THE CENTRAL BANK OF THE BAHAMAS

Consultation Paper on the Areas of National Discretion

Bank Supervision Department

Publication Date: November 5, 2014

Closing date for Comments: January 5, 2015

INTRODUCTION

The Central Bank of The Bahamas ("the Central Bank") is responsible for the licensing, regulation and supervision of banks and trust companies operating in and from within The Bahamas, pursuant to the Banks and Trust Companies Regulation Act, 2000, and the Central Bank of The Bahamas Act, 2000. Additionally, the Central Bank has the duty, in collaboration with financial institutions, to promote and maintain high standards of conduct and management in the provision of banking and trust services.

The Bank has fully embarked on a Basel program that comprises elements of Basel II and III frameworks. The major objective of Basel II has been to align banks' regulatory capital more closely with their risks, taking account of progress in the measurement and management of risk and of the opportunities which these provide for strengthened supervision.

PURPOSE

As you are aware, the Basel II framework sets out a number of areas where national supervisors will need to determine the specific definitions, approaches or thresholds that they wish to adopt in implementing certain prudential approaches. The purpose of this paper is to seek the views of the licensees of the Central Bank and the public with regard to the Areas of National Discretion. The Central Bank has considered, in the context of our domestic market practice and experience, along with benchmarking regional and non-regional jurisdictions and the results of the Basel Readiness Survey, 27 areas of national discretion for **Credit Risk** and 3 areas for **Operational Risk**.

The Central Bank has outlined below, in table format, the areas of national discretion under the Basel II framework, with the corresponding paragraph reference as set out in Part 2 of the Basel Committee report entitled ***International Convergence of Capital Measurement and Capital Standards: A Revised Framework,*** along with comments relative to whether the same has been accepted.

Consultative Period

To make an informed and impartial decision on this topic, the Central Bank wishes to obtain comments from its licensees and other interested parties. The consultative period will run for sixty (60) days, from 5th November to 5th January, 2015, and we welcome your comments.

Questions and/or Comments

Persons are encouraged to submit questions and/or comments relative to this consultation paper to the Policy Unit, Bank Supervision Department, via postal mail or email.

The Policy Unit
Bank Supervision Department
Central Bank of The Bahamas
Market Street
P.O. Box N-4868
Nassau, Bahamas
Tel: (242) 302-2615
Fax: (242) 356-3909
Email: Policy@centralbankbahamas.com

Issued: 5th November, 2014

Areas of National Discretion

I. CREDIT RISK

SECTION 1: RISK WEIGHTS – INDIVIDUAL CLAIMS		
Basel II Para. Ref.	Area of National Discretion	The Central Bank's Position
54	*Lower risk weights (RW) to claims on sovereign (or central bank) in domestic currency if funded in that country. (see paragraph 201)*	**Accepted -** Risk weight should remain at 0%, as is currently the practice, and consistent with the Basel II regime.
55	*Recognition of Export Credit Agencies' (ECAs) assessment of country risk scores*	**Accepted -** The Central Bank will rely on external credit agencies for ratings of external sovereigns. However, if a sovereign is unrated, the Bank will rely on the country risk score assigned by the ECA, once approved by the home regulator. Otherwise, the unrated risk weight will apply if the country does not have an ECA.
57	*Claims on domestic non-central government public sector entities (PSEs) treated as if banks*	**Accepted -** Claims on domestic PSEs, which are not guaranteed by central government and where the PSEs do not participate in a competitive market, will be assessed an equivalent risk weight as a bank. These will carry the appropriate risk weight of Option 1 for banks, whose claims will be rated one category less favourable than the sovereign.
58	*Claims on* ***certain*** *non-central government domestic PSEs treated as if sovereign*	**Accepted -** Claims on domestic PSEs which are guaranteed by central government will be assessed the equivalent risk weight of the sovereign. These will carry a risk weight of 0%.
60 - 63	*Claims on banks: Option 1, RW one category less than sovereign; Option 2, RW based on the bank's external credit assessment*	**Accepted -** Option 1 to be used, i.e., claims on banks will be rated one category less favourable than the sovereign. This will allow all banks to be assessed using a level playing field.
64	*Preferential RW treatment for claims on banks with an original maturity of 3 months or less and denominated and funded in the* ***domestic currency***	**Accepted -** Licensees will be given a preferential risk weight, one category less favorable than that assigned to claims on the sovereign (subject to a floor of 20%), where claims are funded in domestic currency, with a short term maturity of 3 months or less (not to be rolled over), as these funds are considered to be very liquid. For instance, if the sovereign claim is 0%, the preferential risk weight applied will be 20%.
66 - 67	*Increase standard RW for* ***unrated claims on corporates*** *when a higher RW is warranted by the default experience in the jurisdiction*	**Not Accepted -** The standard risk weight, as stated in para. 66, will remain at 100%. Further, no claim on an unrated corporate may be given a risk weight preferential to that assigned to its sovereign of incorporation. Based on default experience in the jurisdiction, and to avoid varying judgments, the Central Bank is of the view that it will not be prudent to exercise this

Basel II Para. Ref.	Area of National Discretion	The Central Bank's Position
		option at this time, given the information needed to make such assessment (that is, credit assessments for corporates) is not readily available. However, it should be noted that this position may be re-considered in the future.
68	*Permit licensees to risk weight all corporate claims at 100%, without regard to external ratings.*	**Accepted -** Risk weight should remain at 100%, as is currently the practice and in full alignment with Basel II requirements.
69-70	*Set a numerical limit for granularity criterion in the retail portfolio (e.g. limit of 0.2% of the overall retail portfolio).*	**Accepted -** Retail claims are currently risk-weighted at 75%. Concerning the granularity criterion, the Central Bank must be satisfied that the retail portfolio is sufficiently diversified, warranting the 75% risk weight. The Central Bank, therefore, intends to set the limit on the overall retail portfolio at $100,000 for exposures to single counterparties. However, the Central Bank will place reliance on the risk management framework of licensees. Furthermore, small business loans by an individual will be subject to the same exposure threshold as that of retail exposures to a single counterparty.
71	*Increase RWs for regulatory retail portfolios (based upon the default experience within the jurisdiction).*	**Not Accepted -** The Central Bank recognizes that, while increasing the risk weight from 75% for retail claims, based on the default experience within The Bahamas may appear reasonable, within our local context, a licensee which is able to control the default experience within its portfolio should not be penalized for other licensees not being able to control theirs. However, where the granularity criterion is not met, a higher risk weight will be imposed for those retail credits which are non-performing.
72-73	*Increase preferential RWs for claims secured by residential properties, based on default experience.*	**Not Accepted –** The current practice will be maintained; that is, 50% risk weight on claims fully secured by mortgages on residential property. For past due (non-performing) loans, a risk weight of 100% will apply.
74 (&FN29)	*Commercial real estate 50% RW only if strict conditions are met.*	**Not Accepted –** The Central Bank will continue to risk weight commercial real estate mortgages at 100%, as is the current practice.
75 (&FN30)	*Reduce RWs to 50% on unsecured portion of past due loans when specific provision is ≥ 50% of the outstanding amount of the loan.*	**Not Accepted –** The Central Bank does not propose to exercise this area of national discretion.
	Treatment for non-past due loans to counterparties subject to a 150% RW.	**Not Accepted –** The Central Bank does not propose to exercise this area of national discretion.
76 (&FN31)	*Transitional period of 3 years for recognition of a wider range of collateral for high risk categories (past due assets).*	**Not Accepted –** The Central Bank does not propose to exercise this area of national discretion.
77	*If past due loan is fully secured by other*	**Not Accepted –** The Central Bank does not

Basel II Para. Ref.	Area of National Discretion	The Central Bank's Position
	forms of collateral, a 100% RW may apply when provisions reach 15% of the outstanding amount.	propose to exercise this area of national discretion.
78	*RW for past due qualifying residential mortgages, net of specific provisions, reduced to 50% when specific provisions are more than 20%.*	**Accepted –** The Central Bank believes that, as opposed to risk weighting all mortgages past due for more than 90 days (net of specific provisions) at 100%, these can be reduced to 50% when the estimated specific provisions are more than 20% of the total portfolio.
79-80	*RW of 150% or higher applied to certain other (higher risk - venture capital, private equity investments) assets.*	**Accepted -** The Central Bank believes that, due to the increased risk, a RW of 150% is appropriate.
81 (&FN32)	*RW gold bullion at 0%.*	**Accepted -** If gold bullion is held in bank's own vaults and can be treated as cash, the risk weight should be 0%, as is for cash.
	RW cash items in the process of collection at 20%.	**Accepted -** This is the current practice for cheques and other items in the course of collection.

SECTION II: EXTERNAL CREDIT ASSESSMENTS

Basel II Para. Ref.	Area of National Discretion	The Central Bank's Position
90-91	*Assessment of ECAIs may be recognized on a limited basis, but should be made public.*	**Accepted -** The Central Bank will make public its criteria for assessing ECAIs and will recognize credit ratings from the following entities: Standard & Poor's, Moody's Investor Service, Fitch Ratings and Dominion Bond Ratings Services.

SECTION III: IMPLEMENTATION CONSIDERATIONS

Basel II Para. Ref.	Area of National Discretion	The Central Bank's Position
92 - 95	*Eligible ECAI's assessments mapped to Risk Weights.*	**Accepted –** Same as for paragraphs 90 – 91.
102 (&FN37)	*Use a borrower's domestic currency rating for exposure in foreign exchange transactions when the loan is extended by certain Multilateral Development Banks (MDBs).*	**Not Accepted –** The Central Bank proposes to use the general rule, where unrated exposures are risk weighted based on the rating of an equivalent exposure to the borrower, foreign currency ratings would be used for exposures in foreign currency and vice versa for exposures denominated in domestic currency.
108	*Allow use of unsolicited ratings in the same way as solicited ratings.*	**Not Accepted -** Only solicited ratings from ECAIs are acceptable, as there may be considerable reputational issues (e.g. reputational risk) in utilizing unsolicited ratings.

SECTION IV: CREDIT RISK MITIGATION

Basel II Para. Ref.	Area of National Discretion	The Central Bank's Position
151 - 155	*Licensees to calculate haircuts using their own internal estimates of market price volatility*	**Not Accepted –** The use of supervisory standard haircuts should apply; for instance, the haircut

Basel II Para. Ref.	Area of National Discretion	The Central Bank's Position
	and Forex volatility (para. 154).	for currency risk, where exposure and collateral are denominated in different currencies, is 8% (also based on a 10-business day holding period and daily mark-to-market).
170	*Under the comprehensive approach, apply a haircut of zero, for repo-style transactions (where certain conditions apply).*	**Accepted -** In using the comprehensive approach, the calculation of capital requirement for collateral instruments will be the same, except that a haircut of zero will be applied to repo-style transactions (government bond repos).
171	*Core Market Participants classified*	**Accepted -** Use the same listing of core market participants, as stated in para. 171 - Basel II.
172	*Recognize other supervisors' preferential treatment of repo-style transactions in securities issued by its domestic government.*	**Accepted -** The Central Bank accepts that, allowing the recognition of other supervisors' preferential treatment of repo-style transactions, issued by their domestic governments, would make the process transparent—with no room for differing interpretations.
201	*Lower RW to claims guaranteed by the sovereign (or central bank) when denominated and funded in domestic currency.*	**Accepted -** Same rationale applies, as in paragraph 54 above.

II. OPERATIONAL RISK

Basel II Para. Ref.	Area of National Discretion	The Central Bank's Position
652	*Allow a bank to use the Alternative Standardized Approach (ASA) provided the bank is able to satisfy its supervisor that this alternative approach provides an improved basis by, for example, avoiding double counting of risks.*	**Accepted -** The Central Bank recognizes that, for some licensees, due to higher net interest margins, gross income may not be the appropriate indicator to use for all business lines in the calculation of the capital charge for operational risk.
654	*Supervisors may adopt a more conservative treatment of negative gross income for the Standardized Approach (i.e., in any given year, prohibit negative capital charges (resulting from negative gross income) in any business line to offset positive capital charges in other business lines without limit).*	**Accepted -** This will ensure that banks are holding adequate capital to cover operational risks. In a given year, negative gross income from a business line will be given a zero capital charge.
663	*Impose qualifying criteria for the Standardized Approach as requirements for non-internationally active banks. (Internationally active banks using the Standardized Approach must meet the criteria).*	**Accepted -** By requiring licensees that use the Standardised Approach to meet the qualifying criteria, the Central Bank will ensure that they have the appropriate operational risk management system in place.