Jersey Financial
Services Commission

BIS 81-000444
13.04.10

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

9 April 2010

Dear Sir or Madam

Feedback on consultative document: "Strengthening the resilience of the banking sector"

The Jersey Financial Services Commission (the "**Commission**") is responsible for the regulation of banks in Jersey, comprising 46 branches or subsidiaries of overseas banks, with no domestic banks. Each is part of a banking group that has sufficient capital to rank within the top 500 international banks, by Tier 1 capital.

The Basel Committee on Banking Supervision issued the consultative document *"Strengthening the resilience of the banking sector"* (the "**Paper**") in December 2009, with a deadline of 16 April 2010 for responses. The Paper presents part of the Basel Committee's proposals to strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector, the main other part being set out in the consultative document *"International framework for liquidity risk measurement, standards and monitoring"*. The Commission will respond separately to the issues set out in that document.

The Commission has considered the proposals set out within the Paper and has also solicited feedback from local banks with respect to these. The following comments identify certain of the proposals that it would like to see expanded upon. These are in respect of the:

- elimination of certain items from regulatory capital;
- recalibration of capital ratios;
- introduction of a maximum leverage ratio; and
- recommendations in respect of buffers.

Elimination of certain items from regulatory capital

Pension deficits: the Commission has allowed Jersey incorporated banks to deduct from regulatory capital the amount of additional funding required by the scheme's trustees to address the deficit over the next five years, the only alternative being to treat the entire deficit as a deduction.

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The Commission has also established the risks arising from pension deficits as a matter to be considered under Pillar 2, with associated stress testing expected where a bank identifies a material risk. A mandated stress testing approach, based upon projecting the additional funding that would be required by the scheme during the next five years under a stressed valuation of the scheme's assets and liabilities, would seem to be a valid alternative to the Paper's related proposal and the Commission suggests that, as a national discretion, this approach should be made available.

Revaluation losses: the Commission requires that unrealised losses (and gains) resulting from the revaluation of available-for-sale assets be ignored when calculating regulatory capital. The Commission considers such unrealised losses to be a Pillar 2 risk. Where a bank holds such assets, it should consider the circumstances that would lead to the losses being realised, such as forced sales resulting from credit rating downgrades.

The Commission also considers it relevant that proposed changes to international accounting standards may allow such assets to effectively be classified as held-to-maturity, eliminating the available-for-sale category. In view of this, the Commission considers that its current approach is proportionate in the near term and that this issue should be revisited to fully take into account ultimate changes to international accounting standards and US GAAP (which may move in the opposite direction i.e. towards revaluing held-to-maturity assets such as loans).

Other deductions from Common Equity: the other proposals, including minority interests and deferred tax benefits, are not significant for most banks in Jersey. However, the Commission considers that the final proposals should provide greater clarity on whether any of the stated deductions from Common Equity should also be applied to broader Tier 1 and Tier 2 capital calculations.

Recalibration of capital ratios

Most banks incorporated in Jersey have capital adequacy ratios significantly in excess of 8%, with all banks being required to maintain a capital adequacy ratio that exceeds 10%. Higher levels are required where unmitigated Pillar 2 risks are identified. Most of this capital is in the form of common equity, with only limited issuance of preference shares or subordinated debt.

The Commission therefore expects that the impact in Jersey of introducing minimum capital adequacy ratios based on common equity, or Tier 1 capital alone, would be minimal, providing that these are set at or below the 8% minimum currently recommended by the Basel Committee.

A change in the 8% recommended minimum ratio based on total capital would have a greater relevance for the Commission and it would seek to understand the rationale for such recalibration. In that respect, does the intended (but as yet unspecified) recalibration reflect specific risks that are currently underestimated or does it reflect a more general international consensus that banks should be safer?

Introduction of a maximum leverage ratio

The Commission considers that a maximum leverage ratio (we address this herein as the ratio of exposure to capital) is a useful measure, but is less certain that it can be internationally calibrated, given the wide range of banking models and accounting standards. The initial step of introducing such a measure is therefore supported in principle but moving to a hard limit in Pillar 1 may be more problematic.

In Jersey's specific case, most banks have balance sheets dominated by low risk assets, with a typical risk weight of 20%. Introducing a maximum leverage ratio set significantly below 30, which would require such banks to hold more capital than required by Basel II, might have undesirable consequences. These could include artificial restructuring of balance sheets, involving a move towards higher risk assets in order to utilise surplus capital.

Of the various options to define the leverage measure, the standardised approach treatments for derivatives and off-balance sheet items seem to have the major advantage of limiting the impact of differing accounting standards and being familiar to both banks and regulators. These are therefore the Commission's preference.

Recommendations in respect of buffers

The Commission does not consider that the proposals in respect of buffers contained sufficient detail to allow the impact to be determined and it is not clear how these measures interact with Pillar 2. The Commission welcomes further guidelines regarding macro-prudential regulation but considers that the current proposals are not sufficiently formed, including whether the principal aim is to protect banks or to provide an additional tool to control the wider economy. If the latter is the underlying motivation, the interaction of this tool with other controls, such as monetary and fiscal policy, is not clear.

The proposal requires an internationally active bank to look at the geographic spread of its credit exposures and calculate its buffer as a weighted average of the buffers applied in the jurisdictions involved. It is unclear whether or how the various national bodies are expected to

co-ordinate their decisions in this respect (it may well be the case that the home regulator/central bank/government wishes to constrain credit creation at the same time as a host government seeks to increase it locally).

Overall view of proposals

The Commission has had little feedback from banks in Jersey regarding the detailed proposals for enhancing risk coverage, reflecting the fact that few banks in Jersey have significant exposure in the areas addressed or use the Advanced Approaches (which are most impacted).

The Commission does not believe that the changes proposed are necessary in Jersey at this time, given the limited risk profile of most Jersey banks and the introduction and use of Pillar 2, with the consequent ability to levy additional capital charges where warranted. However, the Commission recognises the international background to this and considers that implementation of most proposed measures will be feasible within the medium term. An approach to implementation that allows time to effect a smooth transition would be welcome.

The Commission confirms that it is happy for this response to be included within any publication of feedback and is willing to provide additional clarification in respect of any of the above points where requested.

Yours sincerely

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Dear Sir or Madam

Feedback on consultative document: "International framework for liquidity risk measurement, standards and monitoring"

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The Commission's current liquidity risk management framework includes quantitative limits on contractual liquidity mismatches, calculated over one week and one month, with no longer term limits. This involves the application of behavioural adjustments but only where banks provide adequate supporting analysis. Liquid assets are reported so as to reflect saleability, rather than maturity, after the application of standard haircuts. Prudential reporting follows this approach, with all items being reported according to contractual maturity, with behavioural adjustments separately applied.

The Net Stable Funding Ratio ("**NSFR**") proposal in the Paper would be a relatively new concept here, whereas the Liquidity Coverage Ratio ("**LCR**") proposal and related reporting proposals would represent a development of existing measures.

The Commission has considered the proposals set out within the Paper and has also solicited feedback from local banks with respect to these. The following comments identify certain aspects of the proposals that it would like to see addressed. These principally relate to the LCR

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proposal, reflecting the fact that most banks in Jersey have few long term assets, hence reducing the impact in Jersey of the NSFR proposal. Our comments are in respect of the:

- scope of application
- classification of liabilities and run-off rates;
- undrawn facilities; and
- classification of liquid assets.

Scope of application

Solo versus consolidated: the Paper states that the proposals are intended to be applied at the consolidated level for internationally active banks. The Commission considers that this is similar to the scope of application of Basel II, which has become a de-facto standard for solo reporting as well as consolidated. Hence, the Commission considers that guidance should include issues that arise from a solo application, such as the treatment of intra-group placements (see below).

Branches: the Commission does not currently impose limits on branches, although prudential reporting requirements still apply to these banks. This reflects its belief that the home regulator is best placed to monitor and limit liquidity risk.

The Paper is silent on this issue, which could lead to a variety of approaches being adopted, hindering consistency. It is suggested that, where the host regulator is comfortable that the home regulator undertakes equivalent regulation of liquidity, a solution would be for the branch to report consolidated company data (produced for the home regulator) to the host regulator, to evidence compliance at a company level.

Further cross-jurisdictional issues: the treatment of intra-group placements in the LCR and NSFR ratios is not addressed in the Paper. Issued guidance could limit the risk that different regulators would apply different rules where intra-group placements cross borders, leading to anomolous results e.g. in circumstances w here a bank upstreamed deposits to a parent in another jurisdiction, the host regulator permitted contractual repayments of these to be included in the LCR, whereas the home regulator required that all intra-group transactions be excluded. The Commission is of the view that such placements should be treated on a contractual basis, rather than the asymmetric treatment now mandated by the UK Financial Services Authority.

The Commission also considers that the final proposals should address the treatment of overseas operations in consolidated/company level reporting. One solution might be for local rules to apply to the classification of items and for standard assumed run-off rates to be established that would apply to both local and consolidated reporting.

Disclosure: the public disclosure requirements suggested in the Paper appear to be most useful at a consolidated level, in similar fashion to Pillar 3 of Basel II, especially where a subsidiary's market issuance is limited or zero, which lessens the role of market discipline. As such, a Pillar 3 approach is favoured.

As an alternative, a limited disclosure in respect of compliance with local regulators' requirements may actually be more useful to depositors than the very comprehensive disclosure requirements proposed.

Classification of liabilities and run-off rates

The Commission supports the general approach of establishing categories of liabilities and guidelines for standard expected run-off rates but believes that the detailed classification rules surrounding the categories should be more flexible than currently proposed, to allow local regulators to make adjustments to reflect local market conditions. For Jersey, this might include an expanded classification of retail/SME deposits, both to exclude certain high value deposits and to include certain intermediated deposits (currently dependent on further work to identify deposits where the behaviour is akin to retail/SME deposits).

Similarly, the Commission believes that the run-off rates proposed should be subject to greater flexibility to reflect different local conditions. This could be achieved by allowing national discretions in all cases, with the proposed run-off rates being established as generally applicable recommendations.

In the case of retail fixed deposits, the Commission considers that where a bank treats such deposits as contractually committed until maturity, these should not attract the same assumed run-off rate as other retail deposits. The Commission bases this conclusion on only limited experience of stressed banks but considers that multi-year deposits are less likely to roll-over on maturity than one month and shorter dated deposits in unstressed situations; and that this pattern would be likely to persist in stressed circumstances.

The Commission also considers that certain other liabilities, including CDs issued, may behave in a similar manner to fixed deposits, particularly in the retail market. The terminology should

therefore be amended to reflect both this and, conversely, circumstances where adjustments should only be made in respect of deposits.

Lending facilities

The Commission considers that undrawn facilities vary widely in nature and that similar flexibility to that detailed above should be made available to local regulators. Specifically, the Commission considers that lines of credit extended to a wider variety of customers than identified in the Paper should attract an assumed draw down of less than 100%, where historical behaviour supports this. For example, the Commission considers that governments and public sector entities (the Paper proposes 100%) are not significantly more likely to draw down lines than non-financial corporates (10%).

The Commission also believes that classifying factors such as size, nature of the facility and standing of the customer should be considered. The division in the Paper between credit and liquidity facilities appears artificial in that the proposals imply that an existing commitment to refinance maturing debt would be deemed a credit facility and attract a lower assumed draw down rate (10%) in the LCR proposals than a back-up liquidity facility to refinance the same debt in case of need (100%), whereas the likelihood of draw down is similar.

The statement in the "Retail Inflows" section of the LCR proposals that *"any planned outflows needed to refinance outstanding loans should be reflected fully as outflows"* implies that all related inflows and outflows should be reported on a gross basis. However, this would seem to be unnecessarily complicated and the Commission would suggest that net figures only should suffice.

Classification of liquid assets

The Commission supports the proposal that corporate and covered bonds be included within liquid assets. The Commission further considers that certain bonds issued by financial institutions should be eligible, based on the stated corporate criteria. It should also be possible to apply alternative criteria at a local level, e.g. to avoid geographic and sub-sector concentration. In arriving at this conclusion, the Commission considers that a diversified pool of bonds issued by regulated, high grade banks would exhibit better liquidity and less price risk than a concentrated pool of sub-investment grade sovereign debt, although only the latter is currently proposed to be a "liquid asset".

The Commission considers that concentration risk is the principal issue in this respect and that criteria should apply in respect of the amount of liquidity placed with governments, corporates and covered bonds, particularly where counterparty ratings are low. For example, the proposals allow banks to meet all liquid asset requirements from holdings of a single government's debt, which seems unduly risky, particularly where that debt is less liquid or low rated.

Overall view of proposals

The Commission does not consider that the changes proposed are necessary in Jersey at this time, given the liquidity profile of most banks and the efficacy of current regulations. However, the Commission acknowledges the wider international background to this subject and considers that implementation of most proposed measures will be feasible within the medium term, provided that they contain sufficient flexibility to allow regulators to adopt an approach that is appropriate to the risk profiles of their banks.

An approach to implementation that allows time to effect a smooth transition would be essential, allowing necessary time for banks to rebalance their liquidity profiles to meet the new requirements without incurring undue costs relating to the exit of holdings that are no longer eligible.

The Commission confirms that it is happy for this response to be included within any publication of feedback and is willing to provide additional clarification in respect of any of the above points where requested.

Yours sincerely

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