ISLE OF MAN
FINANCIAL SERVICES AUTHORITY
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# FEBRUARY 2017 - UPDATE FOR ISLE OF MAN INCORPORATED BANKS
# Basel III implementation in the Isle of Man: capital adequacy and leverage

## Background

Following consultation in 2015, and the bringing into force of the Financial Services Rule Book 2016 ("2016 Rule Book"), the first phase of implementing key parts of the Basel III package of reforms becomes effective from 1 July 2017.

The 2016 Rule Book contains new capital adequacy rules for banks incorporated in the Isle of Man. These new rules, effective from 1 July 2017, cover revised minimum capital requirements and a new definition of the capital used for assessing and monitoring large exposures. To supplement the rules there will be revised reporting forms and associated guidance. In addition, you will be required to report a leverage ratio.

## Overview of changes to rules and definitions

*Capital resources*

Under Rule 2.19 (capital resources) new *minimum* capital requirements are introduced; a CET1 ratio of 8.5%, Tier 1 ratio of 8.5% and Total capital ratio of 10%. A standard notification level of 11% (for total capital) also applies.

The above ratios are the minimum levels (pillar 1). You will be set individual capital guidance ("ICG") in due course (see ICAAP below) to include any relevant pillar 2 capital and/or additional buffers.

*Large exposures capital base ("LECB")*

The definition of LECB has been simplified such that, from 1 July 2017, it is referenced to your Tier 1 capital. The change to the definition means that you will no longer be required to submit an annual calculation of the LECB as part of your annual financial return submission (Rule 2.21). Further, there will be no requirement to consider the LECB against "adjusted capital base" (Rule 8.39) due to the definitional change.

## Reminder of key changes to capital components

The main changes, compared to the current Basel II approach are:-

a) The introduction of a new sub-category of highest quality capital (CET1) and new minimum (pillar 1) ratios – *see below*;
b) Tighter definitions for issued capital (Tier 1 and Tier 2) – *see below*;
c) Removal of provisions formerly permitted regarding pensions and held for sale reserves;
d) New requirements for deductions in connection with deferred tax assets and minority interests; and
e) Minor consequential changes to risk weighted assets arising from the above.

*New minimum ratios*

The minimum capital levels set by the Authority are such that they effectively include "capital conservation buffers"; the Authority reconfirms that it is not introducing a separate capital conservation buffer regime. The Authority also reconfirms that it is not proposing to introduce a countercyclical buffer, as previously explained in its consultation paper.

*Tighter definitions for issued capital (Tier 1 and Tier 2, including subordinated intragroup debt)*

Alternative Tier 1 ("AT1") and Tier 2 instruments must be capable of being written down or converted to common equity. The difference is that for AT1 the trigger for such action is higher, with the aim of maintaining CET1 capital adequacy, whereas for Tier 2 the trigger is non-viability.

Two routes are permitted in Basel III: instruments can have contractual provisions for write down at the trigger point, or the jurisdiction must have a statutory power to write down relevant instruments.

In the Isle of Man there is no current statutory route available. Therefore, whilst this remains the position, for AT1 and Tier 2 instruments to be eligible they must have embedded contractual terms that would trigger a conversion or write down. For AT1 instruments the trigger will be a breach of the CET1 minimum of 8.5% and for Tier 2 the trigger will be 4.25% of CET1. Full detail is contained in the attached form completion notes (*annexes B and C)*.

***If you currently utilise AT1 or Tier 2 instruments you should review the terms and address deficiencies accordingly to make sure they will be eligible for capital purposes from 1 July 2017.***

## Updated reporting forms and guidance

The reporting form extracts and associated guidance are attached. There have been no changes as a result of the consultation. Please familiarize yourself with the forms and guidance as soon as possible, to make sure that you will be in compliance with the new minimum capital requirements from 1 July 2017.

The first reporting period to the Authority will be as at 30 September 2017 (return submission 31 October 2017). A full new set of reporting forms (excel template) and consolidated guidance will be issued by the end of June 2017. The new report set will be loaded into the Authority's returns system, to be available after your final (June 2017) submission under the current capital requirements.

## ICAAP

We are currently preparing updated guidance for ICAAP to reflect the new capital framework, and developments since Pillar 2 was first put in place. We expect to have a draft version of this guidance available for publication by the end of April 2017.

If you have submitted an ICAAP to the Authority under the Basel II framework, which we have not concluded upon (i.e. we have not yet issued provisional or final ICG), we confirm that we will be completing our review within the next 2 months (prior to end March 2017).

If you are in the process of preparing your ICAAP we recommend that this is put on hold pending our revised guidance, so it can fully reflect the new (Basel III based) capital framework. This will enable us to agree new ICG with you, referenced against the higher pillar 1 capital requirements.

If you have any questions on this matter please do not hesitate to contact me, or your relationship manager.

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