Discussion Paper

Basel III: Capital Adequacy Elements of Basel III

Insight is provided herein on miscellaneous elements of *Basel III* that concern capital adequacy. This follows the issuance by the *Basel Committee* of new and revised standards for determining capital requirements and the *Commission's* issuance of CP No. 8 2015 "*Capital Adequacy and Leverage*", which addressed the related changes to the definition of capital. In particular, *Basel Committee* proposals concerning the Standardised Approach for credit risk are outlined and feedback is sought on these.

Issued: 16 March 2016

› Discussion Paper

Please note that terms in *italics* are defined in the Glossary of Terms.

Feedback is requested on this Discussion Paper by 30 June 2016.

In order to facilitate the analysis of feedback, it is requested that all feedback is either (1) sent by email to fscbankingadmin@jerseyfsc.org or (2) uploaded via the Commission's website, at:

- https://www.jerseyfsc.org/fileuploaddc/

Feedback will inform implementation of the matters discussed and may be published on an anonymous basis.

› Glossary of Terms

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 prudential management of international banks
Basel III Capital CP	Consultation Paper No. 8 2015 "*Basel III: Capital Adequacy and Leverage*", issued in July 2015 by the *Commission*
BI	Business Indicator (risk driver for the *SMA*)
BIA	Basic Indicator Approach for operational risk
CCR	Counterparty Credit Risk
Commission	Jersey Financial Services Commission
IOSCO	International Organisation of Securities Commissions
IPRE	Income Producing Real Estate
LTA	Look Through Approach (option for equity exposures to funds)
LTV	loan to value
MBA	Mandate Based Approach (option for equity exposures to funds)
SMA Paper	Consultation paper "*Standardised Measurement Approach for operational risk*", issued in March 2016 by the *Basel Committee*
Revised LE Framework	"*Supervisory framework for measuring and controlling large exposures*", issued in April 2014 by the *Basel Committee*
RW	risk weight
SAO	Standardised Approach for operational risk
SACR Paper	Consultation Paper "*Revisions to the Standardised Approach for credit risk*", issued in December 2015 by the *Basel Committee*
SME	small and medium-sized enterprises
SMA	Standardised Measurement Approach for operational risk

› Contents

1 Executive Summary

1.1 Overview

1.1.1 This paper addresses capital adequacy elements of the "**Basel III**" package of new and revised international standards issued by the Basel Committee on Banking Supervision ("**Basel Committee**"). These revise the international standards set out in the document "*International Convergence of Capital Measurement and Capital Standards*" ("**Basel II**"), issued in 2006 by the *Basel Committee*, which has previously been implemented in Jersey.

1.2 What is proposed and why?

1.2.1 An outline is provided and feedback from industry is sought on proposals contained in the *Basel Committee* Consultation Paper "*Revisions to the Standardised Approach for credit risk*"[1] ("**SACR Paper**"), issued in December 2015.

1.2.2 A brief overview is provided of miscellaneous relevant *Basel III* papers, together with an indication of the likely timescale for implementation in Jersey:

1.2.2.1 *Basel Committee* papers that set out changes that will impact the Standardised Approach for credit risk;

1.2.2.2 The *Basel Committee* consultation paper "*Standardised Measurement Approach for operational risk*"[2] ("**SMA Paper**"), issued in March 2016; and

1.2.2.3 *Basel Committee* papers that set out changes that will impact the Standardised Approach for market risk.

1.3 Who would be affected?

1.3.1 Banks that are incorporated in Jersey would be impacted directly by the matters addressed herein. Jersey branches will not be impacted by local implementation, though they will be impacted by home country implementation of *Basel III*.

1 http://www.bis.org/bcbs/publ/d347.pdf
2 http://www.bis.org/bcbs/publ/d355.pdf

2 Revisions to the Standardised Approach for Credit Risk

2.1 Background

2.1.1 In December 2014, the *Basel Committee* issued an initial consultation paper on "*Revisions to the Standardised Approach for credit risk*".

2.1.2 Following feedback from industry, the *Basel Committee* issued a second consultation paper, the *SACR Paper*, in December 2015.

2.1.3 Respondents to Consultation Paper No. 8 2015 "*Basel III: Capital Adequacy and Leverage*" ("**Basel III Capital CP**"), issued in July 2015 by the *Commission* stated that changes impacting the Standardised Approach for credit risk would have the highest potential impact if implemented locally and therefore those proposals should be circulated as a priority.

2.1.4 The *Commission* shares this view; key relevant proposals detailed herein are:

2.1.4.1 exposures to banks (**Section 2.2**);

2.1.4.2 exposures to corporates (**Section 2.3);**

2.1.4.3 due-diligence requirements (**Section 2.4**);

2.1.4.4 residential mortgage exposures (**Section 2.**5);

2.1.4.5 loans secured by commercial property (**Section 2.6**);

2.1.4.6 credit conversion factors (**Section 2.7**); and

2.1.4.7 lending in foreign currencies (**Section 2.7**).

2.1.5 The *SACR Paper* also contained proposals concerning the treatment of exposures to multilateral development banks, retail customers and defaulted counterparties, plus rules regarding recognition of credit risk mitigation.

2.1.6 Banks are advised to familiarise themselves with all proposals in the *SACR Paper*, and also seek group views on these.

2.1.7 **Question: Based on your own analysis and group input, are there any areas of the *SACR Paper* (other than those covered in Sections 2.2 to 2.7) that would give rise to a significant impact on the capital adequacy of the locally incorporated bank?**

2.2 Exposures to banks

2.2.1 For externally rated exposures to banks, the *SACR Paper* proposes an approach that is similar to the bank-rating based option in *Basel II*, which has been implemented in Jersey. The existing preferential treatment for short-term exposures (those with an original maturity of three months or less) is retained.

External rating of counterparty	AAA to AA–	A+ to BBB–	BB+ to B–	Below B–
RW	20%	50%	100%	150%
RW for short-term exposures	20%	20%	50%	150%

2.2.2 *Basel II* also contained a sovereign-rating based option, which is not retained in the *SACR Paper.*

2.2.3 If adopted in Jersey, the consequence would be that the Simplified Standardised Approach would be removed as an option.

2.2.4 For unrated exposures, a *RW* of 50%/20% (the latter for short-term exposures) would apply unless: (1) published regulatory buffers were breached (in which case an increased *RW* of 100%/50% would apply) or (2) regulatory minima were breached (in which case a 150% *RW* would apply regardless of maturity).

2.2.5 **Question: Do you have any views on impacts of the *Basel Committee's* latest proposals regarding exposures to banks if they were applied in Jersey?**

2.3 Exposures to corporates

2.3.1 For externally rated exposures to corporates, an approach is proposed that is similar to that of *Basel II*.

External rating of counterparty	AAA to AA–	A+ to A–	BBB+ to BBB–	BB+ to BB–	Below BB–
RW	20%	50%	100%	100%	150%

2.3.2 For unrated exposures, a *RW* of 100% would apply, except in the case of:

2.3.2.1 **Small and medium-sized enterprises ("SMEs"[3]):** a *RW* of 85% would apply;

2.3.2.2 **Project finance, object finance, commodities finance and income-producing real estate finance**: the higher of a 120% *RW* and the normal *RW* of the counterparty would apply; and

2.3.2.3 **Land acquisition, development and construction finance**: the higher of a 150% *RW* and the normal *RW* of the counterparty would apply.

2.3.3 **Question: Do you have views on impacts of the *Basel Committee's* latest proposals regarding exposures to corporates if they were applied in Jersey?**

[3] Entities where the reported sales of the consolidated group of which the firm is a part are less than €50 million.

2.4 Due diligence

2.4.1 In the case of exposures to both banks and corporates (and for both rated and unrated counterparties), banks would be required to perform certain due-diligence on counterparties and consequently increase *RWs* where warranted (they cannot be decreased).

2.4.2 Banks would be required to establish internal grades for exposures and map these to *RWs*. The internal grading processes established by banks would be reviewed as part of the Pillar 2 process.

2.4.3 Banks already perform due-diligence. Refining processes to derive internal grades would be complex but banks could leverage off group resources to achieve this where necessary.

2.4.4 The impact on overall capital requirements is expected to be modest but it seems likely that, for certain exposures, the *RW* would increase.

2.4.5 **Question: Would the due-diligence proposals be likely to either (1) have a significant impact on capital requirements or (2) be difficult to implement in Jersey?**

2.5 Residential mortgage exposures

2.5.1 The *SACR Paper* proposes that the *RW* for residential mortgages should depend on (1) whether repayment is materially dependent on cashflows generated by the property (which is then defined as Income Producing Real Estate - "**IPRE**"), (2) whether certain operational requirements are met (or not) and (3) the loan to value ("**LTV**") ratio, as follows:

	Operational requirements met						**Not met**
LTV ratio	≤ 40%	> 40% ≤ 60%	> 60% ≤ 80%	> 80% ≤ 90%	> 90% ≤ 100%	>100%	All
General (owner occupied)	25%	30%	35%	45%	55%	100%	100%
IPRE (*buy-to-let*)	70%	70%	90%	120%	120%	120%	150%

2.5.2 The operational requirements are detailed in the *SACR Paper* (see paragraph 50 of that paper) and relate to the following areas:

2.5.2.1 **Finished property**: the property securing the exposure must be fully completed;

2.5.2.2 **Legal enforceability**: any claim on the property taken by the lender must be legally enforceable in all relevant jurisdictions;

2.5.2.3 **Claims over the property**: Claims over the property are restricted to situations where the lender holds a first lien over the property, or a single bank holds the first lien plus any sequentially lower ranking lien(s);

2.5.2.4 **Ability of the borrower to repay**: the borrower must meet certain underwriting criteria;

2.5.2.5 **Prudent value of property**: (1) the property must be valued according to set criteria and (2) the value of the property must not depend materially on the performance of the borrower; and

2.5.2.6 **Required documentation**: all the information required at loan origination and for monitoring purposes must be properly documented.

2.5.3 The *LTV* ratio would be determined by comparing the amortized value of the loan to the property valuation at origination – re-valuations subsequently undertaken cannot be used to update the *LTV* (this does not preclude the use of re-valuations in Pillar 2).

2.5.4 For buy-to-let mortgages, the impact would be likely to be adverse where a loan is currently included within the residential mortgages portfolio, based on current criteria (and hence currently attracts a 35% *RW*).

2.5.5 The impact on “owner occupier” mortgages will vary, depending on the *LTV* of the mortgages, but is expected to be modest only for typical mortgage books.

2.5.6 The operational criteria might be problematic for certain categories of mortgages. In particular, historic lending may not be adequately documented for these purposes. This could have a significant adverse impact on applicable *RWs*.

2.5.7 **Question: Do you hold sufficient documentation of historical lending to enable the operational criteria to be met? Are any of the other operational criteria problematic for a significant portion of loans (new or existing)?**

2.5.8 **Question: Would the proposals impact significantly on the capital required to support buy-to-let, or any other, mortgages extended by your bank?**

2.6 Loans secured by commercial property

2.6.1 The *SACR Paper* proposes that the *RW* for loans secured by commercial property should depend on (1) whether repayment is materially dependent on cashflows generated by the property (i.e. *IPRE*), (2) whether operational requirements are met and (3) the *LTV* ratio, as follows:

	Operational Requirements Met			**Not met**
LTV ratio	≤ 60%	> 60% ≤ 80%	>80%	All
General (counterparty’s own premises)	Lower of 60% or the normal *RW* of the counterparty	*RW* of counterparty		100%
IPRE *(premises rented out)*	80%	100%	130%	150%

2.6.2 The operational requirements are set out in the *SACR Paper* (the same as for residential mortgages).

2.6.3 As with residential mortgages, the *LTV* ratio would be determined by comparing the amortized value of the loan to the valuation at origination.

2.6.4 The impact, compared to the 100% *RW* currently applicable in most cases, is likely to be positive, except in the case of *IPRE* (rented premises) with a high *LTV* ratio.

2.6.5 Respondents to the *Basel III Capital CP* advocated preferential *RWs* for this category of lending. The *Commission* will consider this aspect and include it in consultation in due course.

2.6.6 As with residential mortgage exposures, the operational criteria might prove problematic for certain categories of mortgages, particularly less well documented loans, which could have a significant adverse impact.

2.6.7 **Question: If implemented locally, how would the proposals concerning loans secured by commercial property impact on capital requirements for your bank?**

2.7 Other key proposals

2.7.1 **Credit Conversion Factors ("CCFs"):** A number of changes are proposed in *the SACR Paper* to *CCFs*. Perhaps the most significant is the removal of the 0% *CCF* for unconditionally cancellable facilities. This would be replaced by a 10% to 20% *CCF* (final calibration by the *Basel Committee* is awaited) for retail facilities, with non-retail facilities receiving the same *CCF* as for committed facilities.

2.7.2 **Question: Would the removal of the 0% *CCF* for unconditionally cancellable facilities have a significant impact?**

2.7.3 **Lending in foreign currencies:** For unhedged corporate, retail and real estate exposures[4], where the lending currency differs from the currency of the borrower's main source of income, the *SACR Paper* proposes that banks be required to apply an add-on of 50 percentiles to the *RW* applicable, subject to a maximum *RW* of *150*%.

2.7.4 **Question: Would a requirement to apply a 50 percentile increase to the *RW* of unhedged borrowers in foreign currencies have a significant impact?**

[4] For these purposes, an unhedged exposure means an exposure where the borrower has no natural or financial hedge against the foreign exchange risk resulting from the currency mismatch between the currency of the loan and the sources of funds to pay down the loan.

3 Securitisations and Funds

3.1 Overview

3.1.1 Consideration is given here to papers issued by the *Basel Committee* on exposures to securitisations and funds. It is intended to consult on these in 2017.

3.2 Securitisations: capital requirements

3.2.1 In December 2014, the *Basel Committee* issued the paper "*Revisions to the securitisation framework*"[5].

3.2.2 For "normal" securitisations (i.e. not re-securitisations), this establishes an external ratings-based approach that is more risk-sensitive than that currently in place in Jersey, taking into account seniority and maturity as well as ratings.

Rating	Senior tranche		Non-senior tranche	
	Tranche maturity		Tranche maturity	
	1 year	5 years	1 year	5 years
AAA	15%	20%	15%	70%
AA+	15%	30%	15%	90%
AA	25%	40%	30%	120%
AA–	30%	45%	40%	140%
A+	40%	50%	60%	160%
A	50%	65%	80%	180%
A–	60%	70%	120%	210%
BBB+	75%	90%	170%	260%
BBB	90%	105%	220%	310%
BBB–	120%	140%	330%	420%
BB+	140%	160%	470%	580%
BB	160%	180%	620%	760%
BB–	200%	225%	750%	860%
B+	250%	280%	900%	950%
B	310%	340%	1,050%	1,050%
B–	380%	420%	1,130%	1,130%
CCC+/CCC/CCC–	460%	505%	1,250%	1,250%
Below CCC	1,250%	1,250%	1,250%	1,250%

5 http://www.bis.org/bcbs/publ/d303.pdf

3.2.3 For re-securitisations, a more complex standardised model approach is outlined that is intended to be both more risk sensitive and more conservative.

3.2.4 Looking at the historical data on the exposures of Jersey incorporated banks, normal securitisation exposures have, from time to time, been significant for individual banks but re-securitisation exposures have been minimal.

3.2.5 It is therefore intended to develop an approach for normal securitisations built around the ratings-based approach set out in the paper.

3.2.6 For re-securitisation exposures, it is intended to offer banks a choice between:

3.2.6.1 applying a 1,250% *RW* (intended for firms that have incidental exposures, for example as a result of collateral being exercised with an intention to sell); or

3.2.6.2 seeking agreement to use the new complex standardised model approach, with approval subject to:

- appropriate independent verification of the bank's implementation of the standardised model approach; and
- agreement over the provision of related prudential reporting.

3.3 Equity exposures to funds: capital requirements

3.3.1 In April 2014, the *Basel Committee* issued the paper "*Capital requirements for banks' equity investments in funds*"[6].

3.3.2 The paper established two standardised models for calculating capital requirements for equity exposures to funds (not lending to funds):

3.3.2.1 The "Look-Through Approach" ("**LTA**") is the most granular. Subject to meeting the conditions set out for its use, banks employing the LTA would apply the *RW* of the fund's underlying exposures as if the exposures were held directly by the bank; and

3.3.2.2 The "Mandate-Based Approach" ("**MBA**") can be used when banks do not meet the conditions for applying the *LTA*. Banks employing the MBA assign *RWs* on the basis of the information contained in a fund's mandate or in relevant legislation governing funds.

3.3.3 When neither of the above approaches is feasible, a 1,250% *RW* would apply to a bank's equity investment in a fund.

3.3.4 It is intended to develop an approach for equity exposures whereby banks either apply a 1,250% RW or seek individual approval to use the new complex standardised models (LTA and MBA), with approval subject to:

3.3.4.1 appropriate independent verification of its implementation; and

3.3.4.2 agreement over the provision of related prudential reporting.

[6] http://www.bis.org/publ/bcbs266.pdf

3.4 Large exposures – securitisations and funds

3.4.1 In April 2014, the *Basel Committee* issued the paper "*Supervisory framework for measuring and controlling large exposures*"[7] ("**Revised LE Framework**").

3.4.2 Part D of Section IV of that paper, titled "*Collective investment undertakings, securitisation vehicles and other structures*", establishes a specific treatment for exposures to fund and securitisation structures.

3.4.3 It requires banks to consider exposures even when a separate legal structure lies between the bank and the underlying assets. It applies to funds and securitisations and any other structures with underlying assets.

3.4.4 It permits a bank to allocate the exposure amount to the structure itself, as a distinct counterparty, if it can demonstrate that the bank's exposure to each underlying asset of the structure is less than 0.25% of the bank's Tier 1 capital.

3.4.5 A look-through approach would apply for larger exposures; counterparties would need to be identified and exposures to the same counterparties consolidated for large exposures purposes.

3.4.6 Banks would also be required to identify third parties that may constitute an additional risk factor inherent in the structure itself, rather than in the underlying assets, and potentially consolidate these for large exposures purposes. Examples of third parties include originator, fund manager, liquidity provider and credit protection provider.

[7] http://www.bis.org/publ/bcbs283.pdf

4 Operational Risk

4.1 Overview of the *Basel Committee's* proposals

4.1.1 The *Basel Committee* issued the *SMA Paper* in March 2016, following its earlier consultation paper on this subject *"Operational risk - Revisions to the simpler approaches*", issued in October 2014.

4.1.2 The paper proposes to replace the Basic Indicator Approach ("**BIA**"), Standardised Approach to Operational Risk ("**SAO**") and Advanced Measurement Approach with a new Standardised Measurement Approach ("**SMA**").

4.1.3 The *SMA* is similar to the *BIA* and *SAO* but the capital requirement is defined as a percentage of the Business Indicator ("**BI**"), rather than gross income.

4.1.4 The BI is defined as the sum of three components derived from a bank's income statement: the "interest component", the "services component" and the "financial component", with certain adjustments being made to deal with specific issues, such as banks with very high net interest margins.

4.1.5 Instead of a fixed percentage of income (*BIA*) or varying percentages depending on the type of business (*SAO*), it proposes that the factor applicable would depend on the scale of the BI, defined within five buckets.

4.1.6 For example:

4.1.6.1 banks with a BI less than €1 billion would fall into bucket 1 and face an operational risk capital requirement of 11% of BI; and

4.1.6.2 banks whose BI was between €1 billion and €3 billion would fall into bucket 2 and face a capital requirement of €110 million for the first €1 billion plus 15% of the amount by which their BI exceeds €1 billion.

4.1.7 For banks that fall into bucket 1, this would be the only calculation required. However, such banks would also be required to maintain an operational loss dataset, building up to a ten year history of operational losses, at least for those losses exceeding €10,000.

4.1.8 For banks that fall into buckets 2 to 5, the requirement to maintain an operational loss dataset would apply, with an adjustment also required to the capital requirement calculated using the BI based formula, dependent on this data. The exact formula for the adjustment is set out in the *SMA Paper.* Transitional provisions would apply, such as the use of a shorter (five year) operational loss dataset.

4.2 Local implementation plan

4.2.1 It is anticipated that any final standard would be fully implemented in Jersey, though not before the end of 2017, provided that the final formulation (1) remains a simple approach and (2) is appropriate for modest scale banks.

4.2.2 Any impact from local implementation is expected to be modest, as (1) local operational risk requirements are small as a percentage of total capital requirements and (2) most banks already maintain data on operational losses, easing compliance.

5 Counterparty Credit Risk and the Standardised Approach for Market Risk

5.1 Overview of the *Basel Committee's* revisions

5.1.1 *Basel III* has generated several papers on Counterparty Credit Risk ("**CCR**"), including the first *Basel III* paper "*Basel III: A global regulatory framework for more resilient banks and banking systems*"[8], issued December 2010 and revised June 2011, and two later *Basel Committee* publications:

5.1.1.1 "*The standardised approach for measuring counterparty credit risk exposures*"[9], issued in March 2014; and

5.1.1.2 "*Capital requirements for bank exposures to central counterparties*"[10], issued in July 2012.

5.1.2 The *Basel Committee,* working with the International Organisation of Securities Commissions ("**IOSCO**") on risks relating to non-centrally cleared derivatives, published the joint standard "*Margin requirements for non-centrally cleared derivatives*"[11] in September 2013 and re-issued this in March 2015. The revision extended the deadline for full compliance to August 2017 for the largest banking groups and to September 2020 for smaller groups.

5.1.3 In January 2016, the *Basel Committee's* work on market risk and trading book issues culminated in it issuing the paper "*Minimum capital requirements for market risk*"[12]. This paper built on a number of earlier consultation papers. It contains:

5.1.3.1 A revised standardised approach that is fundamentally more risk-sensitive, whilst still providing an appropriate standard for banks that do not warrant a complex treatment for market risk; and

5.1.3.2 Parameters for the establishment of a more objective boundary between the trading book and banking book (intended to reduce incentives for arbitrage between banking and trading books).

5.2 Local implementation plans

5.2.1 Jersey incorporated banks have very little exposure to counterparty credit risk and even less exposure to market risk. Because of this, and given the cost of implementation, the *Commission* sees little necessity to develop these quickly. However, the local framework should be updated in due course, given that (1) many banks in Jersey are part of groups subject to the revised requirements and (2) local requirements need to be appropriate for new or existing banks commencing significant relevant activity.

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8 http://www.bis.org/publ/bcbs189.pdf
9 http://www.bis.org/publ/bcbs279.pdf
10 http://www.bis.org/publ/bcbs282.pdf
11 http://www.bis.org/bcbs/publ/d317.pdf
12 http://www.bis.org/bcbs/publ/d352.pdf

5.2.2 The intention, therefore, is to review these papers and introduce revisions once the higher priority aspects of *Basel III* identified herein have been addressed. The aim will be to ensure that local requirements are consistent with the relevant provisions of these revised international standards. This work is expected to take place before the end of 2019.

6 Summary of Questions on Revisions to the Standardised Approach for Credit Risk

Reference	PAGE	QUESTION
2.1.7	**6**	Question: Based on your own analysis and group input, are there any areas of the *SACR Paper* (other than those covered in Sections 2.2 to 2.7) that would give rise to a significant impact on the capital adequacy of the locally incorporated bank?
2.2.5	**7**	Question: Do you have any views on impacts of the *Basel Committee's* latest proposals regarding exposures to banks if they were applied in Jersey?
2.3.3	**7**	Question: Do you have views on impacts of the *Basel Committee's* latest proposals regarding exposures to corporates if they were applied in Jersey?
2.4.5	**8**	Question: Would the due-diligence proposals be likely to either (1) have a significant impact on capital requirements or (2) be difficult to implement in Jersey?
2.5.7	**9**	Question: Do you hold sufficient documentation of historical lending to enable the operational criteria to be met? Are any of the other operational criteria problematic for a significant portion of loans (new or existing)?
2.5.8	**9**	Question: Would the proposals impact significantly on the capital required to support buy-to-let, or any other, mortgages extended by your bank?
2.6.7	**10**	Question: If implemented locally, how would the proposals concerning loans secured by commercial property impact on capital requirements for your bank?
2.7.2	**10**	Question: Would the removal of the 0% *CCF* for unconditionally cancellable facilities have a significant impact?
2.7.4	**10**	Question: Would a requirement to apply a 50 percentile increase to the *RW* of unhedged borrowers in foreign currencies have a significant impact?

Appendix A

List of representative bodies and other persons who will be sent this discussion paper

- Jersey Bankers' Association
- Jersey Finance Limited
- All registered deposit takers