Consultation

Domestic Systemically Important Banks ("D-SIBs")

This consultation is particularly relevant to existing holders of financial services licences authorising Class 1 regulated activity.

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ISLE OF MAN
FINANCIAL SERVICES AUTHORITY

Lught-Reill Shirveishyn Argidoil Ellan Vannin

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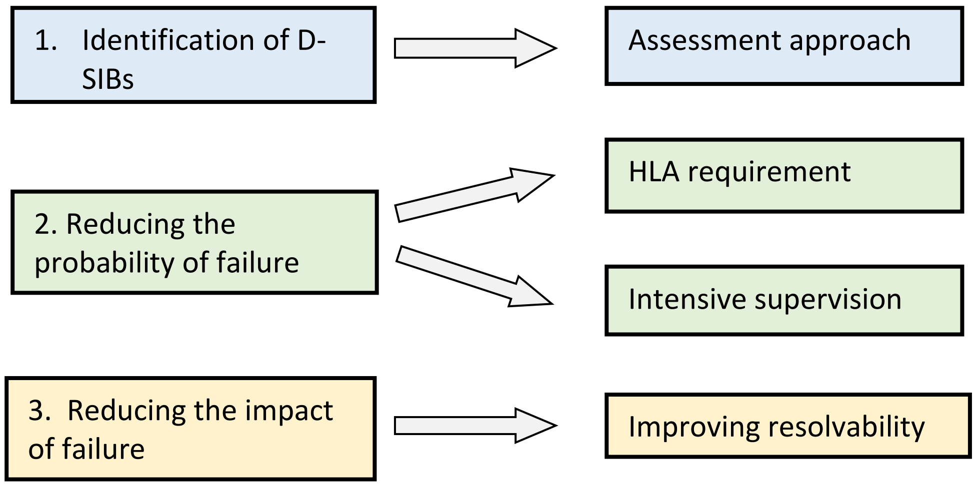
PART A: INTRODUCTION

1. Purpose & Objective

This paper contains proposals for establishing and implementing a regulatory and supervisory framework for banks considered as being systemically important at a domestic level (referred to herein as "**D-SIBs**" and **"the IOM D-SIB framework"**) in the Isle of Man.

The overarching objective of the IOM D-SIB framework is to identify banks whose impact, in the event of distress or failure, could cause significant disruption to the financial system and economic activity locally. To address the negative externalities posed by such banks, regulatory and supervisory measures will be taken with the aim of reducing the probability of failure, and reducing the extent or impact of any failure.

Key components of the IOM D-SIB framework are proposed to be:-



This paper primarily covers components 1 and 2.

With regard to component 3, resolvability, the Isle of Man Financial Services Authority ("the Authority"), in conjunction with the Government, will be developing a separate recovery and resolution planning framework for banks in the Isle of Man. The initial focus will be on those banks that are more systemically important or critical to financial stability in the Isle of Man. Banks designated as D-SIBs will accordingly be prioritised for the implementation of this planning in due course.

Following the close of this consultation, the Authority will further develop and refine its proposals for the IOM D-SIB framework, taking into account feedback received, with a view to:-

a) Issuing a formal policy, setting out the process and methodology for identifying D-SIBs, and the regulatory and supervisory framework that will apply to banks identified as D-SIBs; and
b) Amending relevant guidance (including that pertaining to capital adequacy) and other policy papers, for example the published supervisory approach and licensing policy.

The Authority proposes that the timeframe for implementing the above, subject to consultation responses, will be consistent with the timings outlined for implementing changes to capital requirements in the Isle of Man, as contained in the Authority's "Summary of Responses to the Consultation on Basel III: Capital Adequacy and Leverage" issued on 21 December 2015.

2. Background

In October 2012 the Basel Committee on Banking Supervision ("Basel Committee") published a document on "*a framework for dealing with domestic systemically important banks*" (hereinafter referred to as "**the Basel D-SIB framework**"). This followed the work that had already been done on the policy measures designed for global systemically important banks ("**G-SIBs**"), to enhance their loss absorbency capacity over and above Basel III requirements.

The Basel D-SIB framework is focused on the ***impact*** a bank may have on the domestic economy if it fails (rather than the risk of failure), and therefore not only covers consolidated groups, but also subsidiaries. Jurisdictions may also classify a branch as a D-SIB. It is designed to provide a complementary perspective to the G-SIB framework, focusing on the impact that the distress of banks (including international banks) may have on a jurisdiction's domestic economy.

The Basel D-SIB framework allows for appropriate national discretion to accommodate the structural characteristics of a jurisdiction's domestic financial system. Notably, although the framework is part of Basel III, unlike Basel III, it <u>specifically</u> applies at the subsidiary / domestic level[1] .

The Basel D-SIB framework has twelve key principles ("KPs") covering two aspects:

a) Assessment methodology, set out in KP1 to KP7, which defines what makes a bank a D-SIB; and

[1] The Basel III capital adequacy and liquidity standards are stated to be applicable to all internationally active banks on a consolidated basis, but may also be used by supervisors for domestic banks and for any subset of entities that form part of an internationally active bank where this would ensure greater consistency and apply a level playing field between domestic and cross-border banks.

b) Requirements for D-SIBs to have higher loss absorbency ("**HLA**"), set out in KP8 to KP12.

KP12 also states that other tools, such as more intensive supervision, might play a part in the regulatory architecture, together with the development of a more appropriate framework for recovery and resolution.

Whilst the application to branches of the KPs regarding the assessment of systemic importance should not pose specific problems, the range of policy measures and responses that a host authority has available to deal with systemic branches may be more limited than in the case of a locally incorporated bank.

As part of the preparation to implement an IOM D-SIB framework, a discussion paper ("**the D-SIB DP**") was issued in January 2014, jointly with the Jersey Financial Services Commission and Guernsey Financial Services Commission ("**the Tri-party Group**"). Feedback to the D-SIB DP was generally positive, noting that it would be important to have consistency across the Crown Dependencies as much as possible, that consultation would be required, and that the approach to D-SIBs must be transparent and objective.

The Tri-party Group issued feedback to the D-SIB DP in July 2014, including responses. Where relevant, this feedback is taken into account in the Authority's proposals contained in **Part B** of this paper.

3. High level rationale

The Authority's regulatory objectives are set out in section 2 of the Financial Services Act 2008 ('FSA08') and are as follows:

(a) Securing an appropriate degree of protection for policyholders, members of retirement benefits schemes and the customers of persons carrying on a regulated activity;

(b) The reduction of financial crime; and

(c) The maintenance of confidence in the Island's financial services, insurance and pensions industries through effective regulation, thereby supporting the Island's economy and its development as an international financial centre.

Proposals in this consultation reflect objectives (a) and (c).

In addition to this, under paragraph 3 of Schedule 1 to the FSA08, the Authority is required to give consideration to certain factors[2]. The factors that are most relevant to this proposal are:

FACTOR	INFORMATION
The need for the regulatory, supervisory and registration regimes to be effective, responsive to commercial developments and proportionate to the benefits which are expected to result from the imposition of any regulatory burden.	The proposals are designed to implement international standards whilst being proportionate, achieved by providing a suitable timeframe before being introduced, and broadly covering matters already discussed with industry.
The need to use resources in an efficient, and economic, way.	The timeframe for implementing the proposals, and the focus on banks that pose the most systemic risk, means that the Authority is able to use its existing resources in an efficient, and economic, way.
The desirability of implementing and applying recognised international standards.	The proposals are designed to implement international standards for domestic systemically important banks, whilst taking into account the fact that the Authority is primarily a host supervisor.
The desirability of cooperating with governments, regulators and others outside the Island.	The proposals will align the Isle of Man's framework to international standards for domestic systemically important banks.
The need to safeguard the reputation of the Island.	The proposals are designed to implement international standards for domestic systemically important banks which strengthen the supervisory regime for the benefit of the reputation of the Island.
The international character of financial services, insurance and pensions industries and their markets and the desirability of maintaining the competitive position of the Island.	It is not considered the competitive position of the Island will be impacted, as the proposals are designed to implement the new minimum international standards.
The impact of its decisions on the stability of the financial system of the Island.	The proposals are designed to implement international standards for domestic systemically important banks which strengthen the supervisory regime and improve the stability of the financial system of the Island.

[2] In November 2015 the Isle of Man Financial Services Authority ("the Authority") succeeded the Financial Supervision Commission ("FSC") following the latter's merger with the Insurance and Pensions Authority ("IPA"). The proposals in this paper relate to the Authority's remit under the Financial Services Act 2008.

4. Consultation Process

The Authority considers open dialogue with stakeholders as essential in developing its proposals and greatly appreciates comments on the proposals in this document. Such comments will help to shape the final IOM D-SIB framework. We welcome any suggestions, but please note that your comments may not result in a change to the proposals.

There will be a short subsequent, formal consultation on the final draft IOM D-SIB framework, including the formal policy and amendments to guidance (for capital).

After all comments have been considered, a summary of respondents' comments will be published on the Authority's website. As we wish to encourage submission of views, **comments will not be linked to respondents** and will be anonymised where necessary. However, please do not submit comments anonymously, as these will not be considered nor included in the summary of comments.

We will also publish the Authority's responses to the comments received and indicate the proposed next steps in this project.

The proposals, together with a series of important questions are set out in **Part B**. While comments should cover the specific questions, any general comments and observations will be welcomed.

The closing date for comments is **Thursday 31 March 2016**.

Please send your views in writing and preferably by e-mail[3] to:

Mr Andrew Kermode
Deputy Director, Banking
Banking, Fiduciary and Investment Division

E-mail: andrew.kermode@iomfsa.im

Isle of Man Financial Services Authority, PO Box 58, Finch Hill House,
Bucks Road, Douglas, Isle of Man, IM99 1BT. Direct Tel: (01624) 689320

[3] Please do not send scanned documents

PART B: PROPOSALS

1. Executive summary

This paper contains full details of proposals to establish and implement a regulatory supervisory framework for:-

(a) Identifying and designating licenceholders as domestic systemically important banks (both subsidiaries and branches), and
(b) Applying a range of prudential and supervisory requirements to those licenceholders.

The proposals are primarily derived from those contained the D-SIB DP (and associated feedback), issued by the Tri-party Group in January 2014 (feedback July 2014).

The proposals in the consultation paper are organised as follows: Section 2 describes the way in which the Authority proposes to identify and assess D-SIBs (KPs 1 to 7); Sections 3 and 4 discuss the proposed policy measures for reducing the probability of failure of D-SIBs (KPs 8 to 12), and Section 5 briefly covers the relevant policy measures needed for reducing the impact of failure of D-SIBs.

2. Identification and assessment of D-SIBs

2.1 Background

There are seven KPs that focus on the assessment methodology and identification of D-SIBs.

KP1 states that "national authorities should establish a methodology for assessing the degree to which banks are systemically important in a domestic context", and "***that all national authorities should undertake an assessment of banks to consider their systemic importance"***. The assessment, under KP2, should be based on the impact of failure, not risk of failure, and under KP3 the reference point for assessing impact is the domestic economy.

Further KPs cover the scope of the assessment at home and host levels, the factors to consider when assessing D-SIBs, the frequency of assessments, and public disclosure.

Further detail of how these KPs are proposed to be applied by the Authority under an IOM D-SIB framework are covered in **sub sections 2.2 to 2.6** below.

2.2 Proposed scope and basis of assessment for D-SIBs

The Authority proposes to include all licensed deposit takers (banks) within the assessment sample for the IOM D-SIB framework, which is consistent with the approach outlined in the D-SIB DP (and feedback). This means that locally incorporated banks, and branches of overseas banks, will be included when assessing which banks may be classified as D-SIBs. This starting point is considered appropriate based on the current policy in the Isle of Man of hosting branches or subsidiaries of larger financial services groups with existing banking experience.

The Basel D-SIB framework states that a host authority should assess subsidiaries in their country on a consolidated basis[4]. The reference point for the assessment remains the local economy, even when considering downstream subsidiaries. Therefore, the Authority proposes to assess all Isle of Man incorporated banks within scope on a consolidated basis to the extent possible. Overseas banks will be assessed on the position of their Isle of Man office (branch).

The Authority is also currently consulting on proposals to separate out deposit taking licenses into three types; class 1(1) covering full service banks that can take retail deposits, class 1(2) covering banks that can offer all services but not take retail deposits, and class 1(3) representative offices of foreign banks. At this stage the Authority considers that class 1(3) licenceholders would be outside the scope of the IOM D-SIB framework. In relation to the proposed class 1(2) category of banks, although it is unlikely that any of these banks would be D-SIBs, the Authority is still to determine if they should at least be within scope of the proposed IOM D-SIB framework (as they may provide services to important sectors of the local economy, which could become material).

Q1: Do you agree with the proposed scope and basis of the assessment? Q2: Do you think the scope should include the proposed Class 1(2) banks?

2.3 Proposed assessment indicators (criteria) to identify D-SIBs

In accordance with the Basel D-SIB framework, the Authority proposes that the assessment criteria should be based on the impact of failure, not risk of failure, on the domestic economy of the Isle of Man. This is broadly interpreted as a "loss given default" concept rather than a "probability of default" concept. On this basis the

[4] Downstream subsidiaries to be included in the assessment would be limited to those included in regulatory consolidation.

proposed indicators to be used in the IOM D-SIB framework are focused primarily on the measures of the "impact of failure". This means that the proposed criteria address the externalities that the distress or failure of a bank could generate at a local level.

The Authority proposes that the D-SIB assessment should be based on the following four factors, drawn from the Basel D-SIB framework:-

a) Size
b) Interconnectedness
c) Substitutability / jurisdiction's financial institution infrastructure
d) Complexity

The Authority's proposed approach to each of the above factors is explained in more detail below (**sections 2.3.1 to 2.3.4**).

In the D-SIB DP the Tri-party Group outlined a broadly subjective approach to the methodology for assessing banks. However, in the feedback to the D-SIB DP it was acknowledged that the industry would not be satisfied with a purely subjective approach (i.e. only indicating factors and arriving at decisions without a clearer published methodology being in place), and that further thought would be given to this matter in consultation.

The Authority therefore proposes to adopt more of an indicator-based measurement approach based on quantitative information, overlaid with a qualitative approach using supervisory judgement. Further details on the Authority's proposed assessment methodology is contained in **section 2.4**.

2.3.1 Size (with reference to local GDP)

Size is a key measure of systemic importance. The larger the bank, the more widespread the effect of a sudden withdrawal of its services, and therefore the greater the chance that its distress or failure would cause disruption to the financial markets and systems in which it operates, and to the broader functioning of the economy. The proposed size factor broadly measures the volume of a D-SIB's banking activities within the Isle of Man's banking system and economy and therefore provides a good measure of the potential systemic impact in case the bank should fail.

The Authority proposes that the following quantitative factors should be used to determine size:

- Eligible deposit liabilities (up to the compensation limits) under the relevant deposit compensation scheme (a measure of retail deposits and impact on resources), compared to total eligible deposits (up to the compensation limits) across the system and, where appropriate, each scheme's funding resources;

- Value / number of local resident (individual) deposits (compared to total deposits from local resident individuals);
- Total balance sheet footings / assets; and
- Employment (compared to domestic economy / banking sector employment).

In addition to the above the Authority will also consider qualitative factors relating to size such as anticipated business growth or contraction, mergers or acquisitions, the overall size of a bank's activities in the Isle of Man (including those outside of banking) and any other initiatives that may materially impact on a bank's size. A full list of proposed qualitative factors is contained in **table 3 in section 2.4.3**.

2.3.2 Interconnectedness

This measure captures the extent of a bank's inter-connections with other financial institutions that could give rise to externalities affecting the financial system and domestic economy in the Isle of Man.

The Authority proposes that the following factors should be used to capture interconnectedness:

- Clearing facilities / agents for other banks;
- The extent to which the bank provides specialist services to other key sectors in the economy (for example custody of funds, government banker, Isle of Man interbank loans).

The Authority considers that the above, although they can be quantified to some extent, will be better considered under qualitative factors only on an individual bank basis. This is because obtaining reliable data across the population may be more difficult and not an efficient use of resources, and also that the interbank market on the Isle of Man is fairly limited (mainly the large clearing banks, who will exhibit many other features of systemic importance, that accept funds from smaller banks). A full list of proposed qualitative factors is contained in **table 3 in section 2.4.3**.

2.3.3 Substitutability / jurisdiction’s financial institution infrastructure (including the concentrated nature of the banking sector)

The concept underlying substitutability as a factor for assessing systemic importance is the recognition that, the greater the role of a bank in a particular business line, or in acting as a service provider in relation to market infrastructure, the more difficult it will be to swiftly replace that bank, and the extent of the products and services it offers. The risk of disruption in the event that the bank becomes distressed is therefore more significant.

Assessments of substitutability will need to recognise local conditions within the banking industry including the intensity of domestic competition and the homogeneity of product offerings. Further, there are functions performed by some banks in the Isle of Man that would be difficult to substitute at short notice, most notably payment and settlement systems, and issuing / holding Isle of Man Government banknotes.

The Authority proposes that the following quantitative factors will be taken into account when assessing substitutability:

- Value/number of local residential mortgages and current activity in that market (compared to total local mortgages) (*a measure of market share*);
- As above but in relation to lending to local businesses; and
- Level of provision of core retail and business banking services, using call “retail deposits” as an indicator (full transactional current accounts, overdrafts and loans, cheque facilities – i.e. extent of retail banking services).

In addition to the above the Authority will also consider qualitative factors such as whether a bank is key to providing the financial infrastructure for the Isle of Man (e.g. payments systems, banknote issuance for the Government, extent of local branch network for the community, or is it the sole or one of only a few providers of specialist services to other key sectors of the economy). A full list of proposed qualitative factors is contained in **table 3 in section 2.4.3**.

2.3.4 Complexity (including the additional complexities from cross-border activity)

The degree of complexity of a bank is generally expected to be proportionately related to the systemic impact of the bank’s distress, since the less complex a bank is, the more ‘resolvable’ it is likely to be, and in turn the more likely the impact of its failure could be contained.

The Authority has not identified any suitable and reliable quantitative indicators for measuring complexity locally, and therefore proposes that a purely qualitative approach is adopted, to allow for the assessment to accommodate the multifaceted nature of complexity. In this respect, sources of complexity that the Authority proposes to take into account include:

- Business complexity: for example arising from a significant degree of involvement in complex financial products (currently not expected to be material in the Isle of Man);

- Structural complexity (including resolvability), this includes consideration of:
    - Materiality of any downstream subsidiaries (spill-over risks of their failure);
    - Materiality of any up-streaming business model (risk that this may influence the impact of failure and reduce the probability of a successful resolution); and
    - Materiality of any overseas branches (spill-over risks, including cross border claims of branch depositors and differing local regulations on insolvency).

- Operational complexity: for example internal systems such as booking centres outside of the Isle of Man, and any mismatches between where business is originated and booked.

A full list of proposed qualitative factors is contained in **table 3 in section 2.4.3**.

Q3: Do you have any comments on the suitability of the proposed indicators for tracking the four bank-specific assessment factors? Q4: Are there any additional factors that the Authority should consider for assessing the systemic importance of banks in the Isle of Man? Q5: Do you have any suggestions for suitable quantitative indicators of interconnectedness or complexity?

2.4 Proposed assessment methodology

2.4.1 Proposed general approach

The Authority proposes to adopt a two stage approach to assess and then identify D-SIBs. The first stage will involve assessing quantitative factors of size and substitutability, using an indicator based approach. The approach is explained in

section 2.4.2 below, and is considered to address the concerns of the industry as outlined in feedback to the D-SIB DP.

The second qualitative stage will involve judgement and naturally be more subjective. This is designed to complement the quantitative assessment and to refine the assessment made purely on that first basis. Further information is provided in **section 2.4.3** below.

2.4.2 Proposed quantitative indicator approach

Rather than just provide a list of quantitative factors that will be taken into account without further guidance (as first outlined in the D-SIB DP) the Authority now proposes to adopt a more formal scoring and "weighting" approach to this part of the assessment under the IOM D-SIB framework.

This means that a weight will be assigned to the size and substitutability factors.

The Authority proposes to assign a 70% weight to size and 30% to substitutability. Size is considered to be the most dependable quantitative indicator in terms of data reliability and is often a more important measure of systemic importance from an impact perspective. Generally speaking, the larger the size of a bank, the greater its market share of critical financial services and the more interconnected it is to the domestic economy. Of course, there can be exceptions, which is where the qualitative assessment would be used.

An equal weighting would be applied to each indicator within a factor. The proposed weighting system is shown in table 1:

Table 1: Proposed indicator / factor weighting under the quantitative approach

Factor	Quantitative indicator	Weighting
Size (70%)	Eligible deposits under a compensation scheme	17.5%
	Isle of Man resident deposits (individuals)	17.5%
	Total assets	17.5%
	Number of staff employed	17.5%
Substitutability (30%)	Isle of Man residential mortgage lending	10%
	Lending to Isle of Man based businesses	10%
	Retail call accounts (all customers)	10%

Scoring methodology for quantitative indicators

The Authority proposes that a "systemic score" for each bank will be calculated in a similar way to that used in the Basel Committee's G-SIB framework.

This means that the score for a particular indicator (e.g. total assets) is calculated by dividing the individual bank amount (in GBP) by the aggregate amount for the indicator across all banks within the scope of the IOM D-SIB framework. This amount is then multiplied by 10,000 to express the indicator score in terms of basis points.

For example, if a bank's total assets divided by the total assets of all banks in the sample is 0.07 (i.e. the bank makes up 7% of the sample total) its score will be expressed as 700 basis points. The bank's score for each indicator will then be weighted as per table 1 above and the overall systemic score will be the sum of the weighted scores.

The Authority further proposes that once all the systemic scores have been calculated, that it will determine a cut off threshold above which banks are considered systemically important (subject to the qualitative assessment); the cut off threshold (to be established) will take into account the overall distribution of scores and cluster analysis.

Table 2 below provides an example of how the systemic scores for two different banks might look (these examples are not based on actual figures reported to the Authority):-

Table 2: example scoring methodology for systemic risk

Factor	**Quantitative indicator**	**Basis point score (out of 10,000)**	**Weighting**	**Final score**
BANK A – LARGE FULL SERVICE RETAIL BANK				
Size (70%)	Eligible deposits under a compensation scheme	1,000 (e.g. 10% share)	17.5%	175
	Isle of Man resident deposits (individuals)	700	17.5%	122.5
	Total assets	1,000	17.5%	175
	Number of staff employed	1,200	17.5%	210
			Total size score	***682.5***
Substitutability (30%)	Isle of Man residential mortgage lending	2,000	10%	200
	Lending to Isle of Man based businesses	2,000	10%	200
	Retail call accounts (all customers)	900	10%	90
			Total substitutability score	***490***
			TOTAL SYSTEMIC SCORE	**1,172.5**

Factor	Quantitative indicator	Basis point score (out of 10,000)	Weighting	Final score
BANK B – MID SIZE BANK, NOT DOMESTICALLY RETAIL FOCUSED				
Size (70%)	Eligible deposits under a compensation scheme	500 (e.g. 5% share)	17.5%	87.5
	Isle of Man resident deposits (individuals)	200	17.5%	35
	Total assets	350	17.5%	61.25
	Number of staff employed	350	17.5%	61.25
			Total size score	***245***
Substitutability (30%)	Isle of Man residential mortgage lending	100	10%	10
	Lending to Isle of Man based businesses	0	10%	0
	Retail call accounts (all customers)	300	10%	30
			Total substitutability score	***40***
			TOTAL SYSTEMIC SCORE	**285**

While the quantitative indicators for determining substitutability attract a lower weighting under the proposal (and the interconnectedness and complexity factors have no quantitative input at all), each of these factors will be supplemented by the qualitative indicators (see **section 2.4.3** below).

Q6: Do you agree that a quantitative indicator approach for size and substitutability is an appropriate methodology to aid transparency of the assessment process?

Q7: Do you agree that the quantitative indicator for size warrants a higher weighting compared to that for substitutability?

2.4.3 Proposed use of qualitative indicators using supervisory judgement

The Authority considers that a robust assessment cannot rely solely or mechanically on quantitative indicators, and that qualitative information and judgement have a role to play in the D-SIB identification process.

To help make sure that qualitative information is considered in a consistent and appropriate manner the Authority proposes to put in place the following guiding criteria:-

A range of qualitative indicators have been identified that will typically be considered in the assessment process, and these are set out in table 3 below. The list in table 3 is not exhaustive as there may be market developments that influence judgement and, in due course, experience of using the proposed IOM D-SIB framework may mean changes are required.

Due consideration will be given to these qualitative indicators, especially for the factors that are not currently proposed to be captured by quantitative indicators (e.g. interconnectedness and complexity).

Table 3: Proposed list of qualitative indicators

Factor	**Qualitative indicator**
Size	Anticipated business growth / contraction
	Anticipated merger or acquisition
	Overall size of activities (including outside of banking)
Interconnectedness	Clearing facilities / agents for other banks
	Isle of Man interbank loans / deposits
	Specialist services to material parts of the domestic economy – e.g. government, custody of funds, insurance, e-gaming, TCSPs
Substitutability	Provider of payment / settlement facilities to other Isle of Man banks / industries
	Banknote issuance for Government
	Local branch network (community)
	Level of specialist services to material parts of the domestic economy – e.g. government, custody of funds, insurance, e-gaming, TCSPs
Complexity	Business: involvement in, and scale of, the following types of service provided:- Securities / investment broking; Insurance; Custodial / trustee services; Amount and number of non-plain vanilla products / portfolios; Off balance sheet exposures.
	Structural:- Number, and type (materiality), of subsidiaries; Number, and type, of associates, joint ventures , and special purpose vehicles; Number, and activity, of overseas branches; Intragroup exposures (impact of failure and probability of successful resolution).
	Operational:- Booking centres outside of Isle of Man; Level of mismatch between where business is originated and booked; Outsourcing / insourcing (impact on domestic economy only).

Q8: Do you have any suggestions on any other qualitative indicators which might usefully be taken into account in the D-SIB assessment process?

Q9: Do you have any suggestions relating to the criteria to guide the incorporation of supervisory judgement into the assessment process?

2.5 Proposed frequency of assessment (and data sources)

The Authority proposes that the assessment of banks will be undertaken on an annual basis. In this respect the first assessment will be done at a point in time to be determined. Thereafter, although the Authority proposes to conduct a reassessment annually (for example as part of the annual review of a bank's business, and prior to an annual review meeting being held) this subsequent review may be in short form if there have been no material changes – this will particularly be the case for banks that have not been assessed as systemically important in the first assessment round. Conversely, if a significant trigger event occurred (for example a material acquisition) a more frequent assessment may be required.

For banks themselves the Authority does not envisage that there will be significant increased reporting required to support the Authority's assessment. The Authority proposes to utilise information already provided by banks, and held internally (e.g. prudential returns[5], deposit insurance information, annual regulatory returns, file records, internal risk assessments etc) when undertaking an assessment as to whether a bank is a D-SIB. The only additional reporting may arise if an Isle of Man incorporated bank establishes material subsidiaries, where additional consolidated reporting would be needed.

Q10: Do you have any comments on the proposed frequency of assessment?

Q11: Do you have any concerns or comments with the proposed use of data sources?

2.6 Transparency

The Basel D-SIB framework recommends that national authorities should publicly disclose information that provides an outline of the methodology employed to assess

[5] This will include the new lending data forms which will show Isle of Man lending data, for which reporting commences on a best endeavours basis from March 2016.

the systemic importance of banks in their domestic economy which will provide some transparency.

The Authority intends to incorporate the proposals contained in this paper, which are considered to set out the methodology for identifying and assessing D-SIBs in a transparent way (the IOM D-SIB framework), subject to the consultation responses, into a final policy statement which will be published on the Authority's website. The Authority therefore considers that it will meet this recommendation.

Unlike the framework for G-SIBs there is no requirement to publish a list of those banks assessed as being D-SIBs. The Authority does not intend to publish such a list at this time until there is a clearer picture of the international approach in this regard, particularly within the UK and the EU. This approach is consistent with the proposals contained in the D-SIB DP.

The Authority proposes that banks which it intends to identify as D-SIBs (after undertaking the first assessment process) will be informed of the Authority's intention, including the reasons for it. The Authority will then finalise its decision and the banks will be formally advised.

In the absence of having a published list of D-SIBs, the Authority proposes that it will however share its decision with other relevant authorities in the Isle of Man (for example any resolution authority that may be established in due course), and other relevant supervisors and resolution authorities (typically home / host).

Q12: Do you have any comments on the Authority's proposals for publishing information and sharing decisions with other relevant persons? Q13: Do you consider it is appropriate that the Authority does not publish a list of D-SIBs, at the first stage, noting the policy towards this may change in the future?

3. Reducing the probability of failure – higher loss absorbency ("HLA") requirements

3.1 Background

The rationale for imposing a HLA requirement on designated D-SIBs is to reduce the probability of their failure. This is considered both prudent and justified in view of the greater impact that such failure would likely have on the domestic financial system, and the local economy more broadly.

The Authority may require any HLA requirement to be applied on an unconsolidated and or/consolidated basis.

The HLA requirement applied to a designated D-SIB should be determined based on its degree of systemic importance, and will form part of the bank's capital buffer level (this is explained in more detail in **section 3.2**). This is in addition to any pillar 2 capital requirements that may be in place.

Before discussing in detail the application of HLA requirements, and the supervisory approach to D-SIBs in the Isle of Man, it is important to outline the different structural scenarios that could arise, which were also covered in the D-SIB DP:-

The scenarios for <u>subsidiaries (IOM incorporated banks)</u> are as follows:-

- D-SIB in the Isle of Man, parent bank also D-SIB or G-SIB in its home country;
- D-SIB in the Isle of Man, but parent bank (where there is one) not a D-SIB or G-SIB in its home country or part of a G-SIB group; or
- D-SIB in the Isle of Man, parent bank (where there is one) not a D-SIB or G-SIB but is part of a G-SIB group.

The scenarios for <u>branches</u> are as follows:-

- D-SIB in the Isle of Man, bank also a D-SIB or G-SIB in its home country;
- D-SIB in the Isle of Man, but not a D-SIB or G-SIB in its home country or part of G-SIB group; or
- D-SIB in the Isle of Man, but not D-SIB or G-SIB in its home country, though the bank is part of a G-SIB group.

The Authority proposes that the regulatory response and tools to be utilised will differ depending on which of the scenarios above apply, noting that local capital requirements are not applicable for branches. Further information is provided in **section 3.2 and 3.3**.

3.2 A proposed calibration framework - Isle of Man incorporated banks

<u>3.2.1 Overview</u>

The level of HLA capacity for each D-SIB should, according to the KPs, be based analytically on the degree of systemic importance. For G-SIBs, the HLA ranges from 1% up to 3.5% (common equity as a percentage of risk weighted assets), depending on which "bucket" a G-SIB falls into. The HLA is calibrated in 0.5% increments and added to a bank's minimum capital ratio.

The Authority proposes to use a similar incremental regime to determine HLA requirements for D-SIBs that are incorporated in the Isle of Man, whilst also taking into account the group of which the bank is a part and the different scenarios as outlined in **section 3.1**.

The Authority already has the legal powers necessary to set and impose additional capital requirements on banks incorporated in the Isle of Man, through the use of Pillar 2 of the Basel II framework, and the issuance of Directions. Under Basel III, which is subject to a separate, but linked, piece of work, the HLA requirements can be considered as part of an extension to the various buffers applied above the minimum capital requirements. In the Isle of Man, this means any HLA requirements imposed for systemic reasons would be set as part of a bank's individual capital guidance ("ICG").

The Authority therefore proposes that any HLA requirement imposed on any Isle of Man incorporated bank designated as a D-SIB will not be regarded as a "hard limit", the breach of which would result in failure to comply with minimal capital requirements; rather the HLA requirement will be part of a buffer above the minimum pillar 1 and pillar 2 requirements (i.e. within a notification limit range as per the Authority's current approach to capital adequacy).

Further detail on how the regime is proposed to work is provided in **sections 3.2.2 and 3.2.3** below.

3.2.2 A proposed "bucketing" approach

Some jurisdictions have adopted a bucketing approach for HLA requirements for D-SIBs, similar to the framework for G-SIBs, whilst others have proposed a flat surcharge.

Given the diversified nature of groups, and potential varying degrees of systemic importance of banks in the Isle of Man, the Authority considers that a differentiated (bucketing) approach should be adopted, using an HLA range from 0% to 2.5%, with an "empty" top bucket of 3.5% being available in case of need; the latter being consistent with the approach for G-SIBs. Starting the bucketing at 0% will provide the Authority with the flexibility not to impose a D-SIB capital buffer if circumstances might make that feasible; this takes into account the feedback to the D-SIB DP.

The Authority proposes that, initially, any banks identified as D-SIBs will be allocated to one of 5 buckets (with the 3.5% bucket being empty, meaning no bank would have a HLA requirement higher than 2.5% initially) based on the relative distribution of their systemic scores (**see section 2.4**). The proposed buckets are shown in table 4 below:-

Table 4: proposed bucket range

Bucket	HLA requirement (CET1 as % of RWA)
5	3.5%
4	2.5%
3	2%
2	1.5%
1	Between 0% to 1%

The thresholds for each bucket will be drawn with reference to the clusters and range of systemic scores that arise from the identification process. However, the final HLA requirement that the Authority will determine will be after taking into account a range of factors, most notably:-

Intra-group exposures

Consideration of whether increased capital requirements is the right way (or part of wider mitigation) to reduce the probability of failure when the main, or a high proportion of, the D-SIB's assets are claims on group companies.

Home / host relationships

In setting any HLA requirement on a subsidiary, the Authority will need to coordinate with the relevant home authorities before taking action. This is a follow on from the scenarios outlined in **section 3.1** above, such that for any locally incorporated D-SIB which is a subsidiary of a foreign G-SIB or D-SIB the Authority proposes to assess whether some degree of reliance may be placed on the "group" HLA requirement. In determining its position the Authority would consider:

- The way in which the "group" HLA requirement is calibrated, and whether this may have taken into account the systemic impact at a local level (solo, sub consolidated, consolidated);
- Whether there are clear and credible assurances from the parent in terms of forthcoming capital support should the Isle of Man subsidiary come under stress;
- The level of cooperation with, and degree of reliance the Authority is able to place on, the home supervisor regarding the supervision (and when the time comes, orderly resolution) of the D-SIB;
- The planned resolution strategy for the banking group to which the D-SIB belongs, including where it is most appropriate to hold capital within that banking group to be able to successfully execute the resolution.

Q14: Do you agree that a differentiated, rather than a flat rate, approach to the assessment of HLA is merited?

Q15: Do you agree that a “bucketing approach”, broadly reflective of that used in the G-SIB framework, is appropriate to achieve the differentiated HLA requirements?

Q16: For a D-SIB in the Isle of Man that is a subsidiary of foreign G-SIB or D-SIB, do you agree that the Authority should assess whether some reliance may be placed on the “group” HLA requirement in determining any local HLA requirement?

3.2.3 Requirement to be met by Common Equity Tier 1 Capital (CET1) and the interaction with Pillar 2

As suggested in the D-SIB DP, and as agreed with industry at that time, the Authority proposes that any HLA requirement set at the subsidiary level in the Isle of Man will need to be met by CET1 capital. The HLA requirement for systemic importance is not designed to replace / absorb identified Pillar 2 risks, which may be quite separate, although capital should not be held twice for the same risks.

The Authority also proposes that the HLA requirement is taken into account as part of the SREP, when setting minimum capital requirements i.e. the individual minimum is set at the level required under Pillar 2 (excluding any increase due to systemic importance) plus the HLA requirement. The HLA requirement will only form part of a buffer (or notification level), and will not be a binding minimum. These capital requirements will continue to be set out under individual capital guidance (“ICG”).

Further information on how the CET1 capital requirements are proposed to be applied in the Isle of Man were contained in the capital consultation paper issued on 30 July 2015 (closing 30 October 2015), and for which the Authority issued its “Summary of Responses” on 21 December 2015.

An example of how a bank’s ICG might look, including HLA, is as follows:-

<table>
<tr><td>Other buffers</td><td>Notification level (1%)</td><td rowspan="2">Buffers only, minima of 1% above binding requirement</td></tr>
<tr><td>Systemic (D-SIB) buffer (HLA)</td><td>0% to 2.5% CET1</td></tr>
<tr><td>Pillar 2 (risk specific)</td><td>Bank specific</td><td rowspan="2">Binding minima for any bank</td></tr>
<tr><td>Pillar 1[6]</td><td>CET1 8.5%, Tier 1 8.5%, total capital 10%</td></tr>
</table>

[6] The Authority’s pillar 1 minima takes into account Basel III minima inclusive of the capital conservation buffer

The Authority will also be reviewing and updating its ICAAP and SREP guidance, firstly to generally refresh it for the existing Basel II regime and then also to update it as part of Basel III implementation.

Timing of the requirement / implementation of HLA

The Authority has separately stated its intention to introduce the revised minimum capital adequacy standards under Basel III with effect from 1 July 2017. The Authority proposes that any HLA requirements will start to be set after 1 July 2017 with the following transitional arrangements applying:-

- At least 50% of an agreed HLA by December 2017
- 100% of an agreed HLA by December 2018

Q17: Do you agree with the above transitional arrangements for HLA buffer requirements?

3.3 Branches

The primary responsibility for supervising capital adequacy in respect of foreign bank branches rests with the home supervisory authority, and therefore such branches are not subject to local branch capital adequacy requirements in the Isle of Man.

The Authority proposes that if a branch in the Isle of Man is identified as a D-SIB locally, under the proposed IOM D-SIB framework, it will consider if it needs to adopt a more intensive regulatory and supervisory approach in relation to it. This is covered in more detail in **section 4.**

The Authority will also need to take into account the home authority's supervision and regulation of the bank (and where relevant the group), in order to assess the risks posed by the branch to financial stability in the Isle of Man. This will include cooperating with the home supervisory authority and focusing on understanding the adequacy of capital and liquidity at the bank / group level, and the relationship between the bank and its branch in the Isle of Man.

Further, the position of branches is such that the Authority will need to consider its policy on hosting branches that are identified as being D-SIBs. If the bank of which the branch is a part is also a D-SIB in its home state or a G-SIB, this could provide additional comfort as HLA requirements will be applied to the bank as a whole. The bank in its home state should also be subject to more intensive supervision.

However, if a branch in the Isle of Man is identified as a D-SIB but the bank (or group) as a whole is not, and is not subject to HLA requirements in its home state, the Authority will need to consider if such a structure meets its risk appetite and whether that bank is adequately capitalised to support the systemic nature of the branch.

This is supported by the Authority's licensing policy for regulated activities under the Financial Services Act 2008 (last updated December 2015) which states that:

"In the case of a branch which undertakes Class 1 (deposit taking) activities, the Authority will not grant a licence unless it is satisfied that:

- *the regulator of the relevant head office (the "home regulator"), is prepared to exercise consolidated supervision with the Authority; and*
- *this consolidated supervision includes consideration of capital adequacy and liquidity.*

In addition to the above, if a branch wishes to accept retail deposits, the Authority will also expect the following:

- *the bank must have at least a 5 year track record; and;*
- *the bank, or group of which it is part, should have a credit rating of at least investment grade.*

The Authority will also take into account the standing of the bank / group in its home jurisdiction including matters such as systemic importance."

Q18: If a foreign bank branch is designated as a D-SIB in the Isle of Man, are there any other factors that the Authority should take into account in addition to those described above, in determining the most appropriate measures to be adopted in respect of such branches?

4. Reducing the probability of failure – more intensive supervision

In the aftermath of the global financial crisis, much attention has been focused on systemically important banks ("SIBs"), and the regulations and supervisory powers needed to deal with them effectively. It is generally considered that SIBs should be subject to a greater intensity of supervision and that the expectations on, and of, supervisors need to be of a higher order for SIBs, commensurate with the risk profile and systemic importance of these banks.

An effective system of banking supervision, as reflected in the Basel Core Principles, now requires the supervisor to:

- Develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance;
- Identify, assess and address risks emanating from banks and the banking system as a whole;
- Have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.

The Authority already has in place supervisory practices that include on and off site supervision of banks, risk assessment methods (including a basic impact assessment), participation in regulatory colleges and dialogue with the home supervisory authorities and parent groups. However, a key area that needs to be developed further is that pertaining to recovery and resolution, which will be a critical part of the approach to supervising D-SIBs (**see section 5**).

The supervisory framework in the Isle of Man will need to be developed to explicitly refer to the proposed IOM D-SIB framework in due course, and in this regard the proposed D-SIB assessment exercise should consolidate and enhance the existing risk based approach.

The Authority proposes that, in developing its supervisory policy approach to D-SIBs it will introduce a more graduated impact assessment for the banking sector (i.e. D-SIBs will be the highest impact firms, rather than the current position that effectively means all banks which are members of the compensation scheme are “high impact”, irrespective of their overall size or importance to the domestic economy). This approach will lead to the Authority fine tuning and tailoring its strategy for supervising banks generally, and, for individual D-SIBs is proposed to include, for example:-

- More in depth assessments of D-SIBs (such as more frequent on-site assessments, and / or dialogue and engagement on specific areas of risk or importance);
- An increased focus on the risk management, governance structures, and risk profiles, including more frequent engagement with boards (for Isle of Man incorporated D-SIBs), senior management, and receipt of risk and audit reports;
- A deep and thorough understanding of the recovery planning, resolution planning and resolution strategy (noting that this will be subject to a separate and detailed piece of work).

5. Reducing the impact of failure – recovery and resolution planning

The D-SIB DP included a specific section covering recovery and resolution, and in the feedback to the D-SIB DP the following was confirmed (using the EU Bank Recovery and Resolution Directive ("BRRD")) as a benchmark:-

- Banks are required prepare plans for recovery from financial distress (***recovery plans***), which identify options to recover financial strength in stress situations;
- (Resolution) authorities will take the lead in preparing plans (***resolution plans***) setting out modalities for resolving failed banks in a way that preserves their most critical functions and avoids bail out by taxpayers. Resolution authorities must have powers to achieve resolution. In the UK, banks are required to produce resolution packs which are designed to provide information to the authorities to aid resolution planning.

Ensuring that (at a minimum) systemically important banks are resolvable in an orderly manner without taxpayer support is one of the key pillars of the international package of reforms. The Isle of Man is at an early stage in this process (a planning meeting was held with Government representatives and the supervisory authorities of Jersey and Guernsey on 2 December 2015), but will be developing a local recovery and resolution planning framework. The Authority considers that as part of this planning the initial focus should be on those banks that are more systemically important or critical to the local economy.

However, it is also envisaged that there may be circumstances where it is agreed between the home and host supervisors that a bank (not necessarily a local D-SIB in the Isle of Man) that is identified as a D-SIB or G-SIB by the home supervisor should be subject, if it failed, to either:

- Isle of Man recovery and resolution measures (to be developed separately); or
- The home state recovery and resolution process.

This would reflect work already being seen in connection with work on recovery and resolution plans by home jurisdictions. In these cases, the bank and relevant supervisors would normally agree on whether the local (Isle of Man) operation was "in scope", as part of such planning but, ultimately, it is proposed that the decision over whether the operation was in scope would rest with the relevant resolution authority.

Appendix 1 - Glossary of terms

The Authority	Isle of Man Financial Services Authority
Basel Committee	Basel Committee on Banking Supervision
Basel II	"International Convergence of Capital Measurement and Capital Standards", re-issued in comprehensive form in June 2006 by the Basel Committee
Basel III	Collectively, a series of documents issued by the Basel Committee that either revise Basel II or establish new international standards regarding the financial management of international banks
BRRD	EU Bank Recovery and Resolution Directive
CET1	Common Equity Tier 1 capital
D-SIBs	Domestic systemically important banks
G-SIBs	Global systemically important banks
HLA	Higher Loss Absorbency
ICAAP	Internal Capital Adequacy Assessment Process
ICG	Individual Capital Guidance
IOM	Isle of Man
KPs	Twelve Key Principles, from the Basel Committee paper "A framework for dealing with domestic systemically important banks", issued October 2012
Tri-party Group	Comprises the Authority, the Guernsey Financial Services Commission, and the Jersey Financial Services Commission.

Appendix 2 – Summary of Questions

- Q1: Do you agree with the proposed scope and basis of the assessment?
- Q2: Do you think the scope should include the proposed Class 1(2) banks?
- Q3: Do you have any comments on the suitability of the proposed indicators for tracking the four bank-specific assessment factors?
- Q4: Are there any additional factors that the Authority should consider for assessing the systemic importance of banks in the Isle of Man?
- Q5: Do you have any suggestions for suitable quantitative indicators of interconnectedness or complexity?
- Q6: Do you agree that a quantitative indicator approach for size and substitutability is an appropriate methodology to aid transparency of the assessment process?
- Q7: Do you agree that the quantitative indicator for size warrants a higher weighting compared to that for substitutability?
- Q8: Do you have any suggestions on any other qualitative indicators which might usefully be taken into account in the D-SIB assessment process?
- Q9: Do you have any suggestions relating to the criteria to guide the incorporation of supervisory judgement into the assessment process?
- Q10: Do you have any comments on the proposed frequency of assessment?
- Q11: Do you have any concerns or comments with the proposed use of data sources?
- Q12: Do you have any comments on the Authority's proposals for publishing information and sharing decisions with other relevant persons?
- Q13: Do you consider it is appropriate that the Authority does not publish a list of D-SIBs, at the first stage, noting the policy towards this may change in the future?
- Q14: Do you agree that a differentiated, rather than a flat rate, approach to the assessment of HLA is merited?
- Q15: Do you agree that a "bucketing approach", broadly reflective of that used in the G-SIB framework, is appropriate to achieve the differentiated HLA requirements?
- Q16: For a D-SIB in the Isle of Man that is a subsidiary of foreign G-SIB or D-SIB, do you agree that the Authority should assess whether some reliance may be placed on the "group" HLA requirement in determining any local HLA requirement?
- Q17: Do you agree with the above transitional arrangements for HLA buffer requirements?
- Q18: If a foreign bank branch is designated as a D-SIB in the Isle of Man, are there any other factors that the Authority should take into account in addition to those described above, in determining the most appropriate measures to be adopted in respect of such branches?