Julian W. Francis: Basel II and Consolidated Supervision – The Challenges Ahead

Remarks by Mr. Julian W. Francis, Governor of The Central Bank of The Bahamas, at the Opening Ceremony of the ASBA-FSI Seminar on Consolidated Supervision and the New Basel Accord, Nassau, Bahamas, 6th October, 2003.

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Ladies and gentlemen,

It is a pleasure for me to bring opening remarks at this seminar. This event is extremely timely and relevant to our region as we embrace the challenges posed by our preparation for the new Capital Accord. Basel Committee Chairman Caruana, in a recent speech, noted the higher than expected volume of responses to the third consultative paper. In my review of the responses, I was pleased to note that many of the supervisory authorities in our region, including The Bahamas, actively participated in the debate and voiced concerns and suggestions in an effort to ensure that the most effective Accord possible is developed. We should commend the Basel Committee for its consultative approach to the development of the new Accord. Additionally, ASBA and the FSI should be applauded for seminars like this one, which ensure that supervisors are knowledgeable about the issues and are therefore prepared to execute effectively in this new, ever more demanding environment.

It is important to state that The Bahamas is committed to implementing a capital adequacy regime which is appropriate to the maintenance of a strong international banking centre. The Central Bank of Bahamas requires its licensees, by law, to maintain capital arrangements which are at least consistent with the existing Basel requirements.

The Bahamas implemented the current Accord in 1992, with the exception of the market risk amendments which are scheduled to be introduced in 2004. [Because of the Bahamian exchange control requirements and the limited capital market activities of domestic banks, we expect that our retail banks will be below the Basel materiality thresholds for market risk.]

We have also experienced that consolidated supervision has proven to be an essential tool for the supervision of banks. This comprehensive approach to banking supervision takes into consideration the risks and activities of the entire banking group or financial conglomerate, including direct subsidiaries and branches, and also non-bank companies and other financial affiliates and special purpose vehicles. The Supervisory Authority must satisfy itself of the proper management and supervision of the inherent risks of the groups' activities, wherever they are booked and therefore must go well beyond the accounting concept of "consolidation" or the preparation of consolidated accounts, in seeking to monitor and supervise the activities of financial groupings.

Consolidated supervision is a particularly important matter for the Bahamas as this jurisdiction hosts 288 licensees from over 30 countries. As a host jurisdiction, therefore, there are any number of peculiarities which must be understood and responded to, if this critical system is to function as it must.

Cross Border Considerations

First, the vast majority of our banks have extensive international activities. Therefore, cross border supervision becomes extremely important. The Bahamas, as a member of the Offshore Group of Banking Supervisors endorsed the *Report on the Supervision of Cross Border Banking* in 1996 and we have taken important steps in the implementation of the reports recommendations.

The revised supervisory legislation introduced in 2000 in some respects codified practices that were already in place and broadened and deepened the scope for consolidated supervision, information sharing and co-operation with foreign supervisory authorities. Over the past three years, the Bahamas has frequently accommodated onsite inspections by home country regulators. We have also made the inspection of overseas branches and subsidiaries of our licensees a priority for 2004. Negotiations of MOUs between The Bahamas and a number of home-country supervisors have either been concluded or are being actively pursued by ourselves.

Upward Consolidated Supervision

Second, we realize fully, that we must be concerned not only with “downward consolidated supervision”, that is of subsidiaries and branches of our licensees, but also with what we term “upward consolidated supervision”, or addressing supervisory issues as they relate to the parent entities of licensees.

In terms of upward consolidated supervision, the Central Bank must be assured of the financial viability of the parent institution, and the control and oversight provided by the parent office and also the quality of supervision by the parent bank’s regulator. This is especially important to control the risks from intra-group exposures.

The flow of information is, of course, important for upward consolidated supervision. The focus has traditionally been on the flows of information from the subsidiary to the parent company for the purpose of accounting consolidation. However, it is more and more imperative that home supervisors be proactive in raising material issues and concerns with their host country counterparts and respond to host country supervisory requests for information in a timely and satisfactory manner.

Basel 2 and Consolidated Supervision.

Basel 2 requires enhancements to the traditional concept of consolidated supervision. The Basel Committee has stated firmly, that the New Accord should be applied on a consolidated basis to internationally active banks. Additionally the scope of application will extend to any holding company that is the parent entity within a banking group and to every tier within a banking group.

I would now like to address some specific issues of each component of Basel 2 in terms of Consolidated Supervision.

Pillar 1 Issues

It has been observed that Basel 2 provides supervisors with a large number of options for implementation. The Central Bank of The Bahamas is excited about the ability to tailor the Accord to our needs, but recognizes the complexity involved.

Firstly, the Bahamas is a host jurisdiction for a number subsidiaries and branches of US and EU banks. We, therefore, must play close attention to the position taken by these countries with respect to the implementation of Basel 2. We have noted, with interest, Federal Reserve Board Vice Chairman Roger Ferguson's comments that the United States intends only to apply the advanced approaches of Basel 2 to the largest, most internationally active US banks. He estimated that some 20 US banks, which represent approximately 99% of US bank foreign assets, would be expected to adopt Basel 2 from the onset. The remaining 8,000 US banks would be permitted to continue operating in accordance with the existing Accord.

The EU appears to be taking the position, that its banks will be allowed flexibility in terms of options under the new accord, but that most, if not all banks will be required to move to Basel 2.

It will be necessary, therefore, for The Bahamas, and all jurisdictions which host subsidiaries, branches or affiliates of US or EU banks, to be familiar with these different approaches to the New Accord.

As Basel 2 is applied on a consolidated basis to the entire banking group, we can expect that our licensees which are part of US and some EU banking groups will be expected to put in place the infrastructure for the measurement of capital adequacy consistent with Basel 2. In the case of branches and subsidiaries of those 20 or so US banks, we can

expect that our licensees will be using the advanced IRB approach. In the case of branches and subsidiaries of EU banks, we can expect a range of approaches being used.

For those subsidiaries and branches (in our jurisdictions) of banking groups using the advanced IRB approach, there will be a need to construct the required data sets on the Probability of Default (PD), Exposure at Default (EAD), Loss Given Default (LGD) and Maturity (M). This will take time and considerable expertise. Banks in host jurisdictions, like the Bahamas, however, may find it less challenging to move to the more advanced approaches under Basel 2, as the required data for the IRB approach often relates to the home country and in most instances would the same or similar to the parent bank. Nevertheless, we will be required to understand and audit the banks' internal models.

Supervisors in host countries may be faced with the situation where, their licensees are using advanced approaches because of requirements of the home office, while the jurisdiction has not yet fully implemented Basel 1. This scenario brings to mind Roland Raskopf's well known PowerPoint slide of a turtle resting upon a Ferrari. The Ferrari is meant to represent the banking industry, and the turtle represents the Supervisor. The situation is similar here.

This is not to say however, that adequate supervision of the licensee's capital adequacy cannot be provided where the licensee is implementing a more advanced approach. Two options are likely.

First, the host supervisor may require its licensees, in addition to the reporting of capital by the IRB method to the home office, to also measure capital adequacy on a consolidated and solo basis using Basel 1 or the simpler Basel 2 options. This would result in banks having dual systems for the measurement and monitoring of capital; one for the purpose of consolidation into the numbers of the group, and the other to fulfil its statutory requirements to its local regulator. Such an approach may not result in competitive disadvantages for our banks as we already mandate fairly high minimum

levels of capital. Additionally, in the Bahamas, because of the liability driven nature of private banking, average capital ratios are considerably higher than 8%.

A second option entails the expansion of the concept of consolidated supervision. In this scenario, the host supervisory authority may need to rely on the home supervisor's assessment of the group's capital adequacy, including the testing of the bank's and the group's internal models in the short to median term. As such, new MOUs may need to be developed and existing MOUs expanded to establish the protocols for these examinations. Here, we would, need to ensure that the home supervisor is capable of, and willing to provide adequate supervision for the global use and the back-testing of models through the international banking group.

These joint inspections may also enable the transfer of expertise from countries with a long history of models testing to jurisdictions in our region where banks have traditionally operated much more simply.

Pillar 1 and Ratings Agency

While the IRB approach poses several important challenges for small jurisdictions, utilization of the Standardized Approach also has peculiarities for implementation in The Bahamas and will require an even richer relationship with home supervisors.

We note that the Standardized Approach requires the use of credit ratings agencies which currently, for the most part, do not exist in the Caribbean Region. Under Basel 2, Supervisors will be required to approve the credit ratings agencies using strict criteria. This will mean that The Bahamas, where necessary, will need to approve the use of credit ratings agencies in over 30 countries. I say this because it makes little sense for a ratings agency in The Bahamas to rate the risks of a licensee which is a subsidiary of, for example, a Brazilian bank with Brazilian exposures. It would be better for that Bahamian subsidiary of the Brazilian bank to utilize an approved credit rating agency in Brazil,

perhaps the same credit ratings agency used by the parent bank. Therefore there will be a need to enhance the co-ordination and information sharing between home and host supervisors to ensure that the Standardized Approach functions in this regard.

Pillar 2 Issues

The Bahamas supports the introduction of Pillar 2 – Supervisory Review, into the new capital adequacy framework. The implementation of Pillar 2 should not be a major challenge for the Central Bank of The Bahamas, as powers to require a licensee to hold additional capital above the 8% requirement already exist under current legislation.

Once again, in terms of internationally active banks, Pillar 2 can be strengthened by better consolidated supervision and better flows of information between supervisors. We urge home supervisors to remember that information flows must be bi-directional to ensure effective consolidated supervision. While a problem arising in a subsidiary ***may*** result in difficulties with the parent bank, a problem within the parent entity signals, ***with almost certainty***, problems within the subsidiary entities.

Going forward, the Central Bank of The Bahamas plans to seek negative assurance from all home regulators that nothing during the period of review has come to their attention that would inhibit the parent bank's ability to provide support should it be required. We have also strengthened our requirements for Letters of Comfort by requiring the notification of the home supervisor. In this way, we seek to detect problems before they endanger the solvency of the bank.

Pillar 3 Issues – Market Discipline

Market discipline through disclosure of both quantitative and qualitative information is an important mechanism for reducing the potential for moral hazard by allowing enhanced monitoring of the bank's activities by its shareholder and depositors. More frequent and informative disclosures, also serve to promote better consolidated supervision by increasing the flow of information to the home supervisor and supervisors of other group institutions. As such, we support the introduction of this Pillar.

We note that the more sophisticated and dynamic the market, the better disclosure serves as a disciplining measure. The international banking market is, therefore, well suited for such a mechanism as market participants and stakeholders tend to be sophisticated.

The Bahamas has always required the publication of audited financial accounts of licensees. The Central Bank plans to expand this requirement through the introduction of a new guideline on minimum disclosure requirements. We are also happy to see that the New Accord tidies up some interpretative difficulties over what is to be consolidated into a bank's balance sheet and capital adequacy calculation which are sometimes less than absolutely clear under the present Accord. I have noted that some time will be devoted to this topic at this seminar.

However, under Basel 2 there will be an extra cost for licensees as disclosures will have to be made more frequently. The disclosures, as outlined in Pillar 3, are also quite extensive. We recognize that considerations will also need to be given to the resource constraints for the local audit firms as the required disclosures and the frequency of disclosure expand. Nevertheless, we are certain that the benefits of the disciplining effects of the market through increased transparency and disclosure, will outweigh the costs.

Conclusion

I hope that you have garnered, from this brief presentation, my agreement that the topics of Consolidated Supervision and Basel 2 are natural partners. In some instances, consolidated supervision is the vehicle through which Basel 2 will be properly implemented. In other cases, the new requirements stemming from Basel 2 require enhanced consolidated supervision.

The Bahamas remains positive about the implementation of Basel 2. We feel that it allows for greater risk sensitivity and transfers greater responsibility for determination of capital requirements to the industry. These are appropriate reforms. However, we must be cognizant of the many challenges which the New Accord poses for the regulatory system and for supervisors and prepare to overcome them.

We, in the Bahamas, are certain that improvements to the standards of supervision of banks in general, and to consolidated supervision, including the supervision of cross border establishments, can contribute importantly to the effectiveness of Basel 2. This short seminar is, therefore, an important step in the right direction.

Thank you.