QUARTERLY LETTER TO ALL SENIOR OFFICIALS
01/11
08th April 2011

Dear Senior Official,

During the first quarter of 2011, we issued a number of revisions to various guidelines, as well as a guidance notice, which specifies the Bank's publication requirements, pursuant to Section 8 of the Banks and Trust Companies Regulation Act, 2000 ("BTCRA"), as amended by the Banks and Trust Companies Regulation (Amendment) Act, 2010. On the latter, we would like to clarify, since a number of you have inquired, that if a firm chooses its website as the medium of publication for its audited financial statements, it must publish the Notes to audited financial statements in their entirety. In effect, a firm **will not** be granted a waiver from publishing the Notes if they exceed twenty [20] pages.

As we seek to ensure ongoing conformance of our supervisory regime with international best practices, we have issued revisions to the Corporate Governance Guidelines to clarify the Bank's expectations vis-à-vis the oversight responsibilities of the local senior management of branches of foreign banks. Enhanced requirements for independent non-executive directors (INEDs) now explicitly prohibit the appointment of the Senior Officer I or II of any firm as the INED of another firm. We have also expounded further on the requirement that the Compliance Officer (CO) and Money Laundering Reporting Officer (MLRO) should be independent and free from influences that may affect his/her ability to perform his/her duties objectively. We make it clear that senior management (i.e., the Senior Officer I or II, of any firm) should not be appointed to such posts. For domestic commercial banks, there is the requirement to have an independent compliance resource in each branch, or coverage by an independent compliance resource, which supports a centralised compliance function. The CO and MLRO should also have direct, unrestricted access to the Board and/or Group Compliance. In practice, this would involve making presentations on compliance issues to the Board on a regular basis. Finally, for the convenience of firms, we have updated the list of annual attestations that the Board must make in the Annual Corporate Governance Certificate (see Appendix 3 of the Guidelines) submitted to the Bank.

We have also released revised Guidelines on the Prevention of Money Laundering & Countering the Financing of Terrorism ("the revised AML/CFT Guidelines"), with effect from 7th March 2011, replacing the AML/CFT Guidelines issued in May 2009 and revised in July 2010. A summary of the key revisions to these Guidelines was issued in a separate Notice. Please feel free to contact us, if you have not received a copy.

While on the topic of the AML/CFT Guidelines, we would like to clarify the distinction between "source of wealth information" and "verification of source of wealth information"—the cause of some misunderstanding with the industry—as well as the expectation of Examiners during on-site examinations. As you are aware, the AML/CFT Guidelines do not require source of wealth as a separate category of due diligence data. Instead, it addresses source of wealth at two separate, but related, levels: 1) **source of wealth information** for client risk assessment purposes and 2) **verification of source of wealth information** for account relationships that have been assessed as high risk. With respect to **source of wealth information**, paragraph 36 (xiii) of the AML/CFT Guidelines require that source of wealth be considered as a risk factor in the assessment of client risk. Specifically, it states that, in determining the risk profile of any customer the licensee should take into account such factors as the following, "*in situations where the origin of wealth and/or source of funds cannot be easily verified or where the audit trail has been deliberately broken and/or unnecessarily layered*". The position with respect to the **verification of source of wealth information** is outlined in paragraph 51, which state that, "*In circumstances where the Licensee's customer is considered a high risk client, the Licensee should also confirm the customer's source of wealth*". Our Examiners' current expectation is fully consistent with the requirement of the Guidelines for **information,** in relation to the particular context, on client's source of wealth to be considered as a factor in the risk rating of clients, as well as the standards being observed by the majority of multi-national institutions in the jurisdiction.

As foreshadowed in the December 2010 Quarterly Letter, we have issued, for public consultation, draft **Guidelines for the Management of Market Risk.** The document highlights the key elements of prudent risk measurement and management frameworks, which the Central Bank will expect firms to have in place. Guidance is provided on the principles of best practices for the sound management of market risk, which incorporates effective market risk measurement, monitoring and control functions to enhance the safety and soundness of their institutions. These are consistent with the Basel Committee on Banking Supervision's (BCBS) papers on the *Risk Management Guidelines for Derivatives,* July 1994 and *Principles for the Management and Supervision of Interest Rate Risk,* July 2004. The comment period for the consultation closes on **April 15, 2011.**

The comment period for the **Consultation Paper on Proposed Revisions to the Guidelines for the Management of Liquidity Risk** closed on January 31, 2011. We thank you for your comments, which we are presently reviewing, and will certainly take on board any valid suggestions. In the meantime, we have also issued, for public comment, the accompanying draft Banks and Trust Companies (Liquidity Risk Management) Regulations, 2011, which underpin the Guidelines and provide the legislative framework for the Bank to properly monitor the liquidity risk management practices of firms. The comment period also ends on **April 15, 2011.** We anticipate that the revised guidance, along with the regulations, will be released in the second quarter.

We continue to make steady progress on the implementation of the **Risk-based Supervision Framework** (RBSF) launched in the fourth quarter of 2010. The rollout of the full risk assessment process across the first group of twelve [12] higher impact firms, which began late last year, has been largely completed. Letters communicating the risk assessment to the firms and corresponding risk mitigation programmes are now under review. Progress is also being made with the second phase of the rollout, which commenced in February 2011 and covers the assessment of an additional twelve [12] international firms. Meetings with principals from this second group of firms are currently underway; this phase is expected to be competed in the second quarter of 2011. Thereafter, the final phase of the rollout for higher impact firms is scheduled to begin. The initial desktop risk assessment for commercial banks, conducted in the third quarter of 2010, will be extended over 2011 into full risk assessments. Finally, work began on the development of a simplified risk matrix framework, which continues to incorporate key indicators of financial soundness, to facilitate the assessment of lower impact firms. We expect that the implementation of the simplified risk assessment will start in the second quarter of 2011.

Work continues on extending the **stress test model** to include liquidity and interest rate risks, along with credit risk, which is the most material risk affecting capital. This expanded stress test framework will provide a more comprehensive perspective of the key risks to the financial soundness of the individual commercial banks, and the system as a whole. Despite some initial issues with the accuracy of the maturity-wise analysis and interest rate sensitivity reporting received from the commercial banks for the quarter-end December 2010, efforts are ongoing to ensure the integrity of data with the issuance of amended forms and guidance (see following paragraph). These matters will be included on the agenda of the next quarterly meetings with the commercial banks, scheduled for April. We will also be considering extending the stress-testing framework for interest rate and liquidity risks, developed for the commercial banks, to the international firms.

The most recent version of the Excel Reporting System (ERS) is now available on our website. We draw your attention to two major changes. First, we have added two additional columns, namely **Variable Rate and Non-interest Bearing,** to the **Interest Rate Sensitivity Form**, which disaggregates the liabilities and assets previously classified in the "over 5 years" bucket. The second change is in the **Maturity Wise Analysis Form**, where data, previously reported as having residual maturity, has been changed to **contractual residual maturity**. Likewise, the accompanying ERS Guidance Notes have been amended to explain these changes and provide working examples of how particular assets and liabilities should be reported, to assist you in completing the forms.

Turning finally to the issue of **capital adequacy of firms**—a topic very much at the forefront of the global agenda—firms should be aware that, while the Bank is still operating under Basel I principles for assessing the capital adequacy of its licensees, international standards are moving towards a substantial strengthening of existing capital requirements. These capital reforms, together with the introduction

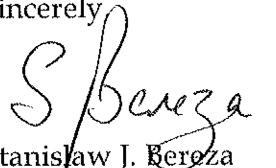
of a global liquidity standard, are driven by key lessons of the global financial crisis. They have resulted in recent amendments to principles under Basel II (now called Basel III), which we are moving towards implementing in The Bahamas, to increase the quality, quantity, and international consistency of capital; to strengthen liquidity standards; to discourage excessive leverage and risk taking, and reduce procyclicality. The Bank for International Settlements (BIS) expects national implementation of the package of reforms to begin, starting 1st January 2013. A key additional requirement, which may be set, will be a minimum of 3.5% for common equity (ordinary shares) to total risk weighted assets. Thereafter, this ratio is expected to increase by 0.5% each year, inclusive of 1st January 2015. Firms should be aware that a minimum of 4.5% might be required by 1st January 2013 for total Tier 1 capital to total risk-weighted assets, increasing by 1% each year thereafter to a minimum of 6.0% by 1st January 2015.

We are currently examining the suitability and implication of these reforms, particularly the new capital standards pertaining to common equity, for The Bahamas with a view to making any necessary amendments to achieve conformity. Clearly, firms will need some lead-time to bring themselves in conformity with the new requirements, as applicable. Therefore, we strongly encourage firms to familiarise themselves with these new capital standards, issued by the Basel Committee for Banking Supervision, by visiting the BIS official website at www.bis.org. We will certainly be updating you further on the Central Bank's approach to these matters, as developments warrant.

Any questions regarding this letter should be directed to:

The Inspector of Banks and Trust Companies
Bank Supervision Department
Central Bank of The Bahamas
Market Street
P.O. Box N4868
Nassau, Bahamas
Tel: (242) 302-2615
Fax: (242) 356-3909
Email: policy@centralbankbahamas.com

Sincerely,



Stanislaw J. Bereza
Inspector