

## WEIGHING UP THE RISK: BASEL III FOR ISLE OF MAN BANKS

by Andrew Newton

The financial crisis and subsequent “great recession” has been described by former Federal Reserve Chairman, Ben Bernanke, as the worst financial crisis in global history, worse than the Great Depression of the 1930s. As a result, regulators globally have reacted; and, in particular in the banking industry, this has included the wide adoption of the Basel III capital adequacy recommendations of the Basel Committee. The Financial Supervision Commission of the Isle of Man (FSC) has, in conjunction with its counterparts in Jersey and Guernsey, issued a public consultation on embracing the Basel III recommendations.

The Basel Committee on Banking Supervision is a body that has, since its conception following the exchange rate breakdown of 1973, provided a forum and recommendations for banking supervision matters. The Committee previously recommended capital adequacy (a ratio to measure risk of insolvency) changes in the form of the Basel I framework in the late 80s and Basel II in 2004.

Following the economic slump conclusions were drawn that too much leverage and inadequate liquidity management were salient causal factors; and, even as Lehman Brothers collapsed, the need to develop Basel II was being discussed. As a means to temper the industry and protect against such failings in future, in the fall of 2010 the Basel Committee introduced new capital and liquidity recommendations in the form of Basel III. Basel III has seen adoption globally, with EU countries already having in-place the risk-based capital and leverage disclosure elements of the recommendations and many other countries embracing all the Basel III recommendations.

The FSC plans, subject to the responses of the consultation which closes on 30 October 2015, to introduce the Basel III proposals in 2017, suitably tailored to the Island’s circumstances. The expectation is that the

proposals are not controversial given their wide adoption globally; and, the FSC estimate that the majority of Isle of Man banks are part of groups that are already subject to or familiar with Basel III from exposure elsewhere, limiting compliance issues.

The current demands for class 1 deposit taking licence holders in regards to capital adequacy is to have a total capital ratio of 8%. This ratio relates to an assessment of the risk to the bank of the assets it holds to measure the risk of insolvency due to heavy losses. Under the proposals the ratio will rise to 10%. This is less than the Basel III proposals (10.5%) but the FSC currently employs a notification requirement once the capital ratio falls to 10.5% and this will rise to 11% under the proposals to provide a 1% cushion.

Total capital is made-up of Tier 1 and Tier 2 capital. Tier 1 relates to capital that can be used to absorb losses without the bank ceasing trading; whereas, Tier 2 relates to capital that can absorb losses if the bank is being liquidated. Under the proposals Tier 1 will have a ratio of 8.5% (in line with Basel III) but also Common Equity Tier 1 (CET1) (a sub-division of Tier 1 representing the highest quality capital a bank holds) will also have a ratio of 8.5% (Basel III is 7%). The reason for this is that the FSC deems the majority of Isle of Man Banks hold capital considered CET1 standard and therefore the ratio has been set at the same level as Tier 1.

The FSC's proposals also include amendments to the definition of capital for calculating risk, including prescribing risk percentages to certain securitisation exposures and significant investments in commercial entities. Many of the Basel III proposals in regard to risk weighted assets have not been embraced in the FSC's proposals as the local impact will be extremely limited being relevant more to banks with trading books and those involved with securitisation.

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