FSC Newsletter

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Financial Services Commission

Background to the Capital Requirements Directive

Introduction

This Newsletter is directed to locally incorporated credit institutions licensed under the Banking Ordinance 1992 and investment firms authorised under the Financial Services Ordinance 1998. The aim of the newsletter is to provide background information to the imminent implementation of the Capital Requirements Directive.

Implementation Committee

The Government of Gibraltar, has set up an implementation committee, coordinated via the Finance Centre. The Committee includes representatives from the Government, the FSC, the Gibraltar Bankers Association, the Gibraltar Association of Stockbrokers and Investment Managers and the Gibraltar Society of Chartered and Certified Accountancy Bodies.

The role of the Committee is to assess how best the requirements of the Directive can be tailored for local firms.

Background to Basel I

In July 1988, the BCBS published 'International Convergence of Capital Measurement and Capital Standards' to address Capital Adequacy within the worldwide banking system. While the scope of the application of these standards was initially limited to large international banks incorporated in countries represented in the Basel Committee, it is now applied in more than 100 jurisdictions. In addition, in many jurisdictions, banks having solely domestic operations are subject to these standards, regardless of their size or the scope of their activities.

The purpose for setting these International Standards was to obtain a definitive benchmark to measure a credit institution's capital. Basel I's aim was to set the minimum prudential amount of capital required to keep a credit institution solvent. It's purpose was to strengthen market and consumer confidence in the system and avoid the costly institutional failures due to the insolvency of a number of large banks.

Definition of Regulatory Capital

Regulatory capital and capital adequacy are intended to ensure that a credit institution can withstand major losses without causing a banking crisis that could threaten the financial system's integrity.

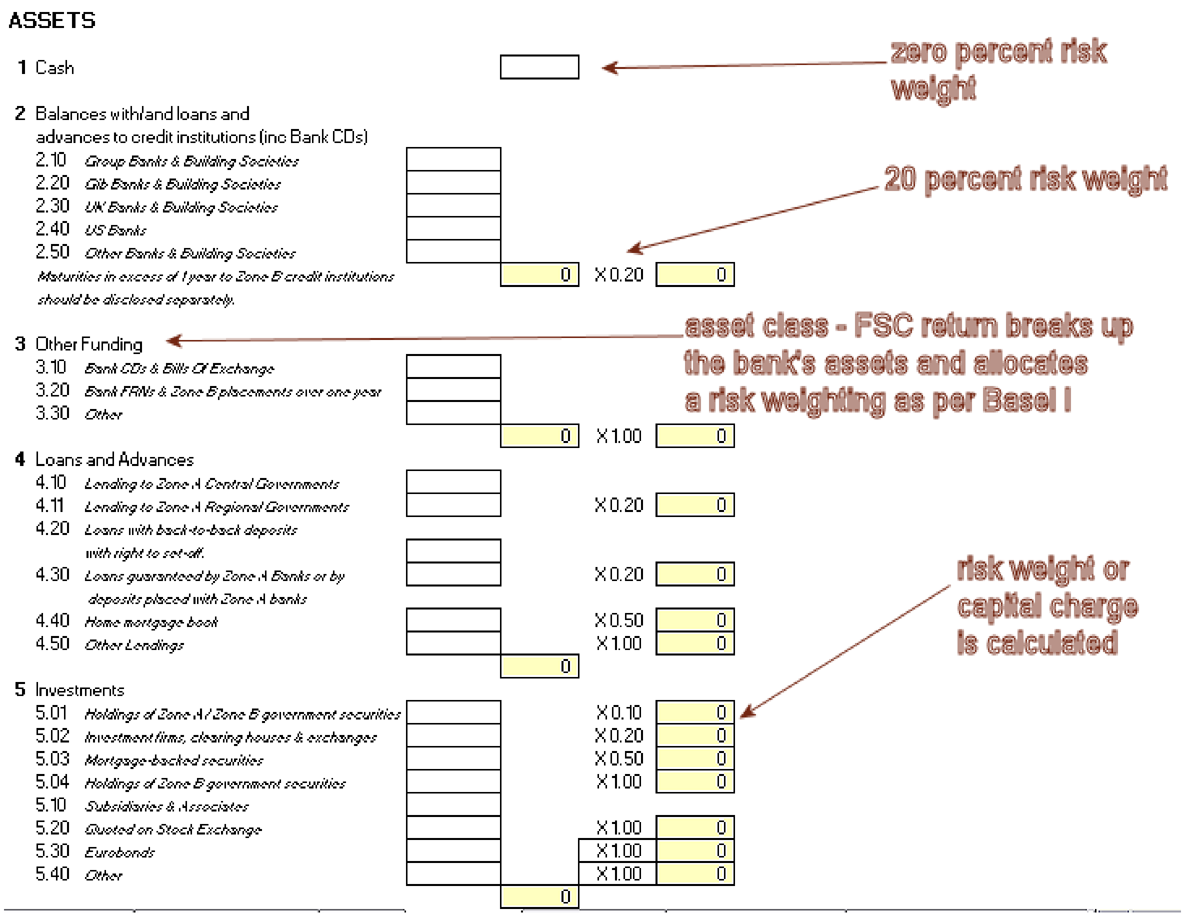
One of the main characteristics of the regulatory definition of capital is that eligibility criteria are prescribed in a largely similar way around the world. Over time, consistency in defining regulatory capital has increased as a large number of countries have adopted Basel I. This has permitted greater comparability among banks and has contributed to levelling the playing field for banks internationally.

Minimum capital ratio of 8 percent.

Basel I set the minimum capital requirement at 8 percent. Therefore the Capital Accord provided institutions and regulators alike with a rudimentary framework to measure credit exposures. The Accord introduced a basic risk sensitive capital adequacy regime which provided essentially only one option for measuring the appropriate capital of internationally active banks. This is regardless of the risk mitigation techniques applied by different firms or the perceived risk exposure of the credit institution's portfolio. The Basel I Accord is contained in the Banking Consolidation Directive (2000/12/EC) which was transposed via the Banking Ordinance 1992 and the various Administrative Notices issued by the FSC.

The FSC Banking Return shown below (Fig 1) provides an example of the measurement methodology currently used under Basel I Capital Accord. All credit risk exposures, including off-balance sheet items converted into on-balance sheet equivalents are risk weighted by using supervisory risk weightings based on the degree of risk. A supervisory risk weighting is an estimate of the credit risk associated with an exposure. Expressed as a percentage, it is used to translate the nominal amount of a credit exposure into a risk-weighted asset (RWA). The higher the risk, the higher the risk weighting assigned to that exposure.

Fig 1



ASSETS				
1 Cash				
2 Balances with/and loans and advances to credit institutions (inc Bank CDs)				
2.10 *Group Banks & Building Societies*				
2.20 *Gib Banks & Building Societies*				
2.30 *UK Banks & Building Societies*				
2.40 *US Banks*				
2.50 *Other Banks & Building Societies*				
Maturities in excess of 1 year to Zone B credit institutions should be disclosed separately.		0	X 0.20	0
3 Other Funding				
3.10 *Bank CDs & Bills Of Exchange*				
3.20 *Bank FRNs & Zone B placements over one year*				
3.30 *Other*				
		0	X 1.00	0
4 Loans and Advances				
4.10 *Lending to Zone A Central Governments*				
4.11 *Lending to Zone A Regional Governments*			X 0.20	0
4.20 *Loans with back-to-back deposits with right to set-off.*				
4.30 *Loans guaranteed by Zone A Banks or by deposits placed with Zone A banks*			X 0.20	0
4.40 *Home mortgage book*			X 0.50	0
4.50 *Other Lendings*			X 1.00	0
		0		
5 Investments				
5.01 *Holdings of Zone A / Zone B government securities*			X 0.10	0
5.02 *Investment firms, clearing houses & exchanges*			X 0.20	0
5.03 *Mortgage-backed securities*			X 0.50	0
5.04 *Holdings of Zone B government securities*			X 1.00	0
5.10 *Subsidiaries & Associates*				
5.20 *Quoted on Stock Exchange*			X 1.00	0
5.30 *Eurobonds*			X 1.00	0
5.40 *Other*			X 1.00	0
		0		

Market Risk Amendment

In 1993 the Basel Committee proposed an amendment to Basel I. This amendment introduced the market risk element to measure a credit institution's exposure to market risk. In the lead up to this amendment the Basel Committee had noted that credit institutions, through their trading and the liberalisation of international markets, had increased their exposure to market risk. There was no internationally recognised way to measure this risk and there was no capital charge set aside for exposures in this scenario. The Market Risk Amendment requires that banks hold regulatory capital against market risk – i.e. to support their trading book.

This requirement was introduced in the EU via the Capital Adequacy Directive (1993/6/EEC) which was transposed via the Banking Ordinance Administrative Notice Number 7 and likewise for investment services firms under the Financial Services Ordinance 1998 Administrative Notice Number 1. The Capital Adequacy Directive required both credit institutions and investment firms to measure and set aside capital relative to their market exposure.

Basel II

Since the introduction of Basel I, supervisors have sought to ensure that credit institutions maintain adequate capital to cover all risks. The supervisory landscape has moved substantially since 1988 to a more risk focused/risk sensitive approach to supervision which is reflected in the way institutions operate.

More than a decade later, the evolution of banking worldwide and the realisation that the best way to measure, manage and mitigate risks, differs from bank to bank, led the Basel Committee to initiate revisions to the 1988 Accord. First proposed in 1999, and due to come into effect in many jurisdictions by the end of 2006, the revised Capital Accord– Basel II – is a comprehensive agreement that establishes a spectrum of risk sensitive approaches for a credit institution's calculations of minimum capital requirements. It provides a supervisory review process for banks to maintain capital at levels commensurate with their risk profiles and encourages market discipline by requiring the disclosure of pertinent information.

The Evolution of the New Basel Accord

Basel II is structured around three so-called pillars -

- **Pillar 1** - relates to the minimum capital requirements each credit institution must hold to cover its exposure to credit, market and operational risk. Likewise investment firms must maintain similar minimum capital requirements for market risk and operational risk.
- **Pillar 2** - is concerned with supervisory reviews that aim to ensure that a bank's capital level is sufficient to cover its overall risk.
- **Pillar 3** - relates to market discipline and details minimum levels of public disclosure.

Pillar 1 provides credit institutions with a choice between two broad methodologies for calculating their capital requirements for Credit Risk. One option is to measure credit risk in a standardised manner, supported by external credit assessments such as those provided by credit rating agencies. The alternative methodology, which is subject to the explicit approval of the bank's supervisor, allows banks to use their own internal rating systems.

Under the Standardised Approach (SA), credit institutions use a risk-weighting schedule for measuring the credit risk of bank assets. The risk weightings are linked to ratings given to sovereigns, financial institutions and corporations by external credit rating agencies.

The Internal Ratings Based Approach (IRB) allows credit institutions to use their own internal ratings of counterparties and exposures, which permits, a finer differentiation of risk for various exposures and hence delivers capital requirements that are better aligned to the degree of risk.

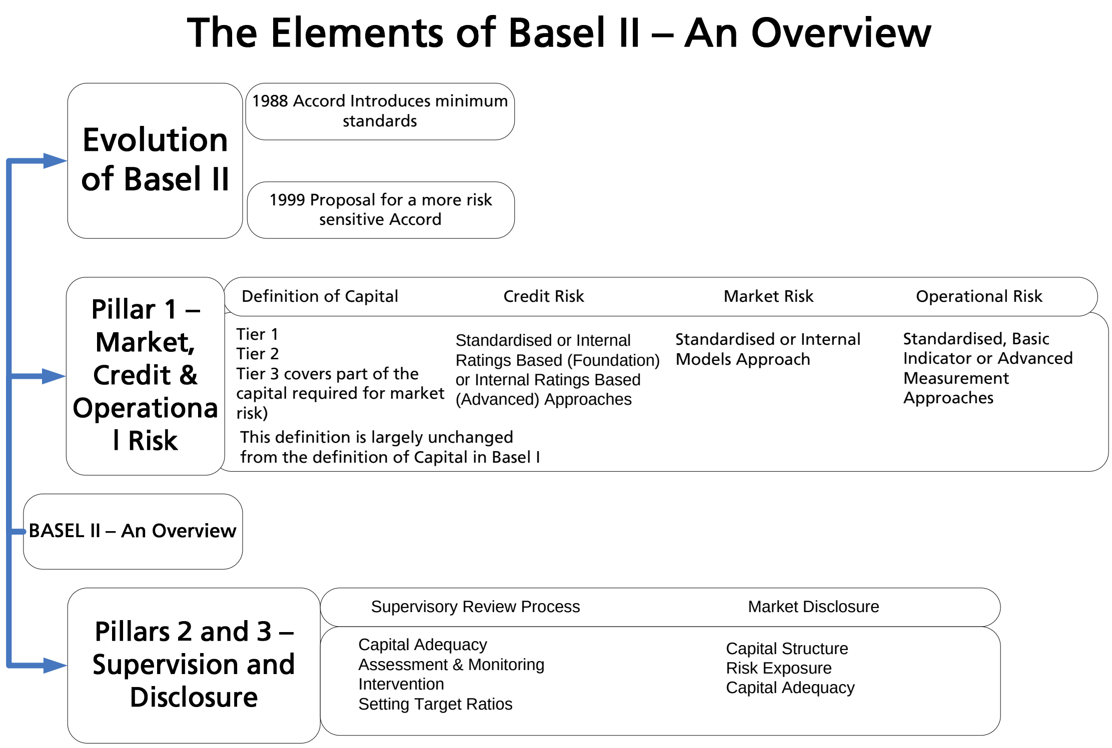
Additionally the new framework also makes some amendments to the Market Risk element. It allows firms who wish to go for more advanced approaches for measurement to use their own market risk models. This methodology requires pre-approval by the relevant supervisory authority.

A completely new element which has not been measured before is that of operational risk. Since the inception of the first accord, operational risk has been an area which has not been measured or supervised effectively. This has in turn resulted in a number of famous losses/collapses due to fraud, for example – Barings Bank.

Therefore the new accord has attempted to capture this risk within the Capital Requirements for a credit institution and investment firm. The new element allows for 3 choices as to what measurement methodology the firm wishes to adopt. These range from the Basic Indicator approach to the Standardised approach to the Advanced Measurement approach. Again as for Credit Risk and Market Risk the measurement approach which the firm wishes to adopt must first be discussed and approved by the regulator.

Fig 2 below provides a diagrammatical representation of how the new elements of the Basel II Accord interlink within the framework.

Fig 2



Pillar II – Supervisory Review

Under this pillar a supervisory agency is responsible for ensuring that a firm maintains adequate capital resources for the risks it carries on its books. To do this a supervisory agency will be required, under the Accord, to periodically check – i.e. question management and re-examine - the procedures and controls in place to ensure that the firm is able to maintain the required standard.

The Accord establishes that once an institution has chosen the relevant methodology to measure its risks the systems and controls must be maintained to achieve high quality standards of data. This is to ensure that the risks are properly measured and that stress testing is done on the models used to verify that they capture severe downturns in economic cycles. Thus the institution should have the right amount of capital set aside.

Pillar III – Market Disclosure

The Accord envisages financial groups making more transparent disclosures with respect to their financial reporting. This is intended to make firms subject to "Market Discipline" i.e. the markets will decide, based on a firm's disclosures, what credit quality it should be assigned. Therefore it is not only the supervisory process that should ensure a firm maintains adequate capital reserves but also this new element of being judged by peers.

The EU Dimension

The European Union has decided that the Basel II Capital Accord will be implemented – in modified form – throughout the EU. Therefore the Commission and EU Parliament have spent some time drafting a new EU Directive – The Capital Requirements Directive. This is intended to replace the Banking Consolidation Directive (2000/12/EC) and the Capital Adequacy Directive (1993/6/EEC).

How does this affect Gibraltar?

Gibraltar as part of the EU is required to implement the Directive by 1st January 2007. On this date the jurisdiction is required to be able to measure and ask firms to report using the standardised approaches for all three elements under Pillar I. As of 1st January 2008 the jurisdiction needs to have legislation in place and reporting requirements for firms to be able to report using the more advanced methodologies if these have been adopted by them.

It is expected that the final Directive will be published sometime during the summer. Publication has been delayed due to the EU having to translate this huge document into the languages of the 25 member states. Currently the FSC and the Implementation Committee is working from draft copies of the final directive.

The Directive will impact credit institutions to a much greater extent than investment firms, however because the Capital Adequacy Directive (1993/6/EEC) also applies to investment firms authorised under the Financial Services Ordinance 1998 there will still be some impact on investment firms. Although the conclusions below mainly refer to credit institutions, given the greater impact on these, investment firms also need to be aware of the requirements of the new Directive and the potential impact that this will have.

Impact for Credit Institutions – Pillar I

Management of locally incorporated institutions will have to decide what models they wish to adopt for their firms. They will then have to communicate these to the FSC and the FSC will examine these based on the information provided prior to approving them. The FSC would look to the home regulator as envisaged in the Accord to ensure that the rest of the group has adopted a similar approach which has been approved by that regulator. The more advanced the proposed approach, the more information and testing of the models to be used that will be required.

It is expected that most of the locally incorporated banks will adopt the more simplified measurement approaches. Most of the local banks do not collect the vast amount of data needed to be able to come up with solid statistical models to undertake advanced measurement approaches. Furthermore there is no external credit agency data regarding the local market therefore banks with a substantial "local retail" portfolio will not have this data available to them.

EEA branches will follow what has been agreed by their head office with their home member state supervisor. These will have little impact in the way the FSC supervises them since they do not have local capital requirements and it is expected that reporting to the FSC will not change.

With regards to Market Risk none of the locally incorporated credit institutions have any major market positions so it is expected that the new Accord will have little impact on this area.

In terms of Operational Risk – most credit institutions follow their parental procedures and controls models. A lot of the local firms outsource their back office activities to group "centres of excellence" and it is envisaged that some simulation runs to obtain a better view of what capital impact this element may have if any may be conducted.

Impact for Credit Institutions – Pillar II

In terms of Pillar II the FSC envisages at this stage that it will not have a significant impact in its approach to authorised firms. The rationale behind the statement is that the Accord requires supervisory authorities to examine that firms are maintaining systems and controls required for the chosen model. Since the FSC supervises firms using a risk based methodology via the FEB COM criteria this can be extended to review capital adequacy models.

Pillar III

Pillar III requires market disclosure by major financial groups. Since most of the locally incorporated credit institutions are members of larger financial groups, their parents can take care of this requirement. Furthermore firms which are not materially important in terms of size, when compared to the rest of the group, can have this requirement under the Accord waived. Therefore this will have a minimal impact on credit institutions and investment firms alike.

Investment Firms

It is envisaged that the locally incorporated investment firms will adopt the basic models to measure capital adequacy under the Directive due to their size and the nature of their business.

Implementation & Reporting

As indicated previously, Gibraltar as part of the EU is required to comply with the Directive which requires implementation of the standardised approach models to be available as from 1st January 2007. This means that the relevant laws and rules will need to be in place by then. Prior to this deadline, firms who have opted for the standardised approaches will be contacted by the FSC to arrange for a date for commencing parallel reporting runs under the current reporting requirements and the new regime.

The FSC will be taking what it considers to be a pragmatic approach to the reporting requirements and will consult with firms on a case by case basis to establish when they will be ready to move onto the new regime. The FSC does however strongly encourage all industry stakeholders to make best efforts to meet the 1st January deadline so that parallel reporting runs can commence as soon as possible.

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