BASEL II & III IMPLEMENTATION ROAD MAP

November 2013

1. Introduction

The Central Bank of The Bahamas ('the Central Bank') has adopted a Basel Implementation Program comprising elements of both the Basel II and Basel III frameworks that will be appropriate to the types of banks and the scale of their operations within this jurisdiction.

While certain new elements will be introduced in terms of capital measurement, risk management, disclosure requirements amongst others, the program seeks to consolidate and build on some of the Central Bank's earlier initiatives around Basel II and Basel III themes. The Central Bank has already established some of the preconditions for Basel II implementation in particular for Pillar 2 requirements through its Risk Based Supervisory Framework. The Central Bank will continue to build on some of its earlier initiatives by focusing its attention on adoption of supervisory policies and systems that will enable a comprehensive, realistic and phased-in approach by establishing key milestones, presented under the three pillars of Basel II as well as the Basel III framework.

This document gives an overview of and sets out the Central Bank's Basel II and III Implementation Program and provides an indication of its timelines and key deliverables/expectations.

2. Basel II

On June 26 2004, the Basel Committee on Banking Supervision ('BCBS') released a document called *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, also known as Basel II* (finalised in June 2006). Basel II is based on three defining Pillars i.e., Minimum Capital Requirements, Supervisory Review and Market Discipline. It describes a more comprehensive measure and standard for capital adequacy that seeks to improve on the existing Basel I rules by aligning regulatory capital requirements more closely to the underlying risks that banks face. The framework requires banks to measure the riskiness of their assets with respect to credit, market and operational risks and it seeks to ensure that risks inherent in banks' portfolios are better reflected in the minimum capital requirements, risk management practices and accompanying disclosures to the public. Notably under the revised framework, the definition of what qualifies as regulatory capital and the minimum risk-weighted capital ratio requirement remains substantively unchanged from the Basel I requirements.

Basel II has several individual areas of national discretion, which the national supervisor has some degree of flexibility in the unique design and implementation of the framework; the Central Bank will through appropriate benchmarking and industry dialogue/consultation seek the necessary inputs as it establishes its Basel II rule book for these various areas.

In summary, the three defining Pillars of Basel II are as follows:

a. PILLAR 1 – CREDIT RISK

Pillar 1 provides details of how banks must calculate their minimum capital requirements. It suggests various approaches for calculating capital for credit, market, and operational risk. The Central Bank has determined that the Standardized Approach for Credit Risk capital measurement will be more appropriate for banks within this jurisdiction, notwithstanding that some banks may be subsidiaries of large international banks that are subject to the more advanced approaches in their home countries.

b. PILLAR 1 – OPERATIONAL RISK

The Basic Indicator Approach is the most likely approach; however the Standardised Approach or the Alternative Standardised Approach (ASA) may be considered for some banks. Banks using the Basic Indicator Approach must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income.

The Central Bank will allow banks who meet the qualifying criteria to use the Standardized Approach. Under this Approach, banks' activities are divided into eight business lines: corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage. Accordingly, within each business line, gross income is a broad indicator that serves as a proxy for the scale of business operations and thus the likely scale of operational risk exposure within each of these business lines. The capital charge for each business line is calculated by multiplying gross income by a factor (denoted beta) assigned to that business line. Beta serves as a proxy for the industry-wide relationship between the operational risk loss experience for a given business line and the aggregate level of gross income for that business line.

c. PILLAR 1 – MARKET RISK

The Central Bank has completed its implementation of the 1996 Market Risk Amendment to Basel I, with the release of the Guidelines for the Management of Market Risk in December 2012. It is not envisaged that any changes will be made to the framework for Basel II, given the limited trading book activity and number of banks that are subject to a market risk capital charge.

d. PILLAR 2 – SUPERVISORY REVIEW PROCESS

The Central Bank has already established some of the preconditions for Basel II implementation in particular for Pillar 2 requirements, through its Risk Based Supervisory Framework. Notably, Pillar 2 concerns the supervisory approach to banks' capital management. Importantly, it calls for banks to have a process for assessing their overall capital adequacy and a strategy to maintain their capital levels. Pillar 2 also establishes an expectation on supervisors to impose higher capital requirements in excess of Pillar 1 capital requirements where warranted. Pillar 2 reinforces Pillar 1 by addressing key risks and factors not covered under Pillar 1. Central to Pillar 2, is the requirement that banks make an assessment of capital required to support all their material risks which is referred to as the Internal Capital Adequacy Assessment Process (ICAAP). The purpose of the ICAAP is to ensure that banks have sufficient available capital to meet the minimum capital requirements, even under stressed scenarios. Banks are expected to address weaknesses and gaps in their risk management framework, and use better risk management techniques in the monitoring and management of risks.

The Central Bank will introduce an ICAAP framework, which is intended to provide banks' board and senior management with an ongoing assessment of the bank's risks and how much current and future capital is necessary having considered other mitigating, factors. The Central Bank will use the ICAAP framework to understand the bank's ICAAP and to determine whether there should be additional capital requirements to supplement the minimum capital requirements under Pillar 1.

e. PILLAR 3 – MARKET DISCIPLINE

Pillar 3 introduces requirements for banks to disclose their risk information to the financial markets, to allow market participants to gauge the capital adequacy of banks, to better enable them to exert discipline on banks' behavior. Banks will be required to make core and supplementary disclosures on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. Pillar 3 reinforces Pillars 1 and 2 through the use of increased disclosure requirements, to impose market discipline on financial institutions.

3. Basel III

In response to the key lessons learnt from the 2007/2008 global financial crisis, the Basel Committee released in December 2010 (revised June 2011), *Basel III: A global regulatory framework for more resilient banks and banking systems,* also known as Basel III.

Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to:

- improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
- improve risk management and governance
- strengthen banks' transparency and disclosures.

As a consequence of this new initiative, which came into effect 1st January 2013, banks are expected to maintain a minimum of 3.5% for Common Equity to Risk Weighted Assets (CET1), the highest quality of capital. This ratio would increase by 0.5% each subsequent year to reach a maximum of 4.5% on 1st January, 2015. Further, beginning 1st January, 2016, a Capital Conservation Buffer would be introduced, in increments of 0.625% each year until 1st January 2019, accumulating to 2.5%, such that when combined, the minimum CET1 (4.5%) plus the Capital Conservation Buffer of 2.5% would bring the CET1 requirement to 7%. These reforms raise both the quality and quantity of the regulatory capital base and enhance the risk coverage of the capital framework.

Basel III introduced a minimum Leverage Ratio. The Leverage Ratio is calculated by dividing Tier 1 capital by the bank's average total consolidated assets; under the framework, banks are expected to maintain the leverage ratio in excess of 3%. The Leverage Ratio which serves as a backstop to the risk-based capital measures is intended to constrain excess leverage in the banking system.

Basel III introduced two required liquidity ratios. The Liquidity Coverage Ratio requires a bank to hold sufficient high-quality liquid assets to cover its total net cash outflows over 30 days; the Net Stable Funding Ratio requires the available amount of stable funding to exceed the required amount of stable funding over a 30-day period of extended stress.

In implementing the Basel II framework, the Central Bank will also focus on the rollout-out of certain key features of Basel III particularly around capital structure and use a measured approach in considering the adoption of the capital buffers and other key ratios contained within that framework. The Central Bank will also introduce a framework for Domestic Systemically Important Banks (‘D-SIBs’).

4. Applicability

The Central Bank's Basel II and III Implementation Program is expected to be both pragmatic and flexible thus taking into account the different profiles of locally incorporated banks. The scope of application will include locally incorporated unrestricted (public) banks and bank & trust companies. Trust Companies are not covered under this framework. Branches of international banks operating within this jurisdiction are not required to maintain a separate capital requirements, and as such will also be excluded from the rules for Basel II and III in our domestic context. The Central Bank will however retain the right through its ongoing supervisory review to assess whether trust companies and foreign branches have appropriate risk management and governance oversight to manage the risk of the institution.

5. Implementation and Timelines

The Central Bank proposes to stage the implementation of its Basel Program in three phases with a full roll-out over a 30-month timeline. The formal program commenced in Q2 of 2013 and is expected to end Q4 of 2015, with live implementation to commence in Q1 of 2016. The first phase which commenced in July 2013 will be primarily focused on the Pillar 1 Capital Measurement and Pillar 3 – Minimum Disclosure Requirements as well as amending the definition of Minimum Regulatory Capital in accordance with Basel III. The Central Bank will conduct its first QIS around Pillar 1 requirements.

The second phase of implementation will start in Q1 of 2014 with the primary focus around Pillar 2 – Supervisory Review requirements. During this phase, the Central Bank will issue its framework on the ICAAP, which banks will begin to submit. The Central Bank also plans to conduct a parallel run for Pillar 1 reporting in the second phase. The parallel run will include five consecutive quarters of reporting. Banks will be allowed to report on a best efforts basis for two quarters. All banks would have to report at least two quarters of clean data in order to demonstrate their readiness for live reporting. The Central Bank will conduct onsite benchmarking meetings, before and after the parallel run. These meetings would allow the Central Bank to assess licensees' Basel II and III readiness and get an understanding of specific issues to be addressed regarding implementation. All of the commercial banks would be targeted as well as several of the larger international banks as a part of these special focus meetings. Additionally, the Central Bank will introduce the framework for the key liquidity ratios under the Basel III framework as a part of phase 2.

The final phase of the implementation program commences Q3 2014 and it would involve work around key Basel III elements and the release of the final reporting forms and Guidelines. During this phase the Central Bank will continue the parallel run, spanning several quarters of reporting, which would culminate into the final QIS before the live implementation by Q1 2016. A detailed timetable of the various plans and deliverables of the Basel Implementation Program is provided at Annex 1.

Annex 1: High-Level Summary of Deliverables

2013 | 2014 | 2015 | 2016

PHASE 1

(Q3 2013-Q4 2014)

- Industry Briefing
- Publish Road Map
- Basel Readiness Survey
- Consultative Papers under Pillar 1 - Credit Risk
- Consultative Papers under Pillar 1 - Operational Risk
- Consultative Papers under Pillar 3 - Minimum Disclosures
- Consultative Paper for Basel III - Capital Structure
- Conduct QIS for Pillar 1 Requirements
- Orientation and Awareness Training for Pillar 1 Requirements

PHASE 2

(Q1 2014-Q4 2015)

- Consultative Paper - ICAAP
- Amend Corporate Governance Guidelines (to include Basel II and Basel III Expectations)
- Amend Ladder of Supervisory Intervention Framework
- Issue Draft Guidelines on Consolidated Supervision
- Publish Consultative Papers under Basel III - Capital Buffers, LCR, NSFR and Leverage Ratios
- Parallel Run on Pillar 1 and Basel III
- Conduct onsite Benchmarking Meetings with Licensees
- Industry Briefing for ICAAP and Reporting Forms

PHASE 3

(Q3 2014-Q4 2015)

***Q1 of 2016**

- Consultative Paper for D-SIBs
- Implement the LCR, NSFR and Leverage Ratio
- Issue Final Reporting Forms and Guidelines
- Conduct Full QIS Exercise
- Live Implementation*