QUARTERLY LETTER TO ALL SENIOR OFFICIALS
COMMERCIAL BANKS
04/08
26th January 2009

Dear Senior Official,

In view of the special issues that affect commercial banks in The Bahamas, we have decided to write separately to you to outline some specific matters and developments affecting you and your peer group. This first letter covers the final quarter of 2008 and, as usual, we write to update you on developments that happened in the quarter, indicate future plans, where we can, and clarify guidance, where necessary.

In the context of the continued turbulence in global financial markets, our current assessment is that, so far, The Bahamas' financial services sector has been relatively insulated from the effects of the global financial crisis. This reflects factors such as the absence of external wholesale deposits in domestic banks, strong liquidity requirements, a strong capital position and the absence of investments in overseas assets such as sub-prime mortgages that have lost value and now have become illiquid. Nevertheless, this fairly positive assessment leaves no room for complacency in view of the continuing dramatic deterioration in the global real economy, on which key industrial sectors in The Bahamas are critically dependent. Signs of pressures for commercial banks have appeared in 2008 in the significant and sustained increases in loan arrears and 2009 will be a very challenging year for the Bahamian financial system in general and commercial banks in particular. These concerns underscore the importance of banks having a robust risk governance framework to enable them to continue to support clients with long-term viability, while maintaining strong capital and liquidity positions. In response to this difficult business environment, we have taken steps to increase our monitoring of the prudential positions of commercial banks.

A key objective, therefore, is to ensure that emerging difficulties in material firms are identified quickly to enable timely and proportionate mitigation actions to be taken by supervisors and firms' management working together. To this end, we have taken steps over the last quarter to strengthen our oversight of banks credit activities. We are requiring commercial banks to submit, on a monthly and quarterly basis, information on the largest on and off-balance sheet exposures, more granular aging information for arrears, a breakdown of restructured assets and information on lending policies and procedures. Going forward, we will enhance reporting in other areas, including quarterly reporting of banks' regulatory capital position in line with the Basel Capital Accord requirements.

We have also decided to increase our regular contacts with the commercial banks to discuss with senior management the credit situation (including the enhanced credit risk reporting) on a quarterly basis. The first round of these meetings was held in December when a team from the Bank Supervision Department, including on-site examiners, met with senior management at the commercial banks, providing a vital perspective on the credit situation and the evolving control frameworks for credit in the difficult economic environment. While we are still discussing how findings will be communicated to individual firms and the sector as a whole, there are a few initial observations that we wish to communicate.

- The first is that firms have relatively limited capacity to stress test their credit exposures on a portfolio basis, although we were encouraged to see that a few institutions were beginning to develop frameworks to consider the impact of plausible distressed economic scenarios. We believe that such stress testing frameworks are essential risk management tools for firms, particularly in the current environment. In January 2009, the Basel Committee on Banking Supervision issued the consultative paper Principles for Sound Stress Testing Practices and Supervision, which we recommend to you and for consideration in developing your internal frameworks.

- A second observation relates to the fact that the majority of firms have not yet implemented reporting and monitoring arrangements for loans whose terms have been restructured in response to the difficulties of their clients in the current business environment. We believe that transparency in this area is vital in managing problem assets in the current environment and we would again encourage you to implement robust internal monitoring and reporting arrangements, in line with our **Guidelines for the Measurement, Monitoring and Control of Impaired Assets** that reflect best international practices in this area.

In the context of our programme of on-site examinations, we are also planning to undertake a series of visits to commercial banks, through September 2009, to include a review and benchmarking of their management of liquidity and credit risk against our relevant guidelines. We feel these areas are particularly important in the current business-operating environment.

We also wish to inform you of our decision to make two organisational changes in the structure of the Banking Supervision Department. Firstly, supportive of the effort outlined above, a **Commercial Bank Unit** is being established to focus, in line with the implementation of a risk-focused approach to supervision, on the critical issue of oversight of the commercial banks.

Secondly, we also intend to establish an **Authorizations Unit** in the first quarter of 2009 to increase efficiency and allow the technical staff to focus on the core supervisory functions – on-site and off-site analysis. We are still in process of defining the scope of responsibilities to be captured under this new centralised process; however, one of its core functions will be authorizations of new licenses. We hope that this will lead to a more timely and consistent response within this important function.

The next point we wish to mention is the review of the commercial banks' **KYC/AML/CFT** operations, which we conducted in 2008, in order to determine the level of compliance with Bahamian regulatory requirements. Separate invitation letters have been issued in respect of the Roundtable we will be hosting on February 11th to discuss the findings of these reviews.

The development of our **Risk Based Framework (RBF)** continues apace. The project team has devised a risk matrix incorporating the outputs from both the existing on-site and off-site processes, and drawing on existing models from some of the major jurisdictions to derive a single composite risk rating for each firm. The team has piloted the risk matrix on a test firm and we will be applying the model, in conjunction with our review of liquidity and credit risk management of commercial banks as mentioned earlier, before developing full guidance and refining the implementation plan. As indicated previously, we will be contacting you separately over the coming months to outline the framework, brief you on our roll-out plans for the RBF and solicit your views.

We have also initiated a review of our **examination processes**, with the aim of improving consistency, increasing focus on higher risk issues, improving communication with the licensees and ensuring better follow up of identified issues. A project team has presented a revised approach to senior supervisory management, produced a draft Report Writing Template and completed the process flow charts for discussion and refinement. Work will continue into the first quarter of 2009, with the revised process being applied on a trial basis from the middle of January. The team will also begin the process of reviewing the various on-site templates in conjunction with the development of a new on-site supervision manual.

The revision of our **on-site examination manual** is essential for the robustness and consistency of the on-site work for supervisors and examiners to have a comprehensive and up-to-date on-site supervision manual that reflects the full legal requirements within The Bahamas and current operational practices. In this respect, we have secured external assistance to help with further developing a practical manual for on-site examinations. In the first instance, our work in this area will focus on ensuring our practices in reviewing KYC/AML and credit risk management processes are in line with evolving international standards.

There have been no new guidelines issued since our last letter. However, we have issued a consultation document on additional proposed revisions to the **Guidelines on the Prevention of Money Laundering & Countering the Financing of Terrorism ("the AML/CFT Guidelines")** issued in October 2005. You will recall that revisions were initially issued for consultation in November 2007, following the Mutual Evaluation of the anti-money laundering and combating the financing of terrorism regime of The Bahamas conducted by the Caribbean Financial Action Task Force ("CFATF") during May and June 2006. The additional revisions to the AML/CFT Guidelines were drafted in anticipation of the changes to the AML/CFT legislation and the implementation of the new Wire Transfers Regulations. These seek to enhance compliance of The Bahamas with the FATF's Special Recommendation VII (dealing with wire transfers), as recommended by the CFATF in its Mutual Evaluation Report on The Bahamas, published in December 2007 and to remedy deficiencies in The Bahamas' AML/CFT regime noted by the CFATF Examiners in that Report. They also take account of comments received on the consultation draft published on the Central Bank's website in November 2007. The consultation period ends on **18 February 2009** and, as customary, the consultation paper can be found on our website.

Our final point is a **reminder** that, given the continued global volatility in financial markets we continue to expect that you will immediately contact the Policy Unit to apprise us if you become aware of any exposures and developments (direct or indirect) that are likely to have a material impact on your operations here in The Bahamas.

We wish you all a happy and prosperous New Year.

Any questions regarding this letter should be directed to:

The Inspector of Banks and Trust Companies
Bank Supervision Department
The 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

Sincerely,

Stanislaw J. Bereza
Inspector