



ISLE OF MAN
FINANCIAL SERVICES AUTHORITY

Lucht-Reill Shirveishyn Argidoil Ellan Vannin

Summary of Responses to the Consultation on Basel III: Capital Adequacy and Leverage

**This document is relevant to class 1 licenceholders (deposit takers) incorporated in
the Isle of Man**

Consultation period: 30 July 2015 to 30 October 2015

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1. Background

The Isle of Man Financial Services Authority (“the Authority”) issued a consultation¹ during 2015 in order to obtain views on proposals to revise the framework for capital adequacy (including introduction of reporting a leverage ratio) for banks incorporated in the Isle of Man (“IOM Banks”). For the purpose of this document, the consultation is referred to as the “**Basel III Capital Consultation**”.

2. Executive Summary

The Authority received four responses from IOM Banks to its Basel III Capital Consultation. Generally, the proposals were well received and the need for the changes being sought to address specific Basel III issues and to amend the relevant legislation were acknowledged.

3. Summary of Responses

3.1 Overall comments

Respondents generally confirmed that there would be no major impacts from the proposals.

3.2 Responses to questions

3.2.1 Question 1 (costs and benefits)

Are there any specific measures that should be considered that would either increase the benefits of the proposals or reduce any of the associated costs of implementation?

Response:

There were no suggestions put forward to increase the benefits of the proposals or reduce the associated costs of implementation. One bank noted that the offshore jurisdictions (Isle of Man, Jersey and Guernsey) are to implement the capital proposals separately, and requested that as much alignment as possible is used for regulations and reporting templates across the jurisdictions. As far as is possible, the Authority aims to comply with this request, and the reporting templates and guidance included in the Basel III Capital Consultation were already drafted on that basis.

¹ The Basel III Capital Consultation was issued by the Financial Supervision Commission (“FSC”). On 1 November 2015 the FSC was merged with the Insurance and Pensions Authority to form the Isle of Man Financial Services Authority.

3.2.2 Question 2 (reporting forms and completion guidance for the definition of capital)

Do you have any comments regarding the proposed capital definitions as set out in appendix 1?

Response:

No issues were raised.

3.2.3 Question 3 (minor revisions to risk weighted assets)

Do you have any comments on the use of the 250% and 1,250% risk weights for some items currently deducted from capital?

Response:

No issues were raised on the proposed use of risk weights.

One bank noted that the calculation methodology for a) the capital deduction and b) the risk weighted element, was quite complicated, and IOM Banks that would have to apply this may benefit from a further worked example. The Authority will consider this request when issuing final guidance – **see section 5 - next steps.**

3.2.4 Question 4 (transitional provisions: tier 2 instruments)

Would a 2017 deadline provide sufficient time to replace affected instruments (normally being instruments currently held as Tier 2 subordinated debt)? If not, please provide an alternative (also see related question 6).

Response:

Respondents largely commented that they did not hold or rely on such Tier 2 instruments, or that the deadline provided sufficient time. No issues were raised.

3.2.5 Question 5 (prohibition of funding own capital)

Does your bank provide any funding to holding companies that directly or indirectly hold capital instruments issued by it? If so, please comment on the impact of the above and steps that you can take to mitigate the impact, including withdrawing funding.

Response:

None of the respondents provide funding to their holding companies, although one bank noted that there could be insignificant claims that might exist from time to time in respect of intergroup recharges etc. No issues were raised.

3.2.6 Question 6 (write down of alternative tier 1 and tier 2 instruments; contractual terms)

Would a 2017 deadline provide sufficient time to replace or amend any capital issuance that does not meet the proposed standards for regulatory capital?

Response:

Respondents largely commented that they did not hold or rely on such instruments. No issues were raised.

3.2.7 Question 7 (minimum capital requirements, including reporting)

Do you have any comments regarding the proposed Pillar 1 capital requirements, including with reference to the forms and guidance in appendix 3 and the rules in appendix 5?

Response:

Two comments were made regarding the requirements or their calculation:-

One bank raised a question related to the proposed form SR-2C, with respect to the calculation of surplus total eligible capital (in line F9). This bank stated that: “unless it is intended to change the guidance or the regulations, the notification level is just that; a notification point. Dropping below such notification level does not currently give rise to a breach. In consequence, surplus capital is surely that difference between the actual available capital and the minimum requirement?”

The Authority confirms that the notification level is not a minimum and that a bank can operate below the notification level. However, as is currently the case, once a bank’s actual capital ratio falls below the notification level it is a signal that remedial action may be necessary to ensure that sufficient capital is held by that bank to operate above the minimum requirement. Therefore, for reporting and monitoring purposes only the Authority wishes to benchmark surplus capital against the notification level.

Another bank wished to highlight the potential for the D-SIB add-on. This bank commented: “as per our response to the January 2014 Basel III D-SIB discussion paper, we recommend that the CD

regulators develop specific HLA requirements related to D-SIBs operating in the CDs. Applying the G-SIB range of HLA requirements to D-SIB banks in CDs (which generally conduct lower risk banking business) may not be equitable.”

The Authority will be consulting separately on its approach to DSIBs including how HLA requirements may be applied. This separate consultation will not have an impact on moving forward with the main proposals contained in the Basel III Capital Consultation, but will in due course link to the changes needed in the Pillar 2 framework.

3.2.8 Question 8 (pillar 2 and transitional arrangements)

Do you have any comments regarding the proposed Pillar 2 approach, noting that the guidance on Pillar 2 (ICAAP and SREP) will be updated in due course?

Response:

No issues were raised, noting that the Authority will update its Pillar 2 guidance and supervisory approach prior to implementing the proposed new capital requirements – **see section 5, next steps**.

3.2.9 Question 9 (leverage ratio)

Is the form and guidance in appendix 4 sufficiently clear? If not, please provide details of where you think it could be improved / made clearer.

Response:

Respondents considered that the form and guidance in appendix 4 of the consultation were sufficiently clear and did not foresee any issues in completing the form for local reporting.

However, one bank requested that the Authority should issue further guidance on:

- When they expect to introduce a minima for leverage;
- The basis and the process that the Tri-party Group will undertake to set a minima for local leverage requirements; or
- In the event that no minima can be set for any reason, if the CD banks will be required to comply with the international minima under Basel III.

The bank noted that any level of minima that might be introduced would have an impact on their assessment of capital adequacy, which may or may not require the bank to make changes to its current business model. Hence, the bank requested that the Tri-party Group provides clarity over

this requirement as soon as practicable, with a preference that industry is consulted on any such proposed minimum given the importance of this point.

At the present time the Authority does not have any plans to introduce a regulatory minimum for the leverage ratio and certainly not before a period of reporting has commenced. As explained in the Basel III Capital Consultation, the Authority may take a bank's degree of leverage into account as part of its wider supervisory review and assessment of capital under Pillar 2, noting the international minima of 3%. As noted in **section 3.2.8** the Authority will update its Pillar 2 guidance and supervisory approach prior to implementing the proposed new capital requirements, and this will include reference to leverage.

3.2.10 Question 10 (large exposures capital)

Is the period to 2017 sufficient to manage any impact arising from the change to using Tier 1 capital for the purpose of determining the LECB?

Response:

No issues were raised.

3.2.11 Question 11 (other capital adequacy related proposals in Basel III)

Are you aware of any elements of the Basel III package of reforms that you consider either a) warrants earlier introduction or b) should not be introduced in the Isle of Man?

Response:

Generally, respondents raised no issues, although one bank responded as follows:

"The Bank believes that the Basel III element that will have the most impact are any proposed changes to the standardised approach for credit risk and we look forward to the Tri-party Group's comprehensive impact analysis of these rules on CD banks and proposed local treatment (in case of deviations from Basel III) which should be covered in future discussion and consultation papers that will be circulated in due course. The Bank suggests that these papers on new credit risk rules be circulated by the Tri-party Group at the earliest opportunity as it will directly impact on-going assessment of capital adequacy requirements.

Within these papers the Bank would also ask that the Tri-party Group give consideration to the weighting of loans secured against commercial property at 50% where LTVs are <50% and a minimal loss history can be evidenced, consistent with the applicable treatment as set out in both Articles 124 and 126 of CRR / CRD IV and in section 2.5.2 of the BCBS' recent 'Consultative Document on Revisions

to the Standardised Approach for Credit Risk'. The Bank notes that the BCBS publication also proposes a 75% weighting for LTVs <60% secured against such assets which the Group may similarly wish to consider."

The Authority notes the above comments and, as highlighted in the Basel III Capital Consultation, is fully aware that the BCBC proposals have the potential to have a significant impact on IOM Banks. The Authority also provided a summary of these initial proposals to the Isle of Man Bankers' Association on 27 February 2015.

The BCBS has not yet issued feedback following its first consultation. When more concrete final proposals are set out and agreed by the BCBS, with an indicative timeframe for transition, the Authority, in conjunction with the other Tri-Party Group members, will consider the position and consult with the industry as necessary.

4. Post-Consultation Changes to Proposals

Taking into account the feedback received, the Authority is not proposing any material changes to the proposals set out in the Basel III Capital Consultation.

5. Next Steps

The Authority intends to implement the new capital standards and reporting requirements in 2017 with a view to the rules coming into effect from 1 July 2017 (with first reporting due for the quarter ended 30 September 2017).

In order to achieve the above the Authority will be undertaking the following work during 2016:-

- The proposed changes to rules will be included in the next update of the Financial Services Rule Book;
- Final reporting forms and associated guidance will be issued (including taking into account the feedback in section 3.2.3 above), with contingency into early 2017;
- Updated guidance and supervisory policy in respect of ICAAP (Pillar 2) and the supervisory approach will be developed, discussed with industry and issued.

Please direct any related queries to:

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6. Glossary of Terms

Additional Tier 1 capital / AT1	Items permitted within Tier 1 capital, other than CET1 capital
(the) Authority	Isle of Man Financial Services Authority
BCBS	Basel Committee on Banking Supervision
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
CDs	Crown Dependencies – Guernsey, Isle of Man and Jersey
CET1	Common (or core) Equity Tier 1
CRR / CRD IV	(EU) Capital Requirements Regulation and Directive
D-SIB	Domestic Systemically Important Bank
FSC	Financial Supervision Commission
GSIB	Global Systemically Important Bank
HLA	Higher Loss Absorbency (for capital adequacy)
ICAAP	Internal Capital Adequacy Assessment Process
IOM Banks	Isle of Man incorporated deposit takers (banks)
LECB	Large Exposures Capital Base (as contained in the Rules)
LTV	Loan to value ratio
Rules / Rule	Current rules as contained in the Financial Services Rule Book
RWAs	Risk Weighted Assets
SREP	Supervisory review and evaluation process (for ICAAP)
Tri-Party Group	Comprises the Authority, Guernsey FSC and Jersey FSC
Tier 2 / T2	Tier 2 capital (used in forms only)