Feedback on the Discussion Paper on Basel III: Capital Adequacy ("Basel III Capital DP")

1 Introduction

1.1 Feedback received was largely positive, with strong support for the development of a common approach across the Crown Dependencies ("**CDs**") that is aligned to Basel III, where appropriate, with adjustments made to reflect local conditions.

2 Questions 1, 2 & 3:

- **Do you have any comments on the aim to introduce the proposed Basel III compliant measures for the assessment of capital adequacy, including transitional adjustments, by the end of 2015?**

- **With regard to the reporting format (Appendix B), are there any changes that you consider would improve clarity or otherwise make it easier to complete?**

- **Are the proposals regarding the calculation and reporting of transitional adjustments clear? If not, do you have any proposals for improvement?**

2.1 Feedback

2.1.1 There was broad support for the approach outlined in the Basel III Capital DP, including the transitional provisions, and for the proposed reporting formats. However, various suggestions were made concerning (1) simplifying transitional adjustments and (2) avoiding adoption in Q4 2015, given the heightened workloads around the year-end.

2.1.2 One bank proposed (3) that we go further and look to use common reporting software across the Crown Dependencies.

2.1.3 One bank sought clarification of (4) the reporting of bank specific deductions from capital.

2.1.4 One bank sought clarification regarding (5) the impact of the transitional cap with respect to tier 2 subordinated debt that is also subject to amortisation as it approaches maturity (i.e. within last 5 years to maturity).

2.2 Response

2.2.1 Suggestions (1) and (2) will be taken into account in developing the consultative proposal. Specifically:

2.2.1.1 As a minimum, it will be made clear that banks will be permitted to not carry out transitional calculations where the impact is positive (i.e. where not carrying out the adjustment would be more prudent) or where the impact is agreed to be immaterial; and

2.2.1.2 Consideration will be given to adoption in early 2016, as opposed to late 2015.

2.2.2 Re (3), the possibilities for commonality of reporting will be explored to the extent possible but this is unlikely to include developing common software, given the likely complexities of such a project. The intention is to construct common reporting formats and guidance, down to the lowest level of detail (for example, using the same examples).

2.2.3 Re (4), it is intended that any bank-specific required deductions would be reported on the lines provided in the template, such as line 26 "*National specific regulatory adjustments, including Pillar 2 deductions applied to CET1 capital*" (and similar lines are provided for Additional Tier1 and Tier 2 capital).

2.2.4 Re (5), it is intended that all transitional caps would be calculated as a percentage of the relevant capital item as at 1 January 2013: i.e. in this case, the amount of Tier 2 capital on 1 January 2013, post any amortisation applying at January 2013. The cap would only apply to the amortised amount: if amortisation of such capital items led to the balance decreasing so that the amount was below the cap at a future date, the full amortised amount could be included.

3 Questions 4, 5 & 6:

- **Have you issued, before 1 January 2013, any capital item that would fall into items 4 or 4a? If so please provide details.**
- **Would use of the proposed definition of Common Equity Tier 1 capital (before making adjustments) have a significant impact on your capital planning? If so, please describe the impact and any suggestions regarding alternatives.**
- **Are there any issues regarding the proposed required adjustments to Common Equity Tier 1 capital?**

3.1 Feedback

3.1.1 (1) No bank identified any of their capital items as falling within items 4 or 4a.

3.1.2 It was noted that the changes might have an impact (2) in a situation where a bank owns less than 100% of a subsidiary, due to the restriction on the recognition of "surplus" minority interests.

3.1.3 Views were expressed that the impact of Basel III on (3) pension scheme liabilities and deferred tax assets was likely to be minimal and it was therefore suggested that transitional provisions were not necessary.

3.1.4 Some banks queried the treatment of (4) revaluation reserves and Held for Sale ("**HFS**") reserves.

3.1.5 Some banks queried why no transitional provisions were proposed for (5) debit valuation adjustments ("**DVA**") and cash flow hedging reserves.

3.2 Response

3.2.1 Re (1), this result was expected and it is confirmed that, as proposed, no entry will be permitted for such items.

3.2.2 The potential impact on "surplus" minority interests noted in (2) is a consequence of Basel III that is considered relevant locally because such surpluses are not available to meet risks arising in other parts of the group.

3.2.3 Certain transitional provisions, such as those noted in 3.1.3 above, are expected to have a small or minimal impact in most, if not all, cases. As stated in 2.2.1.1, where the item is agreed to be immaterial, a bank would be permitted to omit calculating transitional provisions.

3.2.4 Re (4) revaluation reserves and HFS reserves will both be included within item 3 in Core Equity Tier 1 capital, without any prudential adjustment. Transitional provisions apply re the removal of any prudential adjustment to HFS reserves that applies, as documented in paragraph 5.41 of the Basel III Capital DP re Item 26b, "*Regulatory adjustments applied to CET1 capital in respect of amounts subject to pre-Basel III treatment: available-for-sale reserves*".

3.2.5 No transitional adjustments to (5) DVAs and cash flow hedge reserves were proposed for a mixture of reasons: (A) many banks already exclude such amounts (B) current regulatory guidance differs across the CDs and (C) the impact of transitional provisions would have been minor only.

4 Questions 7, 8, 9, 10, 11 & 13:

- **Are there any issues regarding the proposed definition of and required adjustments to Additional Tier 1 capital?**

- **Are there any issues regarding the proposed definition and required adjustments to Tier 2 capital?**

- **Are there any questions regarding the use of the 1250% risk weight for some items currently deducted from capital, as set out in section 8?**

- **Would the imposition, over time, of the proposed requirements for higher quality capital, within an unchanged effective total requirement, present a significant issue for your business? If so, are there any changes that could be made that would reduce the impact?**

- **Would the timeline for the introduction of revised capital minima adequately mitigate the impact on your business? If not, please provide an alternative that you consider would appropriately reduce the impact.**

- **Would reporting the memoranda items described in Section 10 pose any issues?**

4.1 Feedback

4.1.1 No bank raised concerns re the new definitions of Additional Tier 1 capital and Tier 2 capital, in part because those affected noted that issued debt that becomes ineligible can be re-issued as qualifying debt, which is made easier as most issuance in the CDs is intra-group.

4.1.2 No bank raised concerns re the use of a 1250% risk weight in place of current capital deductions. One bank noted that (1) current rules in Jersey already impose a 1250% risk weight instead of a capital deduction re settlement risk.

4.1.3 The overwhelming majority of banks supported the proposed minima. One bank proposed that (2) capital minima be set in-line with the Basel III minima, after including the capital conservation buffer i.e. CET1 capital minima of 7%, Tier 1 capital minima of 8.5% and Total capital minima of 10.5%, rather than the 8.5% CET1 capital and 10% Total capital minima proposed. Another noted that the proposal would mean more capital was required to be held as CET1 capital (than under the Basel III standard) and that the minimum for total capital would be below the Basel III capital buffer level.

4.1.4 One bank sought clarification re (3) the impact of the changed minima on the practice of effectively deriving risk weighted asset requirements by dividing the capital requirement by 8% - i.e. multiplying by 1250%.

4.1.5 One bank sought an assurance that (4) the time between finalisation of guidance and implementation would be no less than one year.

4.1.6 One bank (5) dismissed the need for an extended timescale for implementation or transitional provisions.

4.1.7 No bank raised any issues regarding the proposed reporting of memoranda items.

4.1.8 One bank enquired re (6) CVA provisions for OTC derivatives in Basel III, suggesting a CRD-IV style carve-out.

4.2 Response

4.2.1 As expected, the impact of the move to use of a 1250% risk weight is not seen as an issue, as the effect is similar to deduction from capital. As noted in (1), a 1250% risk weight, rather than a capital deduction, has been used already in the CDs for settlement risk, following similar logic to Basel III.

4.2.2 Re (2), it is considered that the proposal is more appropriate locally than the Basel III minima, in large part because CET1 capital dominates the current make–up of CD banks' total tier 1 capital, so that the higher minima would have little impact on local banks. The 10% total capital minimum proposed is marginally lower than the Basel III capital conservation buffer level, but higher than the proposed minimum in Basel III (8%). Local banks typically operate significantly in excess of minima and the JFSC and IOMFSC have imposed notification requirements on banks that are at least 1% higher than the minima in all cases, which is expected to continue, hence it is considered likely that in practice banks will continue to maintain total capital in excess of the Basel III capital conservation buffer level.

4.2.3 The current practice of calculating risk weighted asset equivalents by multiplying by 1250% will continue. This is consistent with Basel III, which establishes a range of minima, both higher and lower than 8%, but uses a factor of 1250% to derive risk weighted asset equivalents.

4.2.4 Re (4), the exact timeline will be established as part of the planned consultation and it is expected that this will provide around one year for implementation. The expectation is that reporting will substantially follow the format set out in the Basel III Capital DP, providing banks with more time to (A) prepare for reporting and (B) make any necessary adjustments, for example, re ineligible issued capital.

4.2.5 Re (5), some banks will not be required to apply transitional provisions, as set out in 2.2.1.1, but where they are material they will be retained, as per the proposal in the paper.

4.2.6 Re (6), the Tri-Party Group has not, to date, addressed that element of Basel III that deals with CVA capital charges nor certain other proposed or final changes to the Basel standard that have been published by the Basel Committee (including some introduced in Basel 2.5) that would impact the calculation of risk weighted assets, principally those in connection with trading book assets, derivatives and (re)securitisations. However, in keeping with 6.2.4 of this paper, we would be unlikely to make adjustments to a proposed standard simply because another regulator had made similar adjustments, without considering whether such adjustments were appropriate.

5 Question 12

- **Do you consider that there are any alternatives to the proposal that Pillar 2 minima and buffers should, typically, be required to be met out of CET1 capital? If so, please outline them, together with a supporting rationale.**

5.1 Feedback

5.1.1 A significant minority of banks suggested that (1) some or all Pillar 2 requirements should be met out of Tier 2 capital for the following reasons:

5.1.1.1 To ease capital management within groups;

5.1.1.2 To align to the bank's Pillar 1 capital requirements; and/or

5.1.1.3 To align with the treatment proposed by home regulators.

5.1.2 One bank (2) asked if ICG requirements would be amended in Guernsey to reflect the change in the minimum from 8% to 10%.

5.2 Response

5.2.1 The impact of Pillar 2 will vary depending on the nature of Pillar 2 risks identified. The Basel III Capital DP noted that for many Pillar 2 risks the potential consequence was a loss and hence a resultant impact on CET1 capital for which an increase in the CET 1 minimum would be the most obvious response. This does not preclude the use of other forms of capital in circumstances where the impact is different (eg an increase in risk weighting of certain assets) or where the bank can show that the mitigated impact would differ, such as if it could be demonstrated that, in the relevant circumstances, the conversion of issued capital to CET1 capital could meet the relevant shortfall. This will vary from bank to bank and depend on the specific circumstances and will be considered as part of the Pillar 2 process.

5.2.2 The GFSC will take into account the increase in the minima when setting ICG for banks.

6 Question 14

- **Do you consider there is any evidence that would support divergence from Basel II regarding the treatment of short-term exposures to banks? In light of the impending review by the TFSA, is this an issue that warrants immediate action?**

6.1 Feedback

6.1.1 On this issue, some banks opposed the introduction of higher standards, some called for consistency with Basel II, whilst a vocal minority called for consistency with the EU approach. In some cases, this was because their group was subject to the relevant EU regulation.

6.2 Response

6.2.1 The current situation is that the CDs are compliant with Basel II in this area.

6.2.2 The EU is not aligned with Basel II: it defines short-term claims on banks using "residual", rather than "original" maturity. As stated in the Basel III Capital DP, the TFSA (a Basel sub-committee workstream) is currently reviewing the standardised approaches and any outcomes will be considered in due course.

6.2.3 Whilst the outcome is uncertain, it is perhaps useful to explain that Basel II is built around a constant portfolio assumption and hence the lower risk weight for short-term bank claims was not intended to reflect the shorter period to maturity. Instead, it is understood that the upper bound was set to establish a preferential treatment for claims in the short-term interbank market, where almost all claims have an original maturity of three months or less. Longer term placements and bonds were not considered to become part of this market, even when they achieve a similar residual maturity.

6.2.4 In general, the view of the Tri-Party Group is that regulations should have a starting point of the international standard and then be modified where appropriate for local circumstances; we will not generally make adjustments simply because another regulator has diverged from the international standard.