DRAFT POLICY STATEMENT: USE OF ADVANCED APPROACHES

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DOCUMENT OVERVIEW

This document sets out the JFSC’s policy on approval of the use of advanced approaches for the assessment of risk weighted assets in JIBs.

GLOSSARY

A-IRB advanced IRB
AMA advanced measurement approach
JIB person registered under the Banking Law that is incorporated in Jersey
Banking Book exposures not falling within a Trading Book
Banking Code Code of Practice for Deposit-taking Business
Banking Law Banking Business (Jersey) Law 1991
Basel Committee Basel Committee on Banking Supervision
F-IRB foundation IRB
ICAAP Internal Capital Adequacy Assessment Process
IRB internal ratings-based
IMA internal models approach
JFSC Jersey Financial Services Commission
capital ratios the three capital ratios for which minima are set (CET1 capital, Tier 1 capital and total capital)
Trading Book Exposures falling within the definition of a Trading Book, as set out in “Guidance Regarding the Commission’s Rules Relating to Trading Books”¹, issued February 2013

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1 Introduction

1.1 The currently prevailing international standard for the measurement of risk weighted assets, established by the Basel Committee, states that supervisors may permit the use of both standardised approaches and advanced approaches, the former being fixed rules, whilst the latter depend on JIBs’ internal models and data sets.

1.2 In the case of credit and operational risk, the Basel Committee has issued new international standards applicable to advanced approaches. These include revised floors for credit risk and the removal of the AMA option for operational risk.

1.3 In the case of market risk, it has similarly issued a revised standard for advanced approaches as part of a package that includes a complex standardised approach (and a simpler version for smaller banks), a revised standard for assessment of counterparty credit risk and related matters, such as margining of OTC derivatives.

1.4 In light of these developments, this policy statement establishes an interim policy on approval for the use of advanced approaches, which will in due course be superseded by the implementation of the Basel III plans set out in CP No. X 2019.

2 Credit risk

2.1 The JFSC has not incurred the significant increase in its resources that would be necessary to validate advanced approaches for credit risk (A-IRB or F-IRB). Use will therefore be restricted to instances where the relevant models are subject to initial review by a home regulator and where ongoing review can be provided either by a home regulator or an alternative assurance provider (such as an external auditor).

2.2 The currently prevailing international standard, established by the Basel Committee, requires a floor to be applied to capital requirements derived under A-IRB or F-IRB approaches, equivalent to 80% of the capital requirement derived under Basel I, the international standard for capital prevailing prior to 2006.

2.3 The revised standard leaves this unchanged until 2022, although the Basel Committee has suggested that supervisors may, instead apply a floor based on the (current) standardised approach. From 2022, this will be replaced by an output floor established at 50% of the Basel III standardised approach requirement, rising to 72.5% by 2027.

2.4 In light of these developments, the interim policy is that approval will be subject to a floor of 72.5% of the current (Basel II) standardised approach capital requirement. This will be determined through consideration of the JIB’s initial submissions and thereafter through assessment of ICAAP submissions. It will be established through setting revised minimum capital ratios, combining floor assessment (i.e. an add-on for model risk) with other considerations relating to the JIB’s ICAAP. Appendix A provides a worked example based on a hypothetical assessment.

2.5 As part of the application, JIBs must demonstrate that the advanced modelling process adequately reflects the local risk profile. This must be verified on an ongoing basis through its ICAAP documentation.

2.6 Permission for use will be established as a condition of registration under the Banking Law and will be subject to new or varied conditions concerning:
2.6.1 The capital ratio minima, reflecting floor considerations, as set out above;

2.6.2 The outputs being adequate for the JFSC’s prudential assessment; and

2.6.3 The availability of appropriate ongoing validation and support, including from the home regulator.

2.7 In relation to the second of these, the JFSC will

2.7.1 agree on the use of specific reporting to provide sufficient detail on the output of the models;

2.7.2 specify how the capital requirements/risk weighted assets outputs derived from the models must be reflected in prudential reporting; and

2.7.3 specify reporting of standardised approach outcomes, so that the effective operation of floors can be verified on an ongoing basis.

2.8 The JFSC will also specify other reporting requirements as it considers appropriate, for example copies of management information and copies of relevant internal audit reports.

3 Market risk

3.1 In light of the new Basel Committee proposals and standards and the time anticipated before the JFSC has implemented these, the absence of any existing use or enquiries concerning use of IMA in Jersey, and the absence of any Trading Books or material market risk in Jersey, the JFSC will not approve requests for the use of IMA by JIBs that do not have a Trading Book. This is an interim policy until the longer term implementation of Basel III addresses such matters (see CP No. X 2019).

3.2 If a JIB wishes to create a Trading Book, it may also request use of IMA models for market risk, which may apply to risk in the Trading Book and the Banking Book. As stated above, the JFSC has not incurred the significant increase in its resources that would be necessary to validate advanced approaches. Use will therefore be restricted to instances where the relevant models are subject to initial review by a home regulator and where ongoing review can be provided either by a home regulator or an alternative assurance provider.

3.3 As part of the application, JIBs must demonstrate that the advanced modelling process adequately reflects the local risk profile. This must be verified on an ongoing basis through its ICAAP documentation.

3.4 Use will be established as a condition of registration under the Banking Law and will be subject to conditions concerning:

3.4.1 The outputs being adequate for the JFSC’s prudential assessment; and

3.4.2 The availability of ongoing validation and support from the home supervisor.

3.5 In relation to the second of these, the JFSC will
3.5.1 agree on the use of specific reporting to provide sufficient detail on the output of the models; and

3.5.2 specify how the capital requirements/risk weighted assets outputs derived from the models must be reflected in prudential reporting.

4 Operational risk

4.1 In light of the Basel Committee proposals and the absence of any existing use or enquiries concerning use of AMA, the JFSC will not approve the use of AMA.

Appendix A– Example calculation of minima, taking into account the output floor and a hypothetical ICAAP/SREP determinations

A.1 Hypothetical bank SREP assessment

<table>
<thead>
<tr>
<th>Pre-Floor (A)</th>
<th>RWAs £ millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit AIRB</td>
<td>825.00</td>
</tr>
<tr>
<td>Operational Risk</td>
<td>100.00</td>
</tr>
<tr>
<td>Market Risk</td>
<td>5.00</td>
</tr>
<tr>
<td>Pillar 1 Total</td>
<td>930.00</td>
</tr>
<tr>
<td>Pillar 2 Credit Risk</td>
<td>25.00</td>
</tr>
<tr>
<td>Other Pillar 2</td>
<td>45.00</td>
</tr>
<tr>
<td>Pillar 2 Total</td>
<td>70.00</td>
</tr>
<tr>
<td>Total RWAs</td>
<td>1,000.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Floor calculation (B)</th>
<th>RWAs £ millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Standardised</td>
<td>1,650.00</td>
</tr>
<tr>
<td>Credit AIRB plus Pillar 2 Credit Risk</td>
<td>850.00</td>
</tr>
<tr>
<td>Increase</td>
<td>800.00</td>
</tr>
<tr>
<td>Total RWAs</td>
<td>1,800.00</td>
</tr>
<tr>
<td>72.5% of Total</td>
<td>1,305.00</td>
</tr>
<tr>
<td>Higher of A and B</td>
<td>1,305.00</td>
</tr>
</tbody>
</table>

A.2 The JFSC’s CET1 and Tier 1 ratio minima are both 8.5%. Hence the required CET1/Tier 1 capital would be approximately £111 million in this example (8.5% of £1,305 million). A minimum CET 1 ratio of 11.1% of the Pillar 1 RWAs would ensure that this was maintained since £930m RWAs multiplied by an 11.9% minimum = £111m capital required (approximately).

A.3 The JFSC’s total ratio minimum is both 10%. Hence the required total capital would be approximately £131 million in this example (10% of £1,305 million). A minimum total capital ratio of 14.1% of the Pillar 1 RWAs would ensure that this was maintained since £930m RWAs multiplied by an 14.1% minimum = £131m capital required (approximately).