



Jersey Financial
Services Commission

Discussion Paper

Addressing the Risks posed by Domestic Systemically Important Banks (“D-SIBs”)

Insight is provided, and feedback is requested, on the Commission’s views regarding the implementation of international standards for the supervision of domestic systemically important banks, including recovery and resolution aspects.

Issued: 15 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 III Capital CP	CP No. 8 2015 " <i>Basel III: Capital Adequacy and Leverage</i> ", issued July 2015 by the Commission
BoE MREL Paper	Consultation Paper " <i>The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)</i> ", issued in December 2014 by the Bank of England
BRSB	Bank Resolution Steering Group
Commission	Jersey Financial Services Commission.
DCS	Depositors Compensation Scheme
D-SIB	domestic systemically important bank
D-SIB Framework paper	" <i>A framework for dealing with domestic systemically important banks</i> ", issued in October 2012 by the <i>Basel Committee</i>
D-SIB DP	Discussion Paper " <i>Domestic Systemically Important Banks ("D-SIBs") (including recovery and resolution)</i> ", issued January 2014 by the <i>Tri-Party Group</i>
eligible liabilities	liabilities other than retail deposits and other classes of liabilities that are protected in the planned legal framework for bank resolution
FSB	Financial Stability Board
HLA	higher loss absorbency
home-state supervisor	(for a Jersey branch only) the supervisor in the bank's jurisdiction of incorporation
ICAAP	Internal Capital Adequacy Assessment Process
KA	Key Attribute (from the <i>Key Attributes paper</i>)
Key Attributes paper	" <i>Key Attributes of Effective Resolution Regimes for Financial Institutions</i> ", issued in October 2011 by the <i>FSB</i> , and reissued to incorporate additional guidance in October 2014
KP	Key Principle (from the <i>D-SIB Framework paper</i>)
LCP	Liquidity Contingency Plan
Tri-Party Group	collectively, the <i>Commission</i> and its counterparts in Guernsey and the Isle of Man

> Contents

1 Executive Summary 5

1.1 Overview 5

1.2 What is proposed and why?.....5

1.3 Who would be affected?5

1.4 Next steps..... 5

2 Introduction..... 6

2.1 Overview 6

2.2 International standards.....6

3 SUPERVISION OF D-SIBS 7

3.1 Background7

3.2 Identification of D-SIBs.....7

3.3 Possible criteria to identify D-SIBs8

3.4 Transparency.....9

3.5 More intensive supervision.....10

3.6 Reducing the probability of failure: higher loss absorbency (“HLA”)10

3.7 Timing of implementation of HLA11

3.8 Branches.....11

4 Recovery and Resolution 12

4.1 Background12

4.2 Recovery planning.....12

4.3 Funding for the resolution of D-SIBs incorporated in Jersey13

5 Summary of Questions 15

Appendix A 16

 List of representative bodies and other persons who will be sent this discussion paper.....16

1 Executive Summary

1.1 Overview

- 1.1.1 This paper addresses developments in prudential regulation and certain international standards for the:
 - 1.1.1.1 supervision of systemically important banks, issued by the Basel Committee on Banking Supervision (“**Basel Committee**”); and
 - 1.1.1.2 recovery and resolution of systemically important banks, issued by the Financial Stability Board (“**FSB**”).

1.2 What is proposed and why?

- 1.2.1 It is intended to identify *D-SIBs* using a mixture of quantitative and qualitative factors.
- 1.2.2 The supervision of such banks will be amended to address the risks posed by them. Specifically:
 - 1.2.2.1 higher capital requirements may be warranted under Pillar 2 to reduce the probability of failure so that the total risk posed, taking into account probability and impact of failure, is sufficiently mitigated; and
 - 1.2.2.2 relevant banks would be required to develop recovery plans to demonstrate how capital adequacy would be restored in stressed circumstances.
- 1.2.3 Resolution plans will be established for such banks, following the establishment of a proposed new legal framework for bank resolution (a separate workstream).

1.3 Who would be affected?

- 1.3.1 A bank would be affected only if it was identified as systemic by the *Commission*. This might apply to a bank incorporated in Jersey or one that operates in the Island through a branch.

1.4 Next steps

- 1.4.1 Feedback will be used to develop *Commission* proposals (which it is anticipated will be consulted on in 2017) and to inform input to the government led work on the establishment of a legal framework for the resolution of banks.

2 Introduction

2.1 Overview

- 2.1.1 It has long been recognised that, in the case of certain large banks, failure could cause significant disruption to the financial system and economic activity. These are referred to as systemically important banks. Until the recent financial crisis, little was done worldwide about the riskiness of such banks, with governments implicitly relied upon to take action to avoid such failures.
- 2.1.2 After the crisis, new international standards were issued by the *Basel Committee* and the *FSB*, addressing the risks posed by such banks, focussing on supervision and recovery and resolution.
- 2.1.3 This paper provides an overview of plans to revise the regulatory framework to address these standards and mitigate the risks posed in Jersey by domestic systemically important banks (“**D-SIBs**”).
- 2.1.4 The paper is divided into two sections:
- 2.1.4.1 **Supervision of D-SIBs.** The Commission has a longstanding risk-based approach to supervision and is currently in the process of revising this generally. The paper summarises the specific changes required to reduce the probability of a *D-SIB* failure; and
 - 2.1.4.2 **Recovery and resolution:** The Jersey government is currently developing a legal framework for bank resolution, with the Commission and other stakeholders engaged through the Bank Resolution Steering Group (“**BRSG**”). It is envisaged that the *Commission* will have the lead role in recovery planning in Jersey and the paper provides initial thoughts on key aspects of such planning.

2.2 International standards

- 2.2.1 The plans discussed herein are intended to address two specific international standards:
- 2.2.1.1 The *Basel Committee* paper “*A framework for dealing with domestic systemically important banks*”¹ (“**D-SIB Framework paper**”), issued in October 2012; and
 - 2.2.1.2 The *FSB* paper “*Key Attributes of Effective Resolution Regimes for Financial Institutions*” (“**Key Attributes paper**”), issued in October 2011 and reissued in October 2014² with additional appendices containing further guidance.

¹ <http://www.bis.org/publ/bcbs233.pdf>

² http://www.fsb.org/wp-content/uploads/r_141015.pdf

3 SUPERVISION OF *D-SIBs*

3.1 Background

- 3.1.1 The *D-SIB framework paper* focusses on the impact a *D-SIB* failure might have on a domestic economy, and applies both to consolidated groups as a whole and to their individual subsidiaries and branches. It sets out twelve key principles (“**KPs**”); these have a degree of flexibility to allow for appropriate national discretion to accommodate the structural characteristics of individual domestic financial systems. The *KPs* are divided into two areas:
- 3.1.1.1 Assessment methodology, set out in *KP1* to *KP7* (i.e. what makes a bank a *D-SIB*); and
- 3.1.1.2 Requirements for *D-SIBs* to have higher loss absorbency (“**HLA**”), set out in *KP8* to *KP12*.
- 3.1.2 *KP12* also states that other tools, such as more intensive supervision, should play a part in the regulatory architecture, together with the development of an appropriate framework for recovery and resolution.
- 3.1.3 The proposals set out herein build on those in the Discussion Paper “*Domestic Systemically Important Banks (“D-SIBs”) (including recovery and resolution)*”, (the “**D-SIB DP**”), issued in January 2014, jointly with our counterparts in Guernsey and the Isle of Man (the “**Tri-party Group**”).
- 3.1.4 Responses to the *D-SIB DP* were generally positive, noting that it would be important to have consistency across the Crown Dependencies, that consultation would be required and that the approach to identifying and supervising *D-SIBs* must be transparent and objective.
- 3.1.5 Independently of this work, the Commission has commenced a review of its risk-based approach to supervision and, in particular, the assessment of the risk posed by each registered person, including banks.

3.2 Identification of *D-SIBs*

- 3.2.1 The *D-SIB DP* proposed that *D-SIBs* should be identified locally; responses received from industry accepted that this was appropriate.
- 3.2.2 *KP1* states that “*national authorities should establish a methodology for assessing the degree to which banks are systemically important in a domestic context*”, and that “*all national authorities should undertake an assessment of banks to consider their systemic importance*”. The assessment, required under *KP2*, should be based on the impact of failure, not risk of failure, and, under *KP3*, the reference point for assessing impact is required to be the domestic economy.

- 3.2.3 It is intended to build the assessment of systemic importance into the revised supervisory risk assessment of banks. The *Commission's* assessment of the riskiness of banks is currently, and will continue to be, determined using a risk model, with riskiness determined as a function of perceived impact and probability. In future, the process will include determining whether a bank's failure would be sufficiently impactful as to identify it as a *D-SIB*.
- 3.2.4 This avoids the duplication that would be involved in developing a separate assessment approach for this purpose.

3.3 Possible criteria to identify *D-SIBs*

- 3.3.1 The assessment criteria will be based on the impact of a bank's failure on the domestic economy of Jersey.
- 3.3.2 The *D-SIB framework paper* identifies four indicators:
- 3.3.2.1 Size;
 - 3.3.2.2 Interconnectedness;
 - 3.3.2.3 Substitutability/financial institution infrastructure; and
 - 3.3.2.4 Complexity (including the additional complexities from cross-border activity).
- 3.3.3 In the *D-SIB DP*, the *Tri-party Group* outlined a subjective approach to the methodology for assessing banks. Industry responses favoured a more prescriptive approach.
- 3.3.4 In light of this, the impact of failure will be assessed using objective criteria, but with scope to override the result based on supervisor judgement. All four indicators will be considered but objective criteria will only be established where both a measure and a clear trigger level or levels can be appropriately established.
- 3.3.5 **Size.** Size is seen as the most important determinant of the impact of failure. The current risk model uses two objective criteria to determine the impact component: total deposits and employee headcount. These are likely to be retained and added to; for example, initial work has identified eligible deposit liabilities (i.e. up to the Depositors Compensation Scheme ("**DCS**") limit) as a potential additional criterion. Subjective qualitative criteria will also be considered; for example, if available data on a bank evidences that it is below the criteria but it is expected to exceed the criteria in the near future as a result of growth, the bank would be identified as a *D-SIB* at that stage, rather than waiting for future data to confirm this.
- 3.3.6 **Interconnectedness.** This refers to the extent of a bank's inter-connections with other financial institutions that could give rise to significant impacts for the financial system and domestic economy.

- 3.3.7 **Substitutability.** The greater the role of a bank in a particular business line, or in acting as a service provider in relation to market infrastructure, the more difficult it will be to swiftly replace that bank. It is intended to assess objective criteria in this area, which might include, for example, the proportion of the local deposit and mortgage markets controlled.
- 3.3.8 **Complexity.** This factor relates to how the bank conducts its business. The three key components are considered to be (1) business complexity; for example arising from a significant degree of involvement in complex financial products, including trading book operations, (2) structural complexity (including resolvability); perhaps arising where branches are significant and there is no clear framework for resolution and (3) operational complexity, such as a high level of reliance on outsourcing. Objective criteria will be assessed in this area and might include, for example, the level of business conducted in overseas branches.
- 3.3.9 International examples will be taken into account, such as those set out in the Bank of England consultation paper *“The Bank of England’s approach to setting a minimum requirement for own funds and eligible liabilities (MREL)”* (**“BoE MREL paper”**), issued in December 2014, where two criteria are referenced:
- 3.3.9.1 *“...a firm provides more than around 40,000 accounts on which customers rely for day-to-day payments and cash withdrawals”*; and
- 3.3.9.2 *“...any firm whose total balance sheet exceeds £15-25 billion.”*
- 3.3.10 As stated previously, the *D-SIB* assessment process will be carried out as a standard element of the risk model updating process, with periodicity varying from bank to bank, depending on riskiness levels. To the extent possible, this will be automated, utilising data captured through prudential reporting.
- 3.3.11 **Question: excepting those mentioned in 3.3, are there any specific objective criteria that you believe should inform the Commission’s assessment of the potential impact of the failure of a bank?**
- 3.3.12 **Question: Do you consider that your bank should not be considered to be a D-SIB and, if so, why not?**

3.4 Transparency

- 3.4.1 The *D-SIB framework paper* recommends that national authorities should publicly disclose information that provides an outline of the methodology employed to assess the systemic importance of banks in their domestic economy for the purposes of transparency.
- 3.4.2 The *Commission* will, in due course, publish information on its revised risk based approach to supervision, which will include an outline of the risk model assessment methodology.
- 3.4.3 There is no requirement to publish a list of those banks assessed as being *D-SIBs* and the *Commission* has no plans to do so.

- 3.4.4 The *Commission* will share information on its assessment with the bank in question (1) initially and (2) if it subsequently changes. This will include whether or not it has been determined to be a *D-SIB* and a summary of the relevant factors.
- 3.4.5 The *Commission* will share its decision with other relevant authorities in Jersey (for example, any bank resolution authority that may be established in due course), relevant (home and host) supervisors and other resolution authorities.

3.5 More intensive supervision

- 3.5.1 The *Commission's* existing risk-based approach to supervision means that high risk firms are supervised more intensively than low risk firms. The planned revisions will maintain (and enhance) this approach but also lead to *D-SIBs* facing more intensive supervision than other banks.
- 3.5.2 Likely supervisory measures include:
 - 3.5.2.1 More in depth assessment of *D-SIBs* (such as more frequent on-site assessments, dialogue and engagement on specific areas of risk);
 - 3.5.2.2 An increased focus on corporate governance (for example, more frequent engagement with boards and senior management, requirements for the provision of internal risk and audit reports); and
 - 3.5.2.3 Requirements for the documentation and submission of recovery plans (see **Section 4**).

3.6 Reducing the probability of failure: higher loss absorbency (“HLA”)

- 3.6.1 The rationale for imposing a *HLA* requirement on *D-SIBs* is to reduce the probability of failure, in light of the heightened impact of this.
- 3.6.2 The *Commission* currently takes its assessment of a bank's riskiness into account when establishing Pillar 2 capital requirements. However, only the probability related components are considered, with the impact component being disregarded. (The logic for this is the Island's long established conservative approach to bank failure.)
- 3.6.3 The Pillar 2 approach will be revised so that capital requirements reflect all aspects of a bank's riskiness, including impact components.
- 3.6.4 The capital required to address the impact component of riskiness will (1) be identified separately as the *HLA* component and (2) take the form of an addition to the Pillar 2 buffer, rather than an increase in capital minima.
- 3.6.5 As set out in CP No. 8 2015 “*Basel III: Capital adequacy and Leverage*”³ (“**Basel III Capital CP**”), the Pillar 2 buffer would be required to be met for all regulatory minimum risk asset ratios in normal times, including the ratio of risk weighted assets to Common Equity Tier 1. This is consistent with the requirements described for *HLA* in the *D-SIB framework paper*.

³ <http://www.jerseyfsc.org/pdf/Consultation-Paper-No-8-2015-Capital-Adequacy.pdf>

- 3.6.6 The *Commission* would co-ordinate with home supervisors regarding such buffers but, ultimately, it has sole regulatory responsibility to ensure that capital levels are adequate.
- 3.6.7 **Question: Do you have any objections to the principles established regarding the introduction of an *HLA* component within the Pillar 2 buffer for *D-SIBs*? If so, please set these out with supporting logic.**

3.7 Timing of implementation of *HLA*

- 3.7.1 In the *Basel III Capital CP*, it was stated that it was intended to introduce the relevant changes to capital adequacy in 2017. As part of the work required to achieve this, it is intended to make consequential amendments to the Pillar 2 guidance.
- 3.7.2 To implement *HLA*, consultation will take place regarding changes to the determination of Pillar 2 buffers to reflect the “impact” component of the revised risk model. It is intended to issue revised Pillar 2 guidance to effect this change by the end of 2017.
- 3.7.3 By the end of 2018, the *Commission* would expect to have reviewed all *D-SIBs* and established Pillar 2 buffer requirements that include an *HLA* component.
- 3.7.4 It is intended to provide a transitional period of one year to allow banks time to meet the *HLA* component.
- 3.7.5 These plans would ensure that by the end of 2019 all *D-SIBs* are adequately capitalised to address the risk posed.
- 3.7.6 **Question: Does the timeline set out in Section 3.7 for the full implementation of *HLA* for *D-SIBs* appear appropriate?**

3.8 Branches

- 3.8.1 The primary responsibility for supervising capital adequacy in respect of Jersey branches rests with the supervisor in the bank’s jurisdiction of incorporation (“**home-state supervisor**”), and branches are therefore not subject to capital adequacy requirements in Jersey.
- 3.8.2 Where a branch is identified as a *D-SIB*, more intensive supervision (see **Section 3.5**) will apply.
- 3.8.3 Where the *home-state supervisor* has identified that the bank is systemic, the *Commission* will seek dialogue on the adequacy of capital and liquidity at the whole bank level.
- 3.8.4 If a branch in Jersey is identified as a *D-SIB*, but the bank as a whole is not considered to be systemic by its *home-state supervisor*, the *Commission* will engage in dialogue with the bank and the *home-state supervisor*, seeking to establish measures that sufficiently mitigate the risks posed by the branch in Jersey.
- 3.8.5 **Question: (Branches only) Has the *home-state supervisor* made an assessment of whether your bank is considered to be systemically important? If so, is your bank considered to be a *D-SIB* and has an *HLA* requirement been established?**

4 Recovery and Resolution

4.1 Background

- 4.1.1 The *Key Attributes paper* sets out twelve Key Attributes (“**KAs**”): core elements that the *FSB* considers to be necessary for an effective resolution regime for systemic banks.
- 4.1.2 The *D-SIB DP* provided an initial assessment of the *KAs* and highlighted the need for a bank resolution framework.
- 4.1.3 The Jersey government formed the *BRSB* to look at how bank resolution can be improved in Jersey. Initially, work has focussed on establishing a new legal framework for bank resolution, which is expected to include the power to create a Jersey resolution authority.
- 4.1.4 Feedback is sought herein on two specific areas: recovery planning and resolution funding for *D-SIBs* incorporated in Jersey.

4.2 Recovery planning

- 4.2.1 *KA11 “recovery and resolution plans”*, states that supervisors should require *D-SIBs* to have recovery plans that identify options to restore financial strength and viability when the bank comes under severe stress, which should include:
 - 4.2.1.1 credible options to cope with a range of scenarios, including both idiosyncratic and market wide stress;
 - 4.2.1.2 scenarios that address capital shortfalls and liquidity pressures; and
 - 4.2.1.3 processes to ensure timely implementation of recovery options in a range of stress situations.
- 4.2.2 Jersey incorporated banks are already required to maintain and submit to the *Commission* documents that address certain aspects of this:
 - 4.2.2.1 Internal Capital Adequacy Assessment Process (“**ICAAP**”) documentation. Inter alia, this should document potential management actions that could be undertaken to maintain or restore capital adequacy in a range of stressed conditions. These are required to include reverse stress tests – conditions where the bank will fail; and
 - 4.2.2.2 Liquidity Contingency Plans (“**LCPs**”). These should document actions that could be undertaken to restore liquidity in stressed conditions.
- 4.2.3 For Jersey Incorporated *D-SIBs*, it is proposed to require documentation of recovery plans in a single document, describing actions that could restore both capital and liquidity levels. It is anticipated that this would (1) form part of the *ICAAP*, (2) replace the need for a separate *LCP* and (3) be expected to build on existing plans documented in *ICAAPs* and *LCPs*.

- 4.2.4 For Jersey branches, the *Commission* proposes to require sight of the bank's recovery plans, in whatever form they take.
- 4.2.5 The *Commission* expects all *D-SIBs* to be aware of group level recovery plans and to provide relevant elements to the *Commission*.
- 4.2.6 The *Commission* will review *D-SIB* recovery plans to ensure that they are robust and that they are consistent with group recovery plans.
- 4.2.7 It is intended to consult on detailed provisions relating to this area in 2016, with full implementation in 2017. This would enable the *Commission* to review the recovery plans of all *D-SIBs* before the end of 2018.
- 4.2.8 **Question: Do you have any concerns regarding the steps outlined in Section 4.2 regarding recovery planning?**

4.3 Funding for the resolution of *D-SIBs* incorporated in Jersey

- 4.3.1 It is anticipated that the planned resolution authority would develop resolution plans for all *D-SIBs* (in conjunction with those banks).
- 4.3.2 The bail-in of "**eligible liabilities**" (liabilities other than retail deposits or other classes of liabilities that are protected in the planned legal framework for bank resolution) is likely to be the most reliable source of funding for the resolution of a failed bank that is incorporated in Jersey.
- 4.3.3 It follows that *D-SIBs* are only likely to be resolvable if, at the point of failure, they have sufficient *eligible liabilities*.
- 4.3.4 *Eligible liabilities* of *D-SIBs* would therefore need to be assessed and monitored in order to allow resolvability under resolution plans to be determined. In order to ensure that resolvability is maintained, resolution planning may lead to requirements being imposed on *D-SIBs* to:
 - 4.3.4.1 Ensure a minimum level of *eligible liabilities* is maintained; and
 - 4.3.4.2 Address risks relating to relying on *eligible liabilities* for resolution funding.
- 4.3.5 In many cases, banking groups in Jersey have been identified as systemic and are required to have sufficient capital and bail-inable liabilities. In the European Union this is referred to as the "minimum requirement for eligible liabilities" ("**MREL**") and this term is also sometimes used for liabilities meeting these requirements.
- 4.3.6 The *BoE MREL Paper* states that, for UK systemic banks, *MREL* cannot be met by ordinary eligible liabilities: *MREL* must be issued by group holding companies. *MREL* must then be pre-positioned on a contractually subordinated basis to UK systemic operating companies in order to ensure resolution plans would be effective.
- 4.3.7 It is anticipated that, in many cases, Jersey *D-SIBs* could meet local requirements by pre-positioning *MREL* issued by group holding companies.

- 4.3.8 For any other eligible liabilities to be relied upon, three risks would need to be addressed:
- 4.3.8.1 **Maturity:** liabilities with a short residual maturity may not be available at the point of failure;
 - 4.3.8.2 **Bail-in:** any barriers to bail-in, such as foreign law, would need to be addressed; and
 - 4.3.8.3 **Contagion:** Contagion could be significant, rendering resolution impractical. This risk might be reduced or eliminated if relevant liabilities were contractually identified and subordinated.
- 4.3.9 **Question: Apart from pre-positioned MREL, do you consider that other *eligible liabilities* could provide a reliable source of resolution funding? If so, what do you consider would be appropriate characteristics to address the risks identified in 4.3.8?**

5 Summary of Questions

Reference	PAGE	QUESTION
3.3.11	9	Question: excepting those mentioned in 3.3, are there any specific objective criteria that you believe should inform the Commission's assessment of the potential impact of the failure of a bank?
3.3.12	9	Question: Do you consider that your bank should not be considered to be a D-SIB and, if so, why not?
3.6.7	11	Question: Do you have any objections to the principles established regarding the introduction of an HLA component within the Pillar 2 buffer for D-SIBs? If so, please set these out with supporting logic.
3.7.6	11	Question: Does the timeline set out in Section 3.7 for the full implementation of HLA for D-SIBs appear appropriate?
3.8.5	11	Question: (Branches only) Has the home-state supervisor made an assessment of whether your bank is considered to be systemically important? If so, is your bank considered to be a D-SIB and has an HLA requirement been established?
4.2.8	13	Question: Do you have any concerns regarding the steps outlined in Section 4.2 regarding recovery planning?
4.3.9	14	Question: Apart from pre-positioned MREL, do you consider that other eligible liabilities could provide a reliable source of resolution funding? If so, what do you consider would be appropriate characteristics to address the risks identified in 4.3.8?

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