Jersey Financial Services Commission

Consultation on the implementation of remaining elements of Basel III

Following the implementation of the capital definition and liquidity ratios elements of Basel III in Q1 2019.

Issued: October 2019

Consultation No. 7 2019

Consultation Paper

The Jersey Financial Services Commission (**JFSC**) invites comments on this consultation paper by **29 February 2020**. If you require any assistance, clarification or wish to discuss any aspect of the proposal prior to formulating a response, it is of course appropriate to contact the JFSC.

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Alternatively, Lisa Springate at Jersey Finance Limited (**JFL**) is coordinating an Industry response that will incorporate any matters raised by local businesses. Comments should be submitted to JFL by **29 February 2020**.

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Content from responses will be used in feedback papers. Respondents will be listed in the feedback paper unless requested otherwise.

It is the policy of JFL (unless otherwise requested or agreed) to collate all responses and share them verbatim with the JFSC on an anonymised basis (with reference made only to the type of respondent, e.g. individual, law firm, trust company etc.). This collated, anonymised response will, typically, be placed in JFL's permanent electronic archive which is currently open to all JFL members.

Glossary of Terms

Defined terms are indicated throughout this document as follows:

Advanced Approaches	Frameworks whereby banks model risks themselves, subject to certain constraints, instead of using standardised, simple, models defined by supervisors for credit, operational and market risk.
ADC	Land Acquisition, Development and Construction
Banking Code	Code of Practice for Deposit-taking Business
Banking Law	Banking Business (Jersey) Law 1991
Basel 2.5	'Enhancements to the Basel II Framework', published by the Basel Committee in July 2009 and available at: › https://www.bis.org/publ/bcbs157.htm
Basel II Framework	Predecessor to the Basel III Framework, titled 'International Convergence of Capital Measurement and Capital Standards, A Revised Framework', the 'Comprehensive Version' being issued in June 2006 by the Basel Committee and available at: › https://www.bis.org/publ/bcbs128.htm
Basel III	Set of new and revised standards concerning bank prudential safety, promulgated by the Basel Committee
Basel III Finalisation	'Basel III: Finalising post crisis reforms', published by the Basel Committee in December 2017 and available at: › https://www.bis.org/bcbs/publ/d424.htm
Basel III Framework	Consolidated framework for Basel III, published (in draft form) by the Basel Committee in April 2019 and available at: › https://www.bis.org/basel_framework/
Basel Committee	Basel Committee on Banking Supervision, the international standard setting body for the supervision of banks, formed of representatives from 30 countries
BI	Business Indicator
BI Scalar	Multiplier used to derive the BIC from the BI
BIC	Business Indicator Component
BRRJL	Bank (Recovery and Resolution) (Jersey) Law 2017, not in force at the time of this publication. Available at: › https://www.jerseylaw.je/laws/enacted/Pages/L-10-2017.aspx
CCF	Credit Conversion Factor
CD	Crown Dependencies (Jersey, Guernsey and the Isle of Man)
CRM	Credit Risk Mitigation

CRRE	Commercial RRE
Commission Law	Financial Services Commission (Jersey) Law 1998
Concession Limit	JFSC's approval for exposure to a counterparty to exceed 25% of Tier 1 capital, where the counterparty is a sovereign or group bank, up to a specified amount.
CRC	OECD's Country Risk Classification
D-SIB	Domestic Systemically Important Banks
ECA	Export credit agency
ECAI	External Credit Assessment Institution, such as Moody's, Standard and Poor's and Fitch
EU	European Union
FC	Financial component
FSB	Financial Stability Board, an international body that monitors and makes recommendations about the global financial system
FTE	Full-time equivalent
G-SIB	Global Systemically Important Bank
General LE Requirement	Proposed Banking Code requirement requiring that no exposure exceeds 25% of Tier 1 capital unless the JFSC has approved it
GPO	Banking Business (General Provisions) Jersey Order 2002
ICAAP	Internal Capital Adequacy Assessment Process – document required to be produced by each JIB as part of Pillar 2
ILDC	Interest, leases and dividend component
ILM	Internal Loss Multiplier
Interim Policy	'Interim Policy on the use of Advanced Approaches', the proposed policy set out in **Appendix A**
JFL	Jersey Finance Limited
JFSC	Jersey Financial Services Commission
JIB	Jersey Incorporated Bank; i.e. a Registered Person incorporated in Jersey
JRA	Jersey Resolution Authority (yet to be established at time of publication)
KA Paper	'Key Attributes of effective Resolution Regimes for Financial Institutions', issued by the FSB in 2011 re-issued in expanded form in 2014, available at:

	› http://www.fsb.org/work-of-the-fsb/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/
Large Exposure	An exposure to any single or connected group of counterparties that exceeds 10% of Tier 1 capital
LCR	Liquidity Coverage Ratio
LTV	Loan-to-Value
NSFR	Net Stable Funding Ratio
OECD	Organisation for Economic Co-operation and Development
OIB	Overseas Incorporated Bank; i.e. a Registered person incorporated overseas and operating in Jersey via a branch
Pillar 1	Calculation methodologies prescribed for the calculation of credit, operational and market risk
Pillar 2	Supervisory review of banks' internal capital adequacy assessment processes
Pillar 3	Disclosure requirements
PSE	Public sector entity
Registered Person	A person registered under the Banking Law
Regulatory retail exposure	A retail exposure where: › The product is a revolving line of credit, a personal loan or lease or a small business facility or commitment; › The total connected exposure does not exceed €1 million; and › A granularity test is met.
RWA	Risk weighted asset
RRE	Regulatory Real Estate
RRRE	Residential RRE
SC	Services component
SMEs	Small and Medium-sized Enterprises, being corporates where, for the consolidated group of which the corporate is a part: › reported annual sales are less than €50 million; › balance sheet is less than €43 million; and › employees are less than 250 FTEs.
Specialised Lending	Exposures not related to real estate that fall within the definitions of 'object finance', 'project finance' or 'commodities finance', (see paragraph 20.49 of CRE 20 - **Appendix B -** for the detailed definitions of these terms).
SREP	Supervisory Review and Evaluation Process – the JFSC's review of JIBs' ICAAPs as part of Pillar 2

ST	Short term exposures to banks, being those where the original maturity is 3 month or less or 6 months in the case that they relate to international trade
TLAC	Total loss-absorbing capacity
Trading Book	Positions in financial instrument and/or commodities held either with trading intent or in order to hedge positions held in the Trading Book
Transactors	Those that repay in full credit card balances and undrawn facilities that have not been drawn over the previous 12 months (defined fully in **Appendix B**, paragraph 20.66)

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1 Executive Summary

1.1 Overview

1.1.1 This consultation paper seeks feedback on proposals for the further implementation of Basel III in Jersey. This follows implementation of capital quality and liquidity elements in Q1 2019 and builds on several earlier discussion papers.

1.2 What is proposed and why?

1.2.1 '**Basel III**' denotes a set of international standards that were issued by the Basel Committee on Banking Supervision (**Basel Committee**), the international standard setting body for the supervision of banks. These are intended to make banks safer, addressing a wide range of issues identified during the financial crisis. Several of these standards are in force but others have delayed start dates – typically 1 January 2022 – and in a number of cases there are transitional provisions.

1.2.2 In April 2019, the Basel Committee published a draft consolidated framework (**Basel III Framework**). This brought together all the relevant current and future standards (including the Basel Core Principles) and addressed some less clear issues, outlined in an accompanying consultation (which ran till August 2019). Whilst not final at this time, the Basel III Framework provides the best single source for the Basel III requirements and relevant extracts have been provided in the Appendices.

1.2.3 All major financial centres are committed to the implementation of Basel III and the Basel Committee monitors and publishes information on the implementation progress of its members. It is anticipated that all persons registered under the Banking Law (**Registered Persons**) will become subject to Basel III in due course as home jurisdictions implement it over the next few years, with many elements already having been implemented in relevant jurisdictions.

1.2.4 Registered Persons incorporated overseas (**OIBs**) will become subject to Basel III as and when elements are implemented. For Registered Persons incorporated in Jersey (**JIBs**), they will be impacted by the home state implementation to the extent this impacts on the consolidated bank but also directly impacted by the JFSC's implementation.

1.2.5 The JFSC has committed to implementing international standards. It is therefore seeking to implement the Basel III Framework, against a backdrop of international implementation, in a way that is effective and efficient.

1.2.6 This consultation addresses the subject by setting out a general solution for complex, lower impact aspects that seeks to reflect the fact that many of these issues have or will be addressed by jurisdictions in which groups are headquartered. Leveraging on appropriate implementation work would facilitate implementation but give rise to other issues, outlined in **Section 4**.

1.2.7 An 'Interim Policy on use of the Advanced Approaches' is proposed that would come into force imminently following the conclusion of the consultation (**Section 5**) as this has a very high potential impact.

1.2.8 For four other higher impact areas, initial proposals are set out on the main aspects that it is intended would provide the basis for implementation but only after further consultation on details:

1.2.8.1 Standardised Approach to Credit risk (**Section 6**)

1.2.8.2 Standardised Approach to Operational Risk (**Section 7**)

1.2.8.3 Large Exposures (**Section 8**); and

1.2.8.4 Systemic banks (**Section 9**).

1.2.9 In addressing systemic banks, the JFSC will also take into account the paper 'Key Attributes of effective Resolution Regimes for Financial Institutions', issued in 2011 by the Financial Stability Board (**FSB**) and re-issued in expanded form in 2014 (**KA Paper**), to the extent that it is relevant to supervision of banks.

1.3 Who would be affected?

1.3.1 The proposals in this consultation paper will directly impact JIBs.

1.3.2 The impact on OIBs is expected to be minimal. In most cases, there would be no direct impact, but some aspects are relevant, as outlined in **Sections 4** and **9**. There could be an impact on competition from JIBs but it is understood that relevant jurisdictions will implement Basel III hence it is expected that there will be little variation in requirements once all implementations are complete.

1.3.3 The proposals may also indirectly impact:

1.3.3.1 Borrowers might be indirectly impacted if banks changed the cost or availability of loans as a result of these changes; and

1.3.3.2 Depositors might benefit from the further safeguards built into the Basel III Framework.

2 Consultation

2.1 Basis for consultation

2.1.1 The JFSC has issued this consultation paper in accordance with Article 8(3) of the Commission Law, as amended, under which the JFSC may, in connection with the carrying out of its functions, consult and seek the advice of such persons or bodies whether inside or outside Jersey as it considers appropriate.

2.2 Responding to the consultation

2.2.1 The JFSC invites comments in writing from interested parties on the proposals included in this consultation paper. Where comments are made by an industry body or association, that body or association should also provide a summary of the type of individuals and/or institutions that it represents.

2.2.2 Comments should be received by the JFSC no later than **29 February 2020**.

2.3 Next steps

2.3.1 Following this consultation, the JFSC intends to:

2.3.1.1 Subject to feedback, implement the 'Interim Policy on use of the Advanced Approaches'; and

2.3.1.2 Publish feedback to this Consultation Paper.

2.3.2 The JFSC intends to carry out further consultation in 2020, expanding on these proposals, and then, in 2021, consult on the detailed implementation, including reporting requirements. The current aim is to implement relevant requirements fully by the end of 2022.

3 The JFSC

3.1 Overview

3.1.1 The JFSC is a statutory body corporate established under the Commission Law. It is responsible for the supervision and development of financial services provided in or from within Jersey.

3.2 JFSC's functions

3.2.1 The Commission Law prescribes that the JFSC shall be responsible for:

3.2.1.1 the supervision and development of financial services provided in or from within Jersey;

3.2.1.2 providing the States, any Minister or any other public body with reports, advice, assistance and information in relation to any matter connected with financial services;

3.2.1.3 preparing and submitting to the Minister for External Relations recommendations for the introduction, amendment or replacement of legislation appertaining to financial services, companies and other forms of business structure;

3.2.1.4 such functions in relation to financial services or such incidental or ancillary matters:

- as are required or authorised by or under any enactment, or
- as the States may, by Regulations, transfer; and

3.2.1.5 such other functions as are conferred on the JFSC by any other Law or enactment.

3.3 Guiding principles

3.3.1 The JFSC's guiding principles require it to have particular regard to:

3.3.1.1 the reduction of risk to the public of financial loss due to dishonesty, incompetence, malpractice, or the financial unsoundness of persons carrying on the business of financial services in or from within Jersey;

3.3.1.2 the protection and enhancement of the reputation and integrity of Jersey in commercial and financial matters;

3.3.1.3 the best economic interests of Jersey; and

3.3.1.4 the need to counter financial crime in both Jersey and elsewhere.

4 General approach to Basel III

4.1 Overview

4.1.1 Basel III was set out in a collection of international standards, running to (collectively) more than 1,500 pages. The Basel III Framework consolidates these into a single document and, as an alternative, enables them to be accessed via a structured website.

4.1.2 The Basel III Framework is intended for internationally active banks. Currently, all JIBs are part of internationally active banking groups (there are no domestic banks). The framework states that it should be applied at subsidiary level where subsidiaries are internationally active.

4.1.3 The Basel III Framework incorporates its predecessor, the Basel II Framework, to the extent that it has not been superseded. In many areas the existing international standard persists, albeit with amendments for many elements, not least for Advanced Approaches (frameworks whereby banks model risks themselves, subject to certain constraints, instead of using standardised, simple, models defined by supervisors for credit, operational and market risk).

4.1.4 The Basel III framework is based on the three Pillars approach established in the Basel II Framework:

4.1.4.1 Pillar 1 (the calculation methodologies prescribed in for the calculation of credit, operational and market risk) is substantially revised;

4.1.4.2 Pillar 2 (supervisory review of banks' internal capital adequacy assessment processes - in Jersey, the SREP and ICAAP respectively) has undergone some limited changes; and

4.1.4.3 Pillar 3 (disclosure requirements) has been substantially revised. The JFSC considers that this is relevant at group level but not for local banks that are either subsidiaries of branches and hence has not and does not intend to address Pillar 3.

4.1.5 The JFSC takes the view that all JIBs should be supervised to the same standards and that many/most subsidiaries are internationally active. The current supervisory approach implements the Basel II Framework, the predecessor to Basel III. Hence it is intended to implement the Basel III Framework fully for JIBs. A small number of elements may also be relevant for OIBs and these are indicated in this Section and **Section 9**.

4.1.6 The JFSC has taken local circumstances into account when implementing elements of Basel III (in particular, the Liquidity Coverage Ratio) and will continue to do so where the framework would have an undue impact or does not take into account features of the local market.

4.1.7 The elements implemented fully to date are:

4.1.7.1 Liquidity Coverage Ratio (**LCR**);

4.1.7.2 Capital quality; and

4.1.7.3 Recovery planning for all banks (as part of Pillar 2).

4.1.8 For some elements, limited progress has been made:

4.1.8.1 Pillar 2 aspects of Basel 2.5 have been addressed;

4.1.8.2 Net Stable Funding Ratio (**NSFR**): prudential reporting has commenced;

4.1.8.3 Leverage Ratio: prudential reporting has commenced;

4.1.8.4 Large Exposures: exposures to banks were brought inside the regime previously and the relevant capital base has been amended; and

4.1.8.5 Systemic banks: the JFSC is building a risk model that will identify systemic banks and the Bank (Recovery and Resolution) (Jersey) Law 2017 (**BRRJL**) has been enacted (but is not in force) - relevant for OIBs.

4.1.9 The elements that have not been addressed, other than in discussion papers, include:

4.1.9.1 Standardised Approaches to Credit Risk;

4.1.9.2 Standardised Approaches to Operational Risk;

4.1.9.3 Advanced Approaches, including capital floors;

4.1.9.4 Trading Book (i.e. positions in financial instrument and/or commodities held either with trading intent or in order to hedge positions held in the Trading Book): 'Fundamental Review of the Trading Book' and Counterparty Credit Risk changes;

4.1.9.5 Securitisation/ re-securitisation exposures: Basel 2.5 and later changes;

4.1.9.6 Exposures to funds and central clearing counterparties;

4.1.9.7 Derivatives margining/clearing (relevant for OIBs); and

4.1.9.8 Countercyclical/macro-prudential measures.

4.1.10 **Sections 6** to **9** contain proposals regarding four higher impact elements, setting out the key aspects, with finalisation of details to take place as part of the operational implementation work in 2021/2022, these being:

4.1.10.1 **Section 6** 'Standardised Approach to Credit Risk'

4.1.10.2 **Section 7** 'Standardised Approach to Operational Risk'

4.1.10.3 **Section 8** 'Large Exposures'

4.1.10.4 **Section 9** 'Systemic Banks' - relevant for OIBs

4.1.11 These Sections focus on those aspects likely to have the greatest impact either on capital requirements or operationalising the new requirements, with relevant details of the Basel III Framework provided in Appendices. If any banks have concerns regarding other aspects of the Basel III Framework, feedback would be welcome and will be taken into account in developing proposals.

4.1.12 The proposals do not address reporting, which will be addressed during the detailed implementation work in 2021/2022; the current focus is only on the consequences of the requirements themselves.

4.1.13 For the leverage ratio and the NSFR, it is intended to collect data (through the changes already made to prudential reporting and Pillar 2) and carry out consultation as part a wider consultation on other elements in 2020.

4.2 Way forward for lower impact/high complexity elements

4.2.1 The 2020 consultation will also develop an approach for the lower impact/ high complexity elements that rests on three planks:

4.2.1.1 Define one or more home supervisor regimes as being acceptable;

4.2.1.2 Require banks with relevant exposures to follow an acceptable regime; and

4.2.1.3 Require banks to provide prudential reporting that contains relevant key data and accompanying documents.

4.2.2 For example, for Trading Book exposures:

4.2.2.1 The EU regime might be considered acceptable and, in that case:

- JIBs with relevant exposures would be required to calculate capital requirements following the EU regime; and
- JIBs would include relevant amounts and supporting data within prudential reporting and provide extracts from reporting set out in the EU regime to supplement prudential reporting.

4.2.3 Industry responses are sought now on this general approach and will be used to develop a detailed approach, which it is intended to further detail in the 2020 consultation.

Acceptable regimes

4.2.4 Issues to be addressed include:

4.2.4.1 Whether the list of acceptable regimes would be public?

4.2.4.2 Would one list would be agreed for all JIBs or would it be based on individual circumstances?

4.2.5 The key determinants of whether a regime is acceptable would include whether (1) it implements Basel III for the relevant elements and (2) assurance can be provided that the JIB's implementation is compliant with the regime.

4.2.6 Regarding the former, the JFSC does not have the resources to look into the details of a large number of regimes but would be able to draw on Basel Committee publications for Basel Committee member states so that it seems reasonable to only consider such regimes (i.e. Basel Committee member states only).

4.2.7 Regarding the latter, assurance work by external and internal auditors, as well as JFSC staff and the JIB's own staff, would need to be capable of providing assurance that the JIB's implementation met the relevant requirements.

4.2.8 EU member states have separate regimes, albeit they are similar in most respects. However, because of the degree of overlap, it is likely to be easier to assess multiple EU states.

Establishing bank requirements

4.2.9 The mechanism for establishing requirements would be to amend the Code of Practice for Deposit-taking Business (**Banking Code**). The exact nature would depend on whether the approach is general (in which case the Banking Code would specify fully the requirements) or specific to an individual JIB's circumstances (in which case specifics would be set out by way of a variance to the Banking Code.

4.2.10 Requirements would cover the rules for calculation of capital, reporting and assurance.

4.2.11 It might be that in some circumstances it makes sense to permit/require the overseas regimes rules for aspects of the calculation of capital where the JFSC itself has published rules, in order to ease the process, particularly where the impact is not material.

Reporting

4.2.12 In theory, reporting would be standardised or reflect the requirements of the relevant regime (or a mixture of both). The specifics could be decided on a bank-by-bank basis but it is anticipated that some elements at least would be general.

4.2.13	**Question 1. Do you have any concerns regarding the proposed general approach for lower impact/high complexity elements?**
4.2.14	**Question 2. If you believe the proposed way forward is appropriate, please provide feedback on (1) which overseas regimes should be considered, (2) how bank requirements might best be established and (3) prudential reporting.**

5 Interim policy on use of Advanced Approaches

5.1 Overview

5.1.1 In the JFSC's first consultation on Basel II, (CP No. 6 2008), it was stated that permission to use the Advanced Approaches could be granted subject to certain conditions.

5.1.2 In the intervening years, a small number of JIBs sought permission to use advanced approaches and permission has been granted on occasion.

5.1.3 It is intended to establish an 'Interim Policy on the use of Advanced approaches' (**Interim Policy**), set out in **Appendix A**, for use until the relevant long-term proposals are implemented. It is intended to issue the Interim Policy following the conclusion of this consultation (subject to feedback).

5.1.4 The Interim Policy's main features are:

5.1.4.1 No approvals for use of Advanced Approaches for operational risk or market risk (outside of a Trading Book);

5.1.4.2 Use of Advanced Approaches for credit risk subject to conditions and a Pillar 2 constraint that is broadly similar in effect to the Basel III Framework final state output floor;

5.1.4.3 Trading Book related approvals to be determined on a case-by-case basis, in part based on materiality.

5.2 Key aspects

5.2.1 The rationale for the key aspects of the Interim Policy is as follows:

5.2.1.1 **Operational Risk:** No JIB has a current permission to use an Advanced Approach for operational risk and Basel III removes the Advanced Approach entirely for operational risk. It is therefore considered sensible to remove it entirely now, given that work required to consider and implement such an approach would be disproportionate.

5.2.1.2 **Market Risk (outside Trading Book):** No JIB has a current permission to use an advanced approach for market risk. Levels of market risk seen are minimal. It is therefore considered sensible to remove the option (except, potentially, for banks with Trading Books), given that work required to consider and implement such an approach would be disproportionate.

5.2.1.3 **Market Risk (Trading Book):** Use of Trading Books in JIBs is not currently material. It is proposed that any requests to use advanced approaches for trading books are assessed on a case-by-case basis where the Trading Book is material and otherwise not permit use.

5.2.1.4 **Credit risk - conditions:** JIBs have been permitted to use Advanced Approaches for credit risk. This has been subject to three criteria being addressed. The Interim Policy broadly retains these.

5.2.1.5 **Credit risk - output floors:** The Basel III Framework establishes floors to maintain a level of conformity between banks facing similar risks. The Interim Policy requires JIBs that use Advanced Approaches for credit risk to maintain capital levels that exceed 72.5% of the standardised approach requirement and that this will be assessed as part of Pillar 2.

5.2.2 **Question 3. Do you have any concerns regarding the Interim Policy on the use of Advanced Approaches set out in Appendix B?**

6 Standardised Approach to Credit Risk

6.1 Overview

6.1.1 The JFSC adopted the Basel II Framework's standardised approach for credit risk in 2008. The revised standard, published in December 2017 by the Basel Committee as part of 'Basel III: Finalising post crisis reforms' (**Basel III Finalisation**), is a similar approach in that the risk weighted assets (**RWAs**) are derived by multiplying exposures by the relevant standardised risk weights, but with a number of significant changes.

6.1.2 The new standard outlines around 50 areas where the detail is left to national discretion; the JFSC is required to determine a wide range of elements.

6.2 Way forward on key aspects

6.2.1 This Section sets out the revised standard for key aspects and proposals for local implementation, including addressing national discretions.

6.2.2 This should be read alongside the Basel III Framework, where it is set out in:

6.2.2.1 CRE20 'Standardised approach: individual exposures'

6.2.2.2 CRE21 Standardised approach: use of external ratings

6.2.2.3 CRE22 Standardised approach: credit risk mitigation.

6.2.3 An extract of CRE20 has been made available as **Appendix B**. The key aspects set out in detail concern this part (only a limited overview is provided of the other parts), addressing:

6.2.3.1 Due diligence;

6.2.3.2 Sovereigns and public sector entities (PSEs)

6.2.3.3 Banks

6.2.3.4 Corporates

6.2.3.5 Subordinated debt and equity

6.2.3.6 Retail

6.2.3.7 Real estate; and

6.2.3.8 Off-balance sheet.

6.2.4 The intention is that for all areas (i.e. those addressed herein and other aspects deemed less important), the detailed implementation will be established in 2021, building on responses to this consultation and taking into account international developments. In particular, the JFSC will engage its Crown Dependency (**CD**) counterparts and review EU and UK plans for implementation.

6.2.5 **Question 4: From your own assessment of the Basel III Framework, are there any aspects that concern you regarding the proposed revised standardised approach for credit risk that are not addressed in Section 6?**

6.3 Use of External Ratings

6.3.1 The revised standard includes provisions to enable supervisors to reduce the use or eliminate the use of credit ratings published by External Credit Assessment Institutions (**ECAIs**), such as Moody's, Standard and Poor's and Fitch, but these are optional. The JFSC considers use of credit ratings to be of value and notes that under the new standard the JIB's own due diligence will be required to be reflected where this leads to a more conservative outcome.

6.3.2 The revised standard governing the credit ratings is set out in CRE 21 'Standardised approach: use of credit ratings'. This becomes effective on 1 January 2022 and is available at:

6.3.2.1 https://www.bis.org/basel_framework/chapter/CRE/21.htm?inforce=20220101

6.3.3 Most of the changes are limited, such as those regarding recognition of ECAIs. The JFSC does not intend to undertake assessments of ECAIs because it would require significant resources and other bodies already undertake such assessments. Currently, the JFSC recognises only Fitch, Moody's and Standard and Poor's.

6.3.4 One solution would be, in summary, to resolve this by a combination of permitting banks to use the EU list of approved ECAIs but also requiring that existing ECAIs be retained or requiring an appropriate mix of agencies to be recognised, which might include use of one or more of the current ECAIs. Details would be developed in the 2020 consultation, as the issue has similarities with the wider consideration of the potential use of other supervisor's approaches (see **Section 4**). This consultation would also address other changes to the detailed rules.

6.3.5 **Question 5: Are there any concerns regarding the proposal to (1) continue to use credit ratings and (2) seek to rely to a large extent on the EU list of approved ECAIs?**

6.4 Credit Risk Mitigation (CRM)

6.4.1 The standard governing CRM has been revised, being set out in CRE22 'Standardised approach: credit risk mitigation'. This becomes effective on 1 January 2022 and is available at:

6.4.1.1 https://www.bis.org/basel_framework/chapter/CRE/22.htm?inforce=20220101

6.4.2 The JFSC does not hold sufficient information on the use of specific classes of collateral to enable it to determine if any of the detailed changes would be impactful for any JIB.

6.4.3 Possibly the biggest change in the standard vs the Basel II Framework is the introduction of an approach for jurisdictions that do not permit the use of credit ratings (it broadly retains the existing approach for those that do). As it is intended to permit the use of credit ratings, this alternative would not be available for JIBs. This may disadvantage JIBs vs competitors in some circumstances but it is considered that the use of credit ratings provides an outcome that better reflects the risks than the alternative.

6.4.4 **Question 6: Have you undertaken any assessment of the potential impact of the new standard for CRM, under the assumption that the JFSC continues to permit the use of credit ratings and, if so, are there any concerns regarding the impact?**

6.5 Due Diligence (paragraphs 20.4 to 20.6)

6.5.1 There is significant emphasis on banks carrying out due diligence on exposures, rather than placing undue reliance on the standardised rules and in particular on credit ratings published by ECAIs.

6.5.2 This risk is already addressed through Pillar 2; each JIB must consider if the risk of exposures is underestimated. However, it is agreed that during the crisis there were clear examples of where the standardised rules or credit ratings did not adequately reflect risks and that enhancing the role of due diligence might prove effective in ensuring risks were promptly addressed.

6.5.3 It is proposed to continue to address this underestimation in Pillar 2 but also to require JIBs to identify any deterioration and make additional allowances in both internal and external reporting (i.e. the prudential return), building on JIBs' internal ratings of exposures. No benefit would accrue where internal ratings indicate that exposures are safer than implied by credit ratings.

6.5.4 It is proposed to embed this into Pillar 2 (i.e. require JIBs to outline their approach to internal ratings assessments and hence enable the JFSC to review this as part of the assessment process). For the avoidance of doubt, this applies to both rated and unrated exposures.

6.5.5 **Question 7: Are there any issues regarding the proposed approach to enhancing the role of due diligence?**

6.6 Sovereigns and PSEs (paragraphs 20.7 to 20.12)

6.6.1 The standard is unchanged for sovereign exposures (based on ECAI credit ratings). There are three significant national discretions:

6.6.1.1 to apply a lower risk weight to domestic sovereign exposures denominated in the domestic currency;

6.6.1.2 to recognise overseas governments' use of this discretion; and

6.6.1.3 to permit use of export credit agency (**ECA**) assessment or the OECD's Country Risk Classification (**CRC**), as opposed to ECAI credit ratings.

6.6.2 The JFSC historically applied all of these discretions, applying a zero risk weight to exposures to the Jersey government, recognising similar action by its CD counterparts and permitting use of the CRC.

6.6.3 It is considered that the first two discretions (i.e. those outlined in paragraphs **6.6.1.1** and **6.6.1.2**) are not appropriate. Whilst in some circumstances sovereigns could issue local currency to avoid a local currency default, this is a factor that ECAIs can take into account in arriving at credit ratings, frequently resulting in ECAIs publishing different ratings for a sovereign's foreign and domestic currency borrowings. It is therefore proposed to not exercise these discretions and instead clarify that the domestic currency rating should be used where the exposure is in domestic currency.

6.6.4 The OECD has publicly stated that the CRC is not an assessment of the creditworthiness of a sovereign (this statement is available at http://www.oecd.org/trade/topics/export-credits/arrangement-and-sector-understandings/financing-terms-and-conditions/country-risk-classification/)and, hence, it is not considered appropriate to continue to permit this discretion (i.e., that outlined in paragraph **6.6.1.3**).

6.6.5 The impact is anticipated to be minimal as the most significant sovereign exposures are in connection with liquidity management and these would continue to be zero weighted.

6.6.6 Regarding public sector entities (**PSEs**), the JFSC believes that the option to assess the riskiness of the PSE based on the rating of the relevant sovereign should apply (as per current approach).

6.6.7 There are two significant national discretions:

6.6.7.1 to treat some PSE exposures as sovereign exposures; and

6.6.7.2 to recognise overseas governments' use of this discretion.

6.6.8 This is only considered safe if a guarantee exists from the relevant sovereign - implicit guarantees are not considered to be similarly reliable. However, if a sovereign has guaranteed exposures to a PSE then the CRM framework should be effective in recognising the reduction in risk. Hence it is proposed not to utilise either discretion. This is a change to the current approach.

6.6.9 It is believed that this would have little, if any, impact on capital requirements based on JIBs' current exposures.

6.6.10 The above proposals could act as a constraint on future lending, to the extent that competitor banks were able to ignore ECAI credit ratings, however the changes make capital requirements more reflective of actual risk.

6.6.11	**Question 8: Would the proposals regarding sovereigns and PSEs lead to a material increase in RWAs?**
6.6.12	**Question 9: Are there any considerations that you wish to raise regarding the proposals for sovereign and PSE exposures?**

6.7 Banks (paragraphs 20.16 to 20.32)

6.7.1 For jurisdictions that permit the use of ratings (which is intended, see **sub-section 6.3**), the standard is similar to the current rules for exposures to rated banks, being a mapping between ratings and risk weights and a preferential risk weight for short term (**ST**) exposures, being those where the original maturity is 3 month or less or 6 months in the case that they relate to international trade.

6.7.2 The key changes are:

6.7.2.1 for exposures to single A rated banks the risk weight is 30%, instead of 50% (still 20% ST); and

6.7.2.2 the ratings used must not include implicit sovereign support.

6.7.3 For unrated banks, the current single rating of 50% (20% ST) is replaced with a three Grade (A-C) scale, starting with Grade A for the safest banks, with a reduced risk weight of 40% (20% ST), then increasing to Grade B at 75% (50% ST) and for high risk banks (Grade C) the risk weight would be 150% (150% ST).

6.7.4 Movement between Grades would be based on due-diligence, save that a bank that was found to not be in compliance with prudential requirements would be ineligible for Grade A.

6.7.5 A floor applies for unrated banks, being the risk weight for the sovereign of the bank's home state.

6.7.6 All other sovereign based risk weighting options and national discretions have been removed, without local impact as these were not exercised in Jersey.

6.7.7 The current impact is likely to be close to zero, except for those JIBs that have significant non-ST exposure to single-A rated banks, who would face reduced capital requirements.

6.7.8 JIBs might also be disadvantaged in some circumstances versus banks in jurisdictions that do not permit the use of credit ratings where, in effect, all exposures are treated as unrated and hence ignore credit ratings.

6.7.9	**Question 10: Would the proposals regarding banks lead to a material change in RWAs?**
6.7.10	**Question 11: Are there any considerations that you wish to raise regarding the proposals for bank exposures?**

6.8 Corporates (paragraphs 20.41 to 20.52)

6.8.1 The standard divides exposures into general exposures and specialised lending.

6.8.2 For jurisdictions that permit the use of ratings (which is intended, see **sub-section 6.3**), the standard for general exposures is similar to the current rules for exposures to rated corporates, being a mapping between ratings and risk weights, and a flat 100% risk weight for unrated exposures.

6.8.3 The key changes are that:

6.8.3.1 for exposures to BBB rated corporates, the risk weight is 75%, instead of 100%; and

6.8.3.2 for exposures to unrated corporates, exposures to Small and Medium-sized Enterprises (**SMEs**) attract a risk weight of 85%, instead of 100%.

6.8.4 SMEs are corporates where reported annual sales for the consolidated group of which the corporate is a part are less than €50 million. There is a national discretion to lower the threshold but, instead, it is proposed to add a balance sheet test at €43 million and an employee test (250 FTEs), which reflect the main elements of the current EU definition. This is considered to be reasonable as:

6.8.4.1 the EU definition is already used in existing EU bank rules; and

6.8.4.2 many exposures of JIBs are to corporates operating in the EU and hence subject to similar operating conditions.

6.8.5 Exposures to SMEs may meet the Retail criteria (set out in **sub-section 0**), in which case, as currently, they would be reported as retail exposures and attract a typical risk weight of 75%.

6.8.6 There are also specific requirements for 'Specialised Lending**',** defined as exposures not related to real estate that fall within the definitions of 'object finance', 'project finance' or 'commodities finance', (see paragraph 20.49 of CRE 20 - **Appendix B** - for the detailed definitions of these terms).

6.8.7 For rated Specialised Lending exposures, the mapping to risk weights is the same as for any other corporate exposures except that the rating must be for the for the Specialised Lending exposure – an issuer rating would not be applicable.

6.8.8 For unrated Specialised Lending exposures, object and commodities finance would be risk weighted at 100%, whilst the risk weight for project finance would be:

6.8.8.1 130% during the pre-operational phase;

6.8.8.2 100% during the operational phase; except that

6.8.8.3 An 80% risk weight would apply in the operational phase to high quality, cash flow positive projects where long term debt is being repaid (see **Appendix B**, paragraphs 20.51/20.52).

6.8.9 The current impact is likely to be minimal, except for those JIBs that have significant exposures to BBB rated corporates, SMEs or Specialised Lending.

6.8.10 JIBs might also be disadvantaged in some circumstances versus banks in jurisdictions that do not permit the use of credit ratings (see **Appendix B,** paragraphs 20.44 to 20.27, for the standard applying in jurisdictions that do not permit the use of credit ratings).

6.8.11	**Question 12: Would the proposals regarding corporates lead to a material change in RWAs?**
6.8.12	**Question 13: Are there any considerations that you wish to raise regarding the proposals for corporate exposures?**

6.9 Subordinated debt and equity (paragraphs 20.53 to 20.62)

6.9.1 The standard provides a detailed definition of equity and sets risk weights of:

6.9.1.1 400% for speculative unlisted equites (see **Appendix B**, paragraph 20.58);

6.9.1.2 250% for others; except that

6.9.1.3 A 100% risk weight would apply to holding made subject to national legislated programmes (see **Appendix B**, paragraph 20.59).

6.9.2 Holdings of bank capital instruments are not impacted and there are separate provisions in the Basel III Framework for holding of (1) equity investments in funds and (2) instruments that form part of the total loss-absorbing capacity (**TLAC**) of a Global Systemically Important Bank (**G-SIB**), both of which will be addressed in a later consultation.

6.9.3 Any other subordinated or non-equity capital exposures not falling within the bank capital rules would be afforded a 150% risk weight.

6.9.4 Investments that exceed materiality thresholds remain risk weighted at 1,250%, in accordance with the current prudential rules for capital, set out in the Guidance Note 'Prudential Reporting of Capital Ratios'.

6.9.5 There is no detailed definition of subordinated debt. The JFSC considers that a definition is necessary, particularly in light of resolution developments. This will be considered in detail in a later consultation, drawing on input from the Jersey Resolution Authority (**JRA**) in due course and taking into account international developments. In particular, this will need to clarify the extent to which structurally subordinated debt should be treated as subordinated for this purpose (i.e. debt issued by holding companies as opposed to operating companies).

6.9.6	**Question 14: Are there any relevant legislated programmes that you feel should be considered for the 100% risk weight for related equities?**
6.9.7	**Question 15: Are there any considerations that you wish to raise regarding the proposals for subordinated debt, including how to address structural subordination?**

6.10 Retail (paragraphs 20.63 to 20.68)

6.10.1 Retail exposures are:

6.10.1.1 All exposures to individuals; and

6.10.1.2 Exposures to SMEs that meet the definition of a regulatory retail exposure (those that do not are treated as corporate exposures, see **Sub-section 6.8**).

6.10.2 A regulatory retail exposure is one where (as set out in full in **Appendix B**, paragraph 20.65):

6.10.2.1 The product is a revolving line of credit, a personal loan or lease or a small business facility or commitment;

6.10.2.2 The total connected exposure does not exceed €1 million; and

6.10.2.3 A granularity test is met, which is subject to national discretion.

6.10.3 It is not planned to substantially amend the current granularity test, with each bank's approach being subject to review as part of Pillar 2.

6.10.4 The risk weights that apply to exposures in the retail asset class are as follows:

6.10.4.1 Regulatory retail exposures that do not arise from exposures to '**transactors**' (as defined in **Appendix B**, paragraph 20.66, but briefly those that repay in full credit card balances and undrawn facilities that have not been drawn over the previous 12 months) will be risk weighted at 75%.

6.10.4.2 Regulatory retail exposures that arise from exposures to transactors will be risk weighted at 45%.

6.10.4.3 Other retail exposures (i.e. those to individuals) will be risk weighted at 100%.

6.10.5 It is considered that any material impact is most likely to arise from exposures that meet the transactors definition and hence attract a lower risk weight.

6.10.6	**Question 16: What would be the impact of the lower risk weight for transactors?**
6.10.7	**Question 17: Are there any considerations that you wish to raise regarding the proposals for retail exposures?**

6.11 Real estate (paragraphs 20.69 to 20.91)

6.11.1 Real estate exposures are divided into:

6.11.1.1 Regulatory Real Estate (**RRE**)

6.11.1.2 Land Acquisition, Development and Construction (**ADC**); and

6.11.1.3 Other

6.11.2 **RRE** exposures are further divided into:

6.11.2.1 Residential RRE (**RRRE**):

- Non-income dependent
- Income dependent

6.11.2.2 Commercial RRE (**CRRE**):

- Non-income dependent
- Income dependent

6.11.3 To be treated as RRE (any sub-category), there are a series of requirements, mostly analogous to underwriting requirements (see **Appendix B**, paragraphs 20.71 to 20.76). These criteria include national discretions and some areas where clarification of application in local circumstances may be necessary. Three are highlighted here, where feedback is sought:

6.11.3.1 The property must be prudently valued at origination of the loan. For Loan-to-Value (**LTV**) purposes, this valuation may not be varied in normal circumstances (potential exceptions are to reflect decreases in prices, permanent reductions in value and modifications to the property). The JFSC will publish guidance on prudent valuation.

6.11.3.2 The standard requires the JFSC to ensure that banks assess ability to pay using relevant metrics such as the debt service ratio. Guidance will be provided, taking into account feedback, which it is anticipated would be incorporated within Pillar 2.

6.11.3.3 The standard requires the JFSC to evaluate whether the (new) risk weights are too low taking into account default experience and market price stability. It is proposed to evaluate lending vs real estate lending in Jersey by surveying local banks and using government statistics and to publish the conclusion. For lending vs property located overseas, it is proposed to permit the use of the new risk weights unless the local supervisor has determined that higher risk weights should apply.

6.11.4 **Question 18: What approach do you take to valuing real estate? Are there any local or home state guidelines that apply? Are there any matters that you feel should be included within guidance on this?**

6.11.5 **Question 19: What approach do you take to evaluating ability to pay? Are there any local or home state guidelines that apply? Are there any matters that you feel should be included within guidance on this?**

6.11.6 **Question 20: Would you be able to supply default data on RRE for the past 10 years, divided into the four sub-categories (as per sub-section 6.11.2), for lending secured by Jersey property? If not, please indicate what information is available historically and any concerns regarding the ongoing provision of default data on an annual basis.**

6.11.7 Whether or not an exposure is income dependent will be determined using materiality conditions, which the JFSC will specify, taking into account feedback (See **Appendix B**, paragraphs 20.79 to 20.81). It is proposed to produce guidelines for income dependent RRRE (i.e. buy-to-let) and income dependent CRRE. It is intended that these would apply both where the relevant income is derived from a single mortgaged income-producing property and where the relevant income is derived from a portfolio of income producing properties.

6.11.8 In the standard, the risk weight for non-income dependent RRRE would then either be determined from the LTV using a whole loan approach (one risk weight per loan) or a loan-splitting approach (one risk weight for the covered amount of the loan and a second for any excess) (See **Appendix B**, paragraphs 20.82 and 20.83).

6.11.9 For other types of lending, there is only a whole-loan approach. It is proposed to be consistent and use a whole-loan approach in all cases, as per the following (lowest risk weight applicable):

6.11.9.1 Non income dependent RRRE

LTV	≤50%	≤60%	≤80%	≤90%	≤100%	>100%
Risk weight	20%	25%	30%	40%	50%	70%

6.11.9.2 Income dependent RRRE

LTV	≤50%	≤60%	≤80%	≤90%	≤100%	>100%
Risk weight	30%	35%	40%	60%	75%	105%

6.11.9.1 Non income dependent CRRE

LTV	≤60%	>60%
Risk weight	Lower of (a) 60% and (b) the risk weight of the counterparty	Risk weight of the counterparty

6.11.9.2 Income dependent CRRE

LTV	≤60%	≤80%	>80%
Risk weight	70%	90%	110%

6.11.10 There are national discretions and some areas where clarification of application in local circumstances may be necessary. Perhaps the most significant is in regard to lending versus CRRE where the market is stable, which must be evidenced by the JFSC, based on its analysis of relevant loss data. For such markets, income dependent CRRE may be risk weighted using the non income dependent approach. This analysis may or may not be possible for Jersey CRRE, dependent on banks' ability to provide data. Where the property is located overseas, it is proposed to permit use where the local supervisor permits use and publishes the relevant supporting analysis.

6.11.11 Permitting use of the lower risk weight means that in a crisis there is a risk that capital requirements would increase as a result of the fresh analysis of loss data.

6.11.12 It is intended to require JIBs to specifically consider this risk in Pillar 2, taking into account at least both (1) the relevant published analyses and (2) their own data on the performance of the relevant exposures.

6.11.13 **Question 21: What approach do you take to distinguishing income dependency, both for buy-to-let and CRRE? Are there any local or home state guidelines that apply? Are there any matters that you feel should be included within guidance on this?**

6.11.14 **Question 22: Do you have any concerns regarding the proposals concerning income dependent CRRE and stable markets?**

6.11.15 **Question 23: What impact would the revised risk weights for RRE have?**

6.11.16 ADC exposures are risk weighted at 150%, except that there is a national discretion (see **Appendix B**, paragraphs 20.91 and 20.71) to permit a lower risk weight for financing to individuals financing the building of their future primary residence, subject to conditions that in effect ensure that there is significant owner financing.

6.11.17 It is proposed to implement this, with feedback sought from banks that have experience of such lending.

6.11.18 All other real estate exposures will be risk weighted depending on whether they are income dependent or non-income dependent. The former will be risk weighted at 150%, whilst the latter will be risk weighted as per the counterpart.

6.11.19 **Question 24: Does your bank provide financing for building of primary residences? If so, what criteria do you currently apply and, specifically, do you apply criteria regarding equity put in by the owners?**

6.11.20 **Question 25: would the changes proposed regarding ADC and other real estate lending lead to a material increase in RWAs?**

6.12 Off balance sheet (paragraphs 20.94 to 20.101)

6.12.1 The general approach is similar to the current framework, with credit conversion factors (**CCFs**) specified for a range of off-balance sheet items, with RWAs determined as:

6.12.1.1 Amount x CCF x Risk weight

6.12.2 The most prominent change in the Basel III Framework is that a 10% CCF applies for unconditionally cancellable commitments. This is defined to include all commitments made to individuals, regardless of cancellation rights.

6.12.3 There is a limited national discretion to determine that some arrangements are not commitments (and hence not subject to any capital requirements), which it is intended to utilise. This is restricted in the Basel III Framework to those where:

6.12.3.1 The arrangement is with a corporate counterparty that is subject to close ongoing monitoring of its creditworthiness;

6.12.3.2 No fees apply for the arrangement when undrawn;

6.12.3.3 Every drawdown requires a specific application and approval is required by the bank for any drawdown and the bank's approval is subject to determination of the creditworthiness of the counterparty.

6.12.4 Details will be considered as part of the implementation in 2020/2021, taking into account feedback to this consultation. An example of where it is considered this would apply is where a bank has established a credit limit for a counterparty but no facility has been established.

6.12.5 **Question 26: What would be the impact of applying a 10% CCF to all unconditionally cancellable commitments?**

6.12.6 **Question 27: Are there any specific matters that should be addressed in order to define arrangements that are not commitments?**

6.12.7 A 20% CCF will apply to short term (under 1 year) self-liquidating trade letters of credit arising from the movement of goods.

6.12.8 Commitments to provide funding will generally attract a 40% CCF (unless falling within another category).

6.12.9 Note issuance facilities, revolving underwriting facilities and transaction related contingent items are subject to a 50% CCF.

6.12.10 Credit substitutes, such as guarantees, asset sales with recourse and forward asset purchases, all attract a 100% CCF.

6.12.11 Where more than one CCF applies, the lowest should be used. For example, if a trade letter was unconditionally cancellable it would attract a 10% CCF.

6.12.12 The treatment of counterparty credit risk (i.e. derivatives, long settlement transactions and securities financing transactions) is subject to a different, more complex regime and exposures are not, typically, material, hence at this time only the general way forward has been outlined, see **Section 4**.

6.12.13 **Question 28: Are there any issues regarding the changes with respect to off balance sheet items (other than with respect to unconditionally cancellable commitments)?**

7 Standardised Approach to Operational Risk

7.1 Overview

7.1.1 The JFSC adopted two alternatives from the Basel II Framework in 2008 (the standardised approach and basic indicator approach) and all JIBs use one or other of these. The revised standard, first published in December 2017, is a more complex approach, with some common features but also a number of significant changes and less impactful revisions.

7.2 Way forward on key aspects

7.2.1 This Section sets out the revised standard for key aspects and proposals for local implementation.

7.2.2 The Basel III Framework includes the new standards within the Section on operational risk. An extract from the draft has been included as **Appendix C**.

7.3 Calculation

7.3.1 The RWAs for operational risk are defined as being:

7.3.1.1 12.5 x BIC x ILM

where

7.3.1.2 **BIC** stands for Business Indicator Component, a proxy based on a JIB's financials; and

7.3.1.3 **ILM** stands for Internal Loss Multiplier, a scaling factor based on a JIB's historical operational losses.

7.3.2 The BIC is itself determined as the Business Indicator (**BI**) and a multiplier (the **BI Scalar**) that depends only on the scale of the BI.

7.3.3 The BI is a calculated from the sum of three components, being the interest, leases and dividend component (**ILDC**); the services component (**SC**), and the financial component (**FC**).

7.3.4 If the BI is less than €1 billion, then the BI Scalar is 12%, for a BI between €1 billion and €30 billion, the BI Scalar is 15%, whilst for larger banks the BI Scalar is 18%.

7.3.5 The ILM calculation is only mandatory if the BIC exceeds €1 billion, with an ILM of 1 applying otherwise. The calculation is based on the ratio of the BIC to 15 times the average annual operational losses incurred over the previous 10 years (see **Appendix C**, paragraphs 25.8 for the exact formula).

7.3.6 ILDC, SC and FC are defined in the formulae below, where each term is calculated as the average over the last three years:

7.3.6.1 ILDC = (A) lower of (1) Net Interest Income and (2) 2.25% of interest earning assets, plus (B) dividend income

7.3.6.2 SC = (A) higher of (1) other operating income and (2) other operating expenses, plus (B) higher of (1) fee income and (2) fee expenses

7.3.6.3 FC = (A) absolute value of trading book profit plus (B) absolute value of banking book profit

7.3.7 It is proposed to require JIBs to use the ILM and BI Scalar that apply for their group. Where a group does not compute the relevant figures, it is proposed that JIBs would be permitted to use an ILM of 1 and a BI Scalar of 15% in Pillar 1.

7.3.8 Pillar 2 would, as currently, require JIBs to consider whether the Pillar 1 charge is appropriate or if an increase is warranted.

7.3.9	**Question 29: What would be the impact of applying the new operational risk standard?**
7.3.10	**Question 30: Are there any concerns re the equation specified for the calculation of operational risk?**

7.4 Recording of operational losses

7.4.1 The standard requires banks to record losses in a prescribed manner and publish the total losses for each year in Pillar 3 disclosures. As per other elements of Pillar 3, the JFSC does not consider local publication to be warranted.

7.4.2 However, the information might be valuable in Pillar 2, hence it is proposed for JIBs to (1) require that a record is held in a manner that is consistent with the standard and (2) to report a summary of losses to the JFSC.

7.4.3 Whilst the standard permits supervisors to allow larger firms to only record losses exceeding €100,000, it is considered that the standard threshold of €20,000 is appropriate when considering whether to include an event in the record.

7.4.4 Groups are encouraged to have 10 years of good quality data by 2022 and a minimum of 5 years. It is proposed that JIBs be required to ensure that records are held for ten years and that the history covers at least the period from 2017 and is provided to the JFSC within the ICAAP.

7.4.5	**Question 31: Do you envisage any difficulties in complying with the requirements to record operational losses and report to the JFSC?**

8 Large Exposures

8.1 Overview

8.1.1 The JFSC adopted revised **Large Exposures** requirements, i.e. those relating to exposures to any single or connected group of counterparties that exceed 10% of Tier 1 capital, at around the same time as the Basel Committee was consulting on revisions to the international standard and many of the principles were taken into account, but not all. The final revised standard was issued by the Basel Committee in July 2014. In the Basel III Framework, this is set out in LEX 'Large Exposures' and the relevant excerpt has been made available as **Appendix D**.

8.1.2 Currently, requirements are set out in two ways (1) a general condition of registration, established in the Banking Business (General Provisions) Jersey Order 2002 (**GPO**) and (2) Requirements established in the Banking Code.

8.1.3 The requirements in effect specify the Pillar 1 approach for addressing concentration risk, acting as a backstop.

8.1.4 From 2019, the capital base for Large Exposures purposes was revised to be Tier 1 capital, in line with the Basel III Framework.

8.2 Way forward on key aspects

8.2.1 This Section sets out the revised standard for key aspects and proposals for local implementation. Full details will be set out as part of the implementation process, which will reflect feedback to this consultation, with the intention of adoption in 2022.

8.2.2 Prudential reporting is not addressed in detail, as for other areas. The working assumption is that it would be expanded to include the top 20 exposures in all cases and all exposures that exceed 5% of Tier 1 capital (i.e. both Large Exposures and exposures that are close to the threshold).

8.3 General approach

8.3.1 The central requirement in the Basel III Framework is that no Large Exposure may exceed 25% of Tier 1 capital, in line with the level established for JIBs by the relevant general condition of registration in the GPO.

8.3.2 It is proposed to remove this general condition of registration from the GPO and replace it with a Banking Code requirement (**General LE Requirement**) requiring that no exposure exceeds 25% of Tier 1 capital unless the JFSC has approved it, similar to the requirement in the GPO. This allows the JFSC to clarify exactly what is meant, ensuring the impact is what is intended and removes a criminal penalty, with a civil penalty now being the maximum sanction applying in the case of a breach.

8.3.3 Generally, it is then intended to follow the approach set out in the Basel III Framework, except regarding exposures to sovereigns and connected banks, where it is proposed broadly to retain the current '**Concession Limit**' process to provide approvals.

8.3.4 The current rules concerning JFSC approval (outside of Concession Limits) would be removed, other than to allow for extraordinary circumstances, such as exposures that become connected (as the result of a takeover, say). However, the net impact of new approach would be to enable JIBs to have larger gross exposures provided that sufficient collateral arrangements exist to reduce any net Large Exposure to less than 25% of Tier 1 capital.

8.3.5 To enable JFSC oversight, prudential reporting requirements will be reviewed, as will guidance provided within Pillar 2 as to coverage in each JIB's ICAAP, this will, in effect, replace the current approval process oversight mechanism.

8.4 Sovereigns and Connected Banks

8.4.1 The standard exempts exposures to sovereigns. It is proposed instead to retain the sovereign Concession Limit approach and otherwise to treat exposures to sovereigns like any other exposures. Hence JIBs will continue to be permitted to have Large Exposures in excess of 25% of Tier 1 capital to sovereigns, provided that approval is granted in advance by the JFSC.

8.4.2 The standard is intended to be applied at consolidated level and hence does not fully address intra-group exposures. It is therefore proposed to retain the group bank Concession Limit. Hence, JIBs will continue to be permitted to have Large Exposures to group banks in excess of 25% of Tier 1 capital, provided that approval is granted in advance by the JFSC.

8.4.3 The JFSC's policy on approvals, set out in 'Approval of Concession Limits for Governments and Connected Banks', issued in December 2014, will be retained, broadly unchanged except for consequential amendments.

8.4.4 However, with respect to group bank Concession Limits, it is proposed to state that approval will only be granted if contractual terms would ensure that the exposure would be reduced to below 25% of capital in the event that the counterparty became non-investment grade, for example by requiring collateral to be posted in such circumstances.

8.4.5 This would replace the current requirement for there to be a "clear path" to reducing the exposure, which was intended to have the same effect in the event of such a downgrade.

8.4.6	**Question 32: Are there any issues with retaining the Concession Limit approach?**
8.4.7	**Question 33: Do you foresee any difficulty in putting in place contractual terms to limit exposure in the event of a downgrade of a relevant group bank?**

8.5 Definition of exposure

8.5.1 It is intended to define exposure, for the purposes of the General LE Requirement to be in line with the definition in **Appendix D**, and in particular sub-section LEX 30 'Exposure measurement'**.**

8.5.2 This broadly follows the approach dictated in the standard for the standardised approach to credit risk. Amounts deducted from capital, specific provisions and accounting valuation adjustments are all permitted to reduce the value of an exposure.

8.5.3 In the case of off-balance sheet commitments, a floor of 10% for the CCF applies.

8.5.4 In the case of derivatives and securities financing transactions, the rules reflect the rules in the Basel III Standard, which are not addressed in this consultation. Instead, consideration of the Large Exposure impact will be included within the relevant future consultation that covers these aspects.

8.5.5 In the case of CRM, the standard permits the protected exposure to be reduced but requires that an exposure is then recognised to the CRM provider, equal to the amount of the reduction for the purpose of determining exposure for Large Exposures purposes.

8.5.6 In the case of CRM connected with a sovereign or group bank this would add to the exposure, which must remain within the limit agreed by the JFSC.

8.5.7 JIBs currently assess concentration risk through reviewing applications for approvals, prudential reporting and Pillar 2. Under the revised regime, greater emphasis would be placed on the ICAAP and prudential reporting, with JIBs being required to assess and manage risks arising fully, with the Large Exposures rules being only a backstop.

8.5.8 This will be incorporated in Pillar 2 guidance, which will be developed taking into account responses to this consultation, with the intention being to develop this ahead of the transition, so that the Pillar 2 process is completed ahead of the requirements being changed.

8.5.9 **Question 34: Are there any issues with the change to the approach re determining Large Exposures?**

8.5.10 **Question 35: Regarding Pillar 2 assessment of concentration risk, are there any elements where you consider guidance would be necessary on the JFSC's expectations?**

8.6 Interbank exposures

8.6.1 The standard calls for exposures of global systemic banks to other global systemic banks to be more tightly constrained to less than 15% of Tier 1 capital, in order to limit the risk of contagion.

8.6.2 It is not proposed to implement this specific constraint as it is considered that this is a global measure to address the global systemic risk implications that is relevant at a consolidated level but not for individual subsidiaries.

8.6.3 The standard contains an explicit exemption for intraday interbank exposures and it is considered that this supports retention of the Money-Market Concession.

8.6.4 **Question 36: Are there any changes to rules regarding exposures to banks (such as to the Money Market Concession) that you consider would either reduce risks or ease operations. In the latter case, how would you propose to address any increase in risk?**

8.7 Funds and similar exposures

8.7.1 It is proposed to establish detailed requirements regarding how to address situations where an exposure is indirect. For example, where an exposure to a fund exposes the JIB to a fund's holdings of debt instruments.

8.7.2 It is proposed that this be substantively in line with the international standard, set out in **Appendix D**, paragraphs 30.41 to 30.53, the key points being:

8.7.2.1 Where a JIB can look through the fund to the underlying exposures, it would be required to do this and aggregate those exposures where they are connected.

8.7.2.2 Where a JIB cannot look through, it would be required to treat the fund exposure as an exposure and this might also be required to be aggregated.

8.7.2.3 There is a de-minimus level of 0.25% of Tier 1 capital.

8.7.3 **Question 37: Are there any issues with the proposed approach re determining Large Exposures for fund exposures?**

9 Systemic Banks

9.1 Overview

9.1.1 The most relevant international standards are:

9.1.1.1 Basel Committee standards on Global Systemically Important Banks (**G-SIBs**);

9.1.1.2 Basel Committee standards on Domestic Systemically Important Banks (**D-SIBs**); and

9.1.1.3 The FSB's Key Attributes, set out in the KA Paper.

9.1.2 The first two are part of the consolidated Basel III Framework.

9.1.3 The last is focussed on recovery and resolution but there is some overlap with supervision, principally regarding recovery planning.

9.1.4 All aspects may be relevant to OIBs, except those relating to capital, which is addressed in **sub-section 9.5**.

9.1.5 The JFSC issued a discussion paper in 2016 on this issue titled 'Addressing the Risks posed by Domestic Systemically Important Banks', available at:

9.1.5.1 https://www.jerseyfsc.org/pdf/2016_March-Discussion_Paper-Addressing_the_Risks_posed_by_D-SIBs.pdf

9.1.6 This followed an earlier 2014 discussion paper, issued jointly with Crown Dependency counterparts, and covered identification, supervision, higher capital buffers, recovery planning and resolution.

9.1.7 The JFSC intends to identify systemic banks using a new risk model, the development of which is underway.

9.1.8 Recovery planning requirements for all JIBs have already been implemented, within the Pillar 2 process.

9.1.9 Responsibility for resolution would rest with the Jersey Resolution Authority (**JRA**) under the Bank (Recovery and resolution) (Jersey) Law (**BRRJL**), which has been enacted but is not in force at the time this paper was issued.

9.2 Way forward on key aspects

9.2.1 This Section sets out the revised standard for key aspects and proposals for local implementation, except for resolution where no proposals are presented. Instead, the content here is limited to a summary of the key aspects, reflecting the limited JFSC role.

9.2.2 In the consolidated Basel III Framework, the parts addressed here are SCO 50 'Domestic systemically important banks' and RBC 40 'Systemically important bank buffers', which have been made available as **Appendices E** and **F**.

9.2.3 There are other parts of the Basel III Framework that are intended to address the risk posed by systemic banks. **Section 8.6** addresses the standard for Large Exposures to G-SIBs.

9.2.4 The principal aspect not addressed in this paper is the rules concerning Total Loss Absorbing Capacity (**TLAC**), where the FSB and the Basel Committee have established standards regarding both requirements for the issuance of TLAC by G-SIBs and the treatment of holdings of TLAC. This is a potentially important aspect but consideration has been deferred to a later consultation, with the aim of taking into account resolution plans and the view of any JRA.

9.3 Identification

9.3.1 For G-SIBs, the identification of groups takes place at group level and a list is published by the Basel Committee. Not all parts of a G-SIB are equally important and it is proposed to only consider a local subsidiary to be globally systemic if it is both part of a G-SIB and identified by the relevant home authority as being of strategic importance to the group.

9.3.2 Whether a Registered Person is a D-SIB or not will be based on the JFSC's new Risk Model and, in particular, on the model's assessment of the impact of financial failure. This will be based on a range of inputs, in part derived from data submissions but some of the inputs will necessarily be subjectively determined by supervisors.

9.3.3 Details will be provided to each bank. Further information on the Risk Model will be made available to all firms as progress is made to implementation; at this time, an overview (only) is available at:

9.3.3.1 https://www.jerseyfsc.org/pdf/JFSC_Approach_to_Risk-based_Supervision_2016.pdf

9.3.4 **Question 38: Are there any issues with the approach outlined for identifying systemic banks?**

9.4 Supervision intensity

9.4.1 For all Registered Persons, supervision intensity will be determined by the output of the Risk Model.

9.4.2 For prudential supervision of JIBs, this will be a mixture of:

9.4.2.1 A general supervisory approach, determined for each entity based on its overall risk profile;

9.4.2.2 Prudential review elements, where the periodicity and depth of review will depend on the financial soundness impact; and

9.4.2.3 Specific risk driven action, where the risk of financial failure (taking into account both the impact and probability) is determined to be outside of tolerance or in the event of a 'red flag' event.

9.4.3 How this is communicated to regulated entities will vary but for D-SIBs it is anticipated that the plan will be articulated each year.

9.4.4 For JIBs that are D-SIBs, the prudential review work will focus on the depth and nature of the SREP, reflecting the importance placed on the Pillar 2 process.

9.4.5 For the avoidance of doubt, it is not intended to vary the supervisory approach simply because a JIB is part of a G-SIB.

9.4.6 **Question 39: Are there any issues with the approach of applying greater supervisory intensity for D-SIBs?**

9.5 Capital

9.5.1 For systemic banks, RBC40 (**Appendix F,** paragraphs 40.7 to 40.23) establishes principles for the determination of buffers for banks that are systemic.

9.5.2 The JFSC will articulate its policy within revised Pillar 2 guidance, linked to the new Risk Model and taking into account the impact assessment, which is excluded from consideration in the current guidance.

9.5.3 It is proposed to broadly maintain the existing approach for non-impact considerations and then apply a buffer to account for impact considerations.

9.5.4 For D-SIBs, it is proposed to increase the capital buffer by a minimum of 1% and a maximum of 3.5%. The maximum would only apply in circumstances that do not currently apply, such as if concentrations increased due to consolidation.

9.5.5 Where a JIB is a strategically important part of a G-SIB, it is proposed to add on the relevant G-SIB buffer, unless otherwise determined by agreement reached between the JFSC and the relevant home authority

9.5.6 Where a JIB is both a D-SIB and a strategically important part of a G-SIB, it is proposed to add on the higher of the two amounts.

9.5.7 **Question 40: Are there any issues with the approach of establishing higher capital buffers for JIBs that are either D-SIBs or strategically important parts of G-SIBs?**

9.6 Resolution

9.6.1 The BRRJL requires the JRA to draw up resolution plans for Registered Persons that are systemically important.

9.6.2 Banks supervisors will liaise with the JRA, when it is in force, with a view to establishing a joint view of systemic importance.

9.6.3 The JRA would have wide ranging powers in normal times to require Registered Person to do things that make them resolvable. This includes specifically the power to require them to have adequate levels of loss absorbing liabilities and/or capital.

9.6.4 It would also have the ability to co-ordinate plans with foreign counterparts, both those in home and host jurisdictions.

9.6.5 In the unlikely event of resolution being required, the JRA would have broad powers to resolve Registered Persons by bail-in of non-retail liabilities and to restructure them through disposals etc.

10 Summary of Questions

Page	Question
16	Question 1. Do you have any concerns regarding the proposed general approach for lower impact/high complexity elements?
16	Question 2. If you believe the proposed way forward is appropriate, please provide feedback on (1) which overseas regimes should be considered, (2) how bank requirements might best be established and (3) prudential reporting.
18	Question 3. Do you have any concerns regarding the Interim Policy on the use of Advanced Approaches set out in Appendix B?
19	Question 4: From your own assessment of the Basel III Framework, are there any aspects that concern you regarding the proposed revised standardised approach for credit risk that are not addressed in Section 6?
20	Question 5: Are there any concerns regarding the proposal to (1) continue to use credit ratings and (2) seek to rely to a large extent on the EU list of approved ECAIs?
20	Question 6: Have you undertaken any assessment of the potential impact of the new standard for CRM, under the assumption that the JFSC continues to permit the use of credit ratings and, if so, are there any concerns regarding the impact?
21	Question 7: Are there any issues regarding the proposed approach to enhancing the role of due diligence?
22	Question 8: Would the proposals regarding sovereigns and PSEs lead to a material increase in RWAs?
22	Question 9: Are there any considerations that you wish to raise regarding the proposals for sovereign and PSE exposures?
23	Question 10: Would the proposals regarding banks lead to a material change in RWAs?
23	Question 11: Are there any considerations that you wish to raise regarding the proposals for bank exposures?
24	Question 12: Would the proposals regarding corporates lead to a material change in RWAs?
24	Question 13: Are there any considerations that you wish to raise regarding the proposals for corporate exposures?
24	Question 14: Are there any relevant legislated programmes that you feel should be considered for the 100% risk weight for related equities?

Page	Question
24	Question 15: Are there any considerations that you wish to raise regarding the proposals for subordinated debt, including how to address structural subordination?
25	Question 16: What would be the impact of the lower risk weight for transactors?
25	Question 17: Are there any considerations that you wish to raise regarding the proposals for retail exposures?
26	Question 18: What approach do you take to valuing real estate? Are there any local or home state guidelines that apply? Are there any matters that you feel should be included within guidance on this?
26	Question 19: What approach do you take to evaluating ability to pay? Are there any local or home state guidelines that apply? Are there any matters that you feel should be included within guidance on this?
26	Question 20: Would you be able to supply default data on RRE for the past 10 years, divided into the four sub-categories (as per sub-section 6.11.2), for lending secured by Jersey property? If not, please indicate what information is available historically and any concerns regarding the ongoing provision of default data on an annual basis.
27	Question 21: What approach do you take to distinguishing income dependency, both for buy-to-let and CRRE? Are there any local or home state guidelines that apply? Are there any matters that you feel should be included within guidance on this?
27	Question 22: Do you have any concerns regarding the proposals concerning income dependent CRRE and stable markets?
27	Question 23: What impact would the revised risk weights for RRE have?
28	Question 24: Does your bank provide financing for building of primary residences? If so, what criteria do you currently apply and, specifically, do you apply criteria regarding equity put in by the owners?
28	Question 25: would the changes proposed regarding ADC and other real estate lending lead to a material increase in RWAs?
28	Question 26: What would be the impact of applying a 10% CCF to all unconditionally cancellable commitments?
28	Question 27: Are there any specific matters that should be addressed in order to define arrangements that are not commitments?
29	Question 28: Are there any issues regarding the changes with respect to off balance sheet items (other than with respect to unconditionally cancellable commitments)?

Page	Question
31	Question 29: What would be the impact of applying the new operational risk standard?
31	Question 30: Are there any concerns re the equation specified for the calculation of operational risk?
31	Question 31: Do you envisage any difficulties in complying with the requirements to record operational losses and report to the JFSC
33	Question 32: Are there any issues with retaining the Concession Limit approach?
33	Question 33: Do you foresee any difficulty in putting in place contractual terms to limit exposure in the event of a downgrade of a relevant group bank?
34	Question 34: Are there any issues with the change to the approach re determining Large Exposures?
34	Question 35: Regarding Pillar 2 assessment of concentration risk, are there any elements where you consider guidance would be necessary on the JFSC's expectations?
34	Question 36: Are there any changes to rules regarding exposures to banks (such as to the Money Market Concession) that you consider would either reduce risks or ease operations. In the latter case, how would you propose to address any increase in risk?
35	Question 37: Are there any issues with the proposed approach re determining Large Exposures for fund exposures?
37	Question 38: Are there any issues with the approach outlined for identifying systemic banks?
37	Question 39: Are there any issues with the approach of applying greater supervisory intensity for D-SIBs?
38	Question 40: Are there any issues with the approach of establishing higher capital buffers for JIBs that are either D-SIBs or strategically important parts of G-SIBs?

Appendices

List of representative bodies and other persons who have been sent this consultation paper

› Jersey Bankers Association
› JFL

A. Draft Interim Policy Statement on use of Advanced Approaches

B. CRE20: Standardised Approach: individual exposures

C. OPE25: Calculation of RWA for operational risk

D. LEX: Large Exposures

E. SCO50: Domestic systemically important banks

F. RBC40: Systemically important bank buffers