9 There is an extended implementation timescale, with grandfathering rules, in respect of all the above changes to CET1, Additional Tier 1 and Tier 2 capital. Most ineligible items are phased out over 5 years from 2014, except that issued capital (Additional Tier 1 and Tier 2) that no longer meets the applicable criteria is instead phased out over ten years, starting in 2013.

**8.9.1 Would implementation locally within these timeframes present a problem?**

**8.9.2 Would a simpler transitional framework be appropriate, particularly where no such instruments currently exist?**

## 9 Capital minima

9.1 The Basel III capital standard specifies minima for CET1 capital (4.5% of RWAs), Tier 1 capital (6% of RWAs) and total capital (8% of RWAs). In comparison, Basel II required that total capital exceeded 8% of RWAs and that Tier 1 capital comprised at least 50% of this (i.e. at least 4% of RWAs). The new requirements are to be phased in from 2013 to 2015.

9.2 The Basel III capital standard also calls for a capital conservation buffer. Although this does not establish an absolute minimum requirement, banks that fall into the buffer incur limitations on paying dividends and discretionary bonuses. The buffer has been set at 2.5% of RWAs and has to be held in the form of CET1 capital, equating to a target minimum of 7% of RWAs (4.5% plus 2.5%) for CET1 capital. This also impacts the other ratios and equates to, for example, an effective minimum target of 10.5% of RWAs for total capital. This requirement is to be phased in also, from 2016 to 2019.

9.3 The standard also requires that authorities impose counter-cyclical buffers in times of high growth and rapid asset price inflation. The Countercyclical Guidelines Paper provides additional guidance to authorities regarding implementation; such as establishing a method for determining if an economy is experiencing "high growth". The application of this in the case of an individual bank would reflect the average of any buffers imposed by relevant regulators, weighted with respect to its credit exposures in relevant countries. Because of the depressed global economy, the activation of such buffers has been largely academic and is currently untested.

9.4 The standard also requires authorities to impose additional capital buffers on SIFIs. The G-SIFI Requirements Paper establishes a methodology for determining if a bank is a global SIFI (at consolidated level) and provides a framework of buffers that must be applied to such consolidated entities. This framework could potentially impose a buffer of up to 3.5% of RWAs, although it has been calibrated to ensure that no group attracts a buffer of more than 2.5% based on current operations. Since the requirements for global SIFIs will be set at the consolidated level, this would not directly impact banks in the CDs.

9.5 Detailed proposals regarding the treatment of domestic SIFIs ("**D-SIFIs**") were published for consultation by the Basel Committee on 29 June 2012 for comment by 1 August 2012. These proposals would provide considerable flexibility to take into account local circumstances, although with a focus on ensuring that the CET1 capital minimum is appropriate for such entities. These provisions are relevant to the implementation of Basel III in the CDs and will be taken into account when finalising proposals.

9.6 In the UK and Switzerland, proposals have been made regarding buffers that go beyond the G-SIFI proposals. The Swiss proposal for its largest banks equates to a minimum total capital of 19% of RWAs, of which at least 10% of RWAs must be in the form of CET1 capital.

9.7 The UK proposals are set out in the Independent Commission on Banking ("**ICB**") "*Final Report*", issued September 2011 ("**ICB Report**"), and the subsequent White Paper: "*Banking reform: delivering stability and supporting a sustainable economy*", published in June 2012 ("**White Paper**") by HM Treasury. These proposals create a ringfenced bank concept, similar to the Basel III concept of D-SIFIs. For the largest ringfenced banks, the ICB Report and White Paper calls for total CET1 capital of 10% of RWAs. They also call for a buffer to ensure that for such banks "primary loss absorbing capacity" ("**PLAC")** exceeds 17% of RWAs. The definition of the latter is wider than regulatory capital and interacts with the more general plans to introduce bail-in powers in respect of certain unsecured debt. The White Paper sets out in some detail the various issues regarding the detailed definition of PLAC and the relevant consultation should lead to these being resolved. The application of the ICB Report and White Paper to UK entities operating in the CDs is subject to separate ongoing discussions.

9.8 The EU, in contrast, appears to be looking to implement Basel III with less deviation, which would, on the face of it, conflict with the UK approach. There is therefore some uncertainty over ultimate outcomes as it may be that national supervisors implement Basel III for Pillar 1 but achieve their desired outcome by supplementing this with requirements that look and feel like Pillar 1 requirements but are imposed under regulations permitted under the more flexible Pillar 2 rules.

9.9 The US position is unclear, with its commitment to implement Basel II/III sitting alongside its domestic programme of changes to regulation, several of which appear to conflict with Basel II/III. As an example, current US proposals appear to rule out the use of rating agency credit ratings in determining risk weights.

9.10 Other relevant home supervisors are likely to adopt part or all of Basel III but detailed plans are either not available or not finalised. It is not surprising that there remains uncertainty around the treatment of SIFIs, since the whole issue of "too big to fail" is one of the most challenging issues arising from the 2008 banking crisis.

9.11 In considering the totality of these proposals, it is worth noting that, under current regulations in the CDs, Tier 2 capital is limited to up to 50% of total Tier 1 and 2 capital, which establishes an effective minimum at 5% of RWAs for Tier 1 capital.

9.12 Most CD banks have a capital base that is dominated by CET1 capital and only a few have significant items that would fall outside of the new definition of CET1 capital. These consist of perpetual preference shares, which would typically meet the criteria for Additional Tier 1 capital, and limited issuance of subordinated debt, which would typically meet the criteria for Tier 2 capital (in line with the current treatment).

9.13 The proposed framework of buffers and limits appears overly complex for local subsidiaries. An alternative might be to establish an appropriate minimum for CET1 capital, at a level to be determined (perhaps similar to the current local capital minima rather than Basel III levels), and use Pillar 2 to establish appropriate buffers, some of which might be permitted to be in the form of Additional Tier 1 or Tier 2 capital. This would permit a bank to use a variety of approaches, including holding capital buffers that can be turned into CET1, in order to satisfy itself that the minimum can be maintained. This would be documented in the bank's ICAAP and subject to the normal Pillar 2 oversight of the relevant supervisor.

9.14 If the risk of regulatory arbitrage is to be avoided, such a framework would need to be agreed across the CDs.

**9.14.1 Would you support a move to using a single CET1 ratio for Pillar 1, instead of a framework of minima and buffers? If so, what level do you consider would be appropriate?**

**9.14.2 What timescale would provide sufficient time to enable a smooth transition?**

## 10 Market Risk: Counterparty Credit Risk

10.1 Most of the new provisions in Basel III and Basel 2.5 in the above respect are only relevant for banks that use advanced approaches to compute risk in the trading book. As such, they are relevant to any bank that seeks approval for such a model. It is proposed that implementation be permitted in accordance with home supervisors' requirements, provided that any identified residual risks are addressed in Pillar 2.

**10.1.1 If you currently have a trading book or plan to do so, please provide a brief summary of your home supervisor's communicated plans.**

10.2 In May 2012, the Basel Committee published a consultation paper "*Fundamental review of the trading book*", which contains proposals to strengthen capital standards for market risk. These proposals are intended to address five areas of perceived weakness in the current approach:

10.2.1 Definition of the regulatory boundary;

10.2.2 Lack of credible options in the event that models are found to be flawed;

10.2.3 Shortcomings in the standardised approach;

10.2.4 Shortcomings in the advanced approach; and

10.2.5 Shortcomings in valuation practices.

10.3 These proposals are not in final form; instead, a range of options is presented. It is proposed that implementation be considered only once a revised standard is published. This would only be relevant for a small number of banks that have significant market exposures. At this time, relevant banks are encouraged to familiarise themselves with the Basel Committee paper and with their group's views on it. Any implementation locally would follow the normal consultation process for each island and coordination across the CDs will be considered by the Tri-Party group.

## 11 Other risk weight issues, including the use of credit ratings

11.1 Basel 2.5 and the CCP Requirements Paper address, respectively, the treatment of re-securitisations and central clearing counterparties under the standardised approaches, proposing, briefly, that:

11.1.1 For re-securitisations – higher risk weightings are required and less value is taken into account if used as collateral for an exposure; and

11.1.2 For central clearing counterparties - risk weights are applied to centrally cleared exposures, such as exchange traded futures, which are currently excluded in calculating RWAs.

11.2 Whilst current exposures are minimal, such changes appear appropriate, particularly in case exposure levels increase in the future.

**11.2.1 Do you have, or plan to have, any re-securitisation exposure or exposure to central clearing parties? If so, please comment on the desirability and impact of these changes.**

11.3 The standard also suggests alternatives and changes to the use of rating agency credit ratings. These fall into three areas:

11.3.1 Placing a responsibility on banks to properly use Pillar 2, which includes assessing the adequacy of Pillar 1 risk weightings;

11.3.2 Establishing standards for supervisors to use when considering if rating agencies should be eligible; and

11.3.3 Changes to the credit risk mitigation rules to reduce eligibility criteria for guarantors.

11.4 It is considered that the first of these only reinforces existing Pillar 2 requirements. The second is relevant but it is not considered likely that any of the three currently eligible rating agencies would become ineligible.

11.5 The last measure would benefit holders of very highly risk weighted (150%+) exposures that would benefit from a guarantee extended by a party that itself has a high risk weight (100%, say), whereas current rules specify tighter credit criteria for the guarantor, such that no capital benefit would currently arise from such a guarantee. This is likely to have only a limited impact as holdings of such assets are typically low in CD banks. This measure will be considered in due course, during the wider implementation of Basel III.

11.6 US supervisors have also proposed alternatives to the use of rating agency credit ratings, centred around greater use of OECD country ratings. Limited use of these is currently permitted in the CDs. However, the OECD has recently issued a statement clarifying that these ratings are not risk ratings and do not reflect all relevant matters. Instead, the rating is more analogous to a country ceiling (i.e. the maximum rating a bond issuer could get if it was located in the country). As such, the Tri-Party Group considers that increased use is not warranted and that individual banks that use such ratings should consider how to reduce their use. This might form part of a plan to progress to the standardised approach, which banks that have adopted the simplified standardised approach are now encouraged to do.

**11.6.1 Would you support the removal of the simplified standardised approach in the CDs, over the medium term, once it is no longer in use or do you believe that it remains appropriate for some types of bank?**

## 12 Leverage Ratio

12.1 The Basel III capital standard establishes a timeline for the introduction of a leverage requirement, initially as a Pillar 2 measure but with a planned transition to Pillar 1 after further work on calibration. The measure is defined as the ratio of Tier 1 capital to total (adjusted) assets. A proportion of off-balance sheet items are included, based on the conversion factors used in the standardised approach.

12.2 The minimum ratio set (for Pillar 2 use) is 3%. The ratio will be reviewed by the Basel Committee during the period before Pillar 1 transition, as will alternative formulae for the leverage ratio, such as using total capital and/or alternative standardised factors for off-balance sheet assets.

12.3 The UK ICB Report suggested a higher ratio of 4.06%, proportionate to the higher levels of Tier 1 capital required by the ICB proposals. The subsequent White Paper, however, suggests the leverage ratio should be consistent with the Basel III proposal of 3%.

12.4 No decision has been made at this time regarding implementation in the CDs. In order to facilitate this, data will be needed from banks and one way of achieving this could be to change prudential reporting requirements to capture the necessary data in due course.

12.5 Only small changes would be required and these could be accomplished alongside any other changes in capital and liquidity reporting that are necessary to implement other elements of Basel III.

**12.5.1 Are there any obstacles to reporting the leverage ratio?**

**12.5.2 If a minimum leverage ratio was set at 3% of (adjusted) assets, in line with the current Basel III proposal, do you consider that adhering to this would have any adverse impacts on your bank?**

**12.5.3 Do you consider that there are any aspects of the leverage ratio that should be amended for subsidiary banks even where a consolidated ratio is seen to be appropriate?**

## 13 Countercyclical measures

13.1 A key new measure in the Basel III capital standard is the counter-cyclical buffer. As discussed in section 9, it is not considered that this is an appropriate measure to apply locally. However, for banks that have significant overseas credit operations, Pillar 2 assessments may need to consider counter-cyclical buffers imposed by relevant overseas supervisors. At this time, no such buffers have been established and developments will be considered in due course.

13.2 The main other measure in Basel III is the proposal that accounting rules for impairment be amended to reduce the pro-cyclicality of the current measures.

13.3 Proposed amendments to the Basel Core Principles, set out in the consultation paper "*Core principles for effective banking supervision*", issued in December 2011, include a statement that supervisors should seek to ensure that credit provisions are appropriate, including where international accounting standards do not achieve this. These revised core principles are expected to be formally endorsed in September 2012.

13.4 Concurrently, a new international accounting standard (IFRS 9) has been proposed by the International Accounting Standards Board which would, amongst other things, require an expected loss approach to impairment. The Basel Committee has also published a set of principles in its 2009 paper "*Guiding principles for the replacement of IAS 39*" that reflect how it considers the accounting standard should develop.

13.5 In the UK, the Accounting Standards Board is undertaking a programme of changes to UK GAAP, which appears to be intended to ensure that UK financial institutions apply international accounting standards in most respects, albeit with reduced disclosure requirements for smaller entities.

13.6 The above initiatives cover wider accounting issues than simply impairment but a key focus is on a shift back towards raising general provisions. As the 2009 paper states (Principle 12):

13.6.1 "*Loan loss provisioning should be robust and based on sound methodologies that reflect expected credit losses in the banks' existing loan portfolio over the life of the portfolio. The allowance or provision should be presented separately from total loans. The accounting model for provisioning should allow early identification and recognition of losses by incorporating a broader range of available credit information than presently included in the incurred loss model and should result in an earlier identification of credit losses. For the purpose of these principles, expected credit losses are estimated losses on a loan portfolio over the life of the loans and considering the loss experience over the complete economic cycle.*"

13.7 No immediate changes are proposed in response to this developing situation but consideration of these matters will continue over the medium term. As such, only limited feedback is sought on current accounting practices.

**13.7.1 Do your bank's accounting practices regarding credit provisioning only require provisions to be raised where losses are incurred (as opposed to the expected loss approach outlined by the Basel Committee)?**

**13.7.2 If you do not currently use IFRS, what is the reason for this?**

## 14 Pillar 2 measures

14.1 Basel 2.5 provides additional guidance in respect of Pillar 2. To date, the Tri-Party Group have implemented Pillar 2 separately around a common core requirement for individual banks to follow the internal capital adequacy assessment process ("**ICAAP**") and issued a short paper that established a common initial approach to certain key areas.

14.2 In light of this, there is no plan to develop a joint approach to the revised implementation of Pillar 2.

**14.2.1 Are there any specific areas of Pillar 2 where you consider that a common approach across the CDs would assist banks?**