BASEL II & III

IMPLEMENTATION PROGRAM

The Central Bank of The Bahamas

Industry Briefing

29th October, 2013

AGENDA

- Background
- Basel Implementation Road Map
- Basel II Expectations
  - *Pillar 1: Standardized Approach*
  - *Pillar 2: Supervisory Review*
  - *Pillar 3: Market Discipline*
- Basel III Expectations

ROAD MAP

Conceptual Framework for Basel II Accord

Basel II Structure

Three Pillars

Pillar 1 (P1)	**Pillar 2 (P2)**	**Pillar 3 (P3)**
Minimum Capital Requirements	Supervisory Review Process	Market Discipline
Credit Risk Market Risk Operational Risk	Banks review own Capital adequacy Supervisors evaluate bank's assessments	Increased disclosure Partial consequence of more reliance on internal assessments

Overview

The Central Bank's Basel II and III Implementation Road Map:-

- Provides a high level overview of Basel II and III frameworks;
- Discusses the scope of application of Basel II and III for licensees in this jurisdiction;
- Sets out indicative timelines for Basel II and III implementation for licensees;
- Highlights the key areas of transition and regulatory requirements under the new framework; and
- Discusses next steps (i.e. implementation phases).

Background

- Preliminary Initiatives which set the foundation for Basel Implementation Program
  - Implemented Market Risk Amendments to Basel I (PI)
  - Issued Consultation Paper on the Guidelines for the Management of Op Risk (P1)
  - Introduced Risk Based Supervisory Framework in 2010 (P2)
  - Impose Target and Trigger Ratios (P2)
  - Impose Stress Testing on Commercial Banks (P2)
  - Require publication of Audited Accounts (P3)
  - Conducted Minimum Disclosure Surveys (P3)
  - Align Capital Structure of Commercial Banks with revised definition for Tier 1 and Tier 2 Capital (B3)

Background

- Mobilized a Project Team comprising some 17 persons from Bank Supervision Department (BSD)

- The Project has a governance structure comprising:-
  - Steering Committee,
  - A Project Coordinator
  - An Advisory Board,
  - Regional Consultancy support through CARTAC
  - A dedicated Consultant (to be identified)
  - Six technical working groups that have been given specific high-level mandates covering the requirements of Basel II and III.

Conceptual Framework for Basel III

Basel III does not replace Basel II but complements that framework

Basel III

Capital Reform	Liquidity Standards	Systemic risk and interconnectedness
Quality, consistency, and transparency of capital base	Short-term: Liquidity Coverage Ratio (LCR)	Capital incentives for using CCPs for OTC
Capturing of all risks	Long-term: Net Stable Funding (NSFR)	Higher capital for systemic derivatives
Controlling leverage		Contingent capital
Buffers		Capital surcharge for systemic banks

Key Drivers of the Basel Program

- Basel II significantly provides for more risk sensitive capital requirements and it takes into account operational risk of banks apart from credit and market risks.

- Basel II promotes strong risk management practices by providing capital incentives for banks having better risk management practices.

- Basel II provides for use of assessment of risk provided by banks' internal systems as inputs to capital calculations.

- Basel II provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and national regulators to select the approaches that are most suitable for them.

Key Drivers of the Basel Program

- Basel III provides a fundamental tightening of the definition of capital, with a strong focus on the common equity Tier 1 component.
- Basel III promotes the build-up of capital buffers in good times that can be drawn down in periods of stress, as well as clear capital conservation requirements to prevent the inappropriate distribution of capital.
- Basel III introduces a leverage ratio, which has system-wide benefits by preventing the excessive build-up of debt across the banking system during boom times.
- Basel III improves the banking sector's ability to absorb shocks arising from financial and economic stress.
- Basel III improves risk management and governance.

Applicability

- The scope of application for the Basel II and III Implementation Program will be directed at locally incorporated unrestricted (public) banks and bank & trust companies.

- Currently there are **70** licensees that report under the Basel I capital measurement framework. It is intended that these licensees would migrate to Basel II and III as appropriate.

- While the parent banks in the home jurisdictions may apply advanced approaches for Basel II, their subsidiaries within this jurisdiction will be subject to the simpler approaches.

Applicability

- The Central Bank started the Basel III initiatives earlier with the Commercial Banks, who were required to bring their capital structure in line with the minimum capital rules under Basel III.
- All banks however will be held to the Basel III standards for Capital Structure.
- The Central Bank will determine the scope of applications for other elements of Basel III.

Exceptions

The Central Bank will apply some elements of Pillar 2 around improved risk management and disclosure requirements to following types licensees:-

- Pure Trust Companies
- Branches of Foreign Banks

In addition, these classes of licenses will also be subject to meeting the requirements of the Basel Committee's *Sound Practices for Operational Risk Management*.

Timelines and Implementation

- The entire program runs from Q3 2013 to Q4 2015.
- "Go Live" Implementation scheduled for Q1 2016
- The Program is divided into three separate but overlapping phases.

Timelines and Implementation

Implementation Phases

- The first phase which commenced in July 2013, primarily focuses 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.

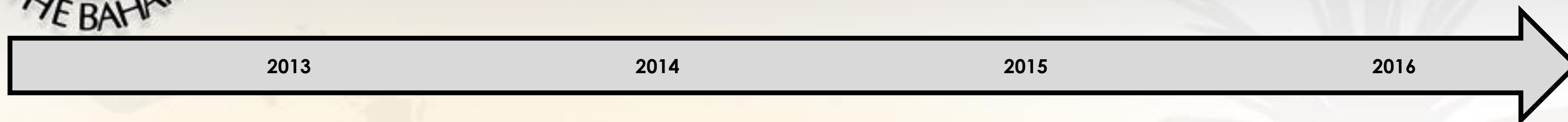
- This phase will also include a Quantitative Impact Study (QIS) for Pillar 1 requirements.

- 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 that banks will be required to prepare and maintain on an on-going basis.

Implementation Phases

- The Central Bank also plans to commence its parallel run for Pillar 1 and Basel III reporting in the second phase.
- The third phase of the implementation program commences Q3 2014 and it would involve the release of the actual reporting forms and Guidelines.
- As a part of phase 3, the Central Bank will introduce the framework for the key liquidity ratios under the Basel III framework.
- And finally, during this phase the Central Bank will continue with the parallel run, spanning several quarters of reporting, which would culminate into the final QIS before the live implementation by Q1 2016.

High-Level Summary of Deliverables



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 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

Immediate Next Steps

- Publish the Basel II and III Implementation Road Map
- Request Licensees to identify Basel II and III Implementation Coordinator
- Conduct Basel Readiness Survey
- Publish Quarterly updates through a dedicated Basel Implementation Program Newsletter, commencing Q1 2014
- Conduct internal and industry sessions after certain key milestones of phase 1 are met

BASEL II: Pillar 1 - Minimum Capital Requirements

Credit Risk – Standardized Approach

Credit Risk – Standardized Approach

- Basel II offers four (4) approaches / methodologies for the assessment of Credit Risk
  - Simple Standardized Approach (Basel I)
  - Standardized Approach (SA)
  - Foundation: Internal Ratings Based (IRB) Approach
  - Advanced: Internal Ratings Based (IRB) Approach
- CBOB has determined the SA approach appropriate for banks in this jurisdiction

Important Improvements from the Basel I Accord

- Risk weights more sensitive to inherent riskiness
  - Wider spectrum of risk buckets
  - Recognition of external credit assessment institutions
  - Greater recognition of collateral (credit risk mitigation techniques)
- Introduction of additional risk weights (e.g. 75%, 150%)
- Removal of current OECD/non-OECD rule for risk weighting of sovereign exposures
- Refinement to treatment of Securitization
- Refinement of off-balance sheet risk weights

Areas of National Discretion

- Basel II comprises a number of explicit "national discretion items" to allow local application and flexibility to regulators
- The selection of these items depends on the supervisor's own judgement and assessment of its appropriateness in the local context.
- Approximately 24 National Discretion (ND) areas under Credit Risk – Standardized Approach
  - Consideration – Standardized approach for securitization exposures
  - Conduct a Securitization Survey to better understand scope of application

Standardized Approach – Summary of Risk Weights

Table 1: Risk-weights for credit risk in Basel II (standardized approach) and in Basel I

			Basel II (standardized approach)							**Basel I**	
Portfolio			AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	Below B-	Not rated	**OECD**	**Non-OECD**
Corporate			20%	50%	100%	100%	150%	150%	100%	100%	100%
										LT	
Bank[a]	**Option 1**		20%	50%	100%	100%	100%	150%	100%	20%	100%
		LT	20%	50%	50%	100%	100%	150%	50%	***ST***	
	Option 2	**ST**	20%	20%	20%	50%	50%	150%	20%	20%	20%
Sovereign			0%	20%	50%	100%	100%	150%	100%	0%	100%

Note: [a] The distinction between Option 1 (risk-weight one category below that of the sovereign) and Option 2 (risk-weight based on the rating of the bank) applies only in Basel II

Source: Basel Committee on Banking Supervision (2004)

Comparative Risk Weights under Basel I and II Frameworks

Exposure / Asset	Basel I Bahamas	Basel II	Basel II Bahamas
Cash or Deposits at Central Bank	**0%**	**0%**	**0%**
Claims on sovereigns (governments or on central banks, denominated / funded in the national currency)	**0%**	**0% - 150%**	**0% - 150%**
Claims on Public Sector entities (PSEs)	**20%**	**ND**	**ND**
Claims on Multi-lateral Development Banks (MDBs)	**20%**	**0%**	**0%**
Claims on banks and securities firms	**20% - 100%**	**20% - 150%**	**20% - 150%**
Claims on corporate	**20% - 100%**	**20% - 150%**	**ND**
Claims on retail portfolio (credit cards, overdraft facilities etc.)	**100%**	**75%**	**ND**
Claims secured by residential mortgages	**50%**	**35%**	**ND**
Claims on commercial real estate	**100%**	**100%**	**100% / ND**
Past due loans (over 90 days)	**100%**	**100% - 150%**	**100% - 150%**
Higher-risk categories	**100%**	**≥ 150%**	**150%**
Other assets	**100%**	**100%**	**100%**
ND - National Discretion			

Comparative Risk Weights under Basel I and II (cont'd)

Off Balance Sheet Exposures / Assets	**Basel I Bahamas**	**Basel II**	**Basel II Bahamas**
Short-term Commitments (e.g. Standby facilities, credit lines)	0%	**0% - 20%**	**20%**
Long-term Commitments	50%	**0% - 50%**	**50%**
Short-term, self-liquidating, trade related contingencies	20%	20%	20%
Transaction-related contingent items (e.g. warranties, standby letters of credit)	50%	50%	50%
Direct credit substitutes (e.g. General guarantees, endorsements, repurchase agreements)	100%	100%	100%

Credit Risk Mitigation Techniques

Basel I Accord

- Limited recognition of collateral and guarantees
- Substitution with risk weights of the collateral issuer or guarantor

Basel II Accord

- Collateral
  - Cash
  - OECD government and PSE securities
  - Securities issued by certain MDBs
- Guarantees
  - OECD government and PSEs
  - Multi-lateral development banks
  - Banks and Securities Firms

The Way Forward

- Issue a Securitization Survey to better understand scope of application re Securitization framework in this jurisdiction
- Develop criteria and guidance for recognition of ECAIs
- Issue 1st Draft Guidelines for Credit Risk Framework – Standardized Approach

BASEL II - Pillar 1: Minimum Capital Requirements

Operational Risk –

Basic Indicator Approach (BIA) and Standardized Approach (SA)

Approaches to Calculating the Capital Charge for Operational Risk

- There are three methods for calculating the capital charge for operational risk, each progressing in sophistication and risk sensitivity:
  - Basic Indicator Approach (BIA)
  - Standardized Approach (SA)
  - Advanced Measurement Approach (AMA)

Summary of Approaches Proposed to be Allowed by the Central Bank

Approach	Allowed by The Central Bank?
Basic Indicator Approach	✓
Standardized Approach	✓
Alternative Standardized Approach	✓
Advanced Measurement Approach	✘

- The BIA is the default approach
- Licensees must seek the Central Bank's approval to use the SA and the ASA
- Licensees will not be allowed to revert to the BIA, without the Central Bank's approval, once it has been approved for the SA or ASA

Basic Indicator Approach

- Simplest of the approaches in calculating the operational risk capital charge

- Licensees must hold capital equal to 15% of *positive* gross income averaged over the previous 3 years.
  - Gross income is equal to net interest income + net non-interest income

- *No specific criteria for use of the BIA, but licensees are encouraged to comply with the Basel Committee's guidance on Principles for the Sound Management of Operational Risk (June 2011)*

Basic Indicator Approach

Capital charge under BIA:

$$K_{BIA} = [\sum(GI_{1\ldots n} \times a)]/n$$

where:

K_{BIA} = the capital charge under the Basic Indicator Approach

GI = annual gross income, where positive, over the previous three years

N = number of the previous three years for which gross income is positive

a = 15%, which is set by the Committee, relating the industry wide level of required capital to the industry wide level of the indicator.

Standardized Approach

- Licensees' activities are divided into eight (8) business lines
- The capital charge for each business line is calculated by multiplying gross income by a factor assigned to that business line:

	Business Line	Factor (%)
1 2 3	Corporate Finance Trading & Sales Payment and Settlement	18%
4 5	Commercial Banking Agency Services	15%
6 7 8	Retail Banking Asset Management Retail Brokerage	12%

Standardized Approach

- The total capital charge is calculated as the 3 year average of the simple summation of the capital charges across each business line each year.

- In any given year, negative capital charges (resulting from negative gross income) in any business line may offset positive capital charges in other business lines without limit.

Standardized Approach

Capital charge under SA:

$$K_{SA} = \{\sum_{years\ 1\text{-}3} \max [\sum GI_{1\text{-}8} \times \beta_{1\text{-}8}), 0]\}/3$$

where:

K_{SA} = the capital charge under the Standardized Approach

$GI_{1\text{-}8}$ = annual gross income in a given year, for each of the eight business lines

$\beta_{1\text{-}8}$ = a fixed percentage, set by the Committee, relating the level of required capital to the level of the gross income for each of the eight business lines.

Standardized Approach

- Qualifying criteria include:-
  - Board and Senior Management as appropriate are actively involved in the oversight of the licensee's operational risk management framework;
  - The licensee has an operational risk management system that is conceptually sound and implemented with integrity;
  - The licensee has sufficient resources to adequately implement its framework across its major business line as well as in its control and audit areas.

Alternative Standardized Approach

- The calculation is the same as for the SA, except for two business lines – retail banking and commercial banking – which are based on the loan portfolio.

- Instead of using Gross Income, loans and advances for these business lines are multiplied by a fixed factor of 3.5%.

- The capital charge under the ASA for retail banking (with the same basic formula for commercial banking) can therefore be expressed as:

$$\mathbf{KRB = \beta RB \times m \times LARB}$$

where:
KRB = the capital charge for the retail banking business line
βRB = the beta for the retail banking business line
LARB = total outstanding retail loans and advances (non-risk weighted and gross of provisions), averaged over the past three years
m = 0.035

The Way Forward

- Issue surveys to:
  - Assess licensees' level of compliance with the *Principles for the Sound Management of Operational risk*
  - Determine the approaches licensees intend to use
- Issue 1st draft of Methodology for the Computation of the Capital Charge for Operational Risk

BASEL II - Pillar 1: Minimum Capital Requirements

MARKET RISK

Market Risk

- CBOB has completed its implementation of the **1996 Market Risk Amendment** to Basel I
- Guidelines for the Management of Market Risk released in December 2012
- No changes are envisaged to the current framework for market risk, given:
  - limited trading book activity and
  - number of licensees subject to a market risk capital charge

Pillar 1 – Capital Charge Computation

Credit Risk + Operational Risk + Market Risk = 8%

BASEL II: Pillar II – Supervisory Review

Overview of Pillar II

- Encourages banks to enhance risk management techniques. Starting point and emphasis is on bank's internal capital adequacy assessment ("ICAAP")
- Ensure banks have sufficient capital to support *all* risks
- Focus on internal, not regulatory capital
- Accommodate differences between banks
- Promote effective, risk-based supervisory practice

Summary of Four Key Principles

- **Four Key Principles**

- Banks' own assessment of capital (ICAAP)
- Supervisory review of the adequacy of capital
- Ensure Capital is above regulatory minimum
- Supervisory intervention as appropriate

Key Principle 1

"Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels."

- Internal Capital Adequacy Assessment Process (ICAAP)
- No set model
- Banks must have a formal process to build a comprehensive risk profile and assessment of economic capital
- Can be complex economic capital model or more basically derived from Pillar I plus add-ons

Key ICAAP Features

- Identification/assessment of risk appetite and risk profile
- Identification and quantification of material risks
- Evaluation of capital and capital planning
- Scenario and stress testing
- Internal audit review

Pillar II Capital Risks

- Pillar I Risks +
  - Concentration Risks
  - IRRB (interest rate risk in the banking book)
  - Reputation Risks
  - Pension Risks
  - Liquidity Risks
  - Legal Risks
  - Securitization Risks
  - Business/Strategic Risks

Key Principle 2

2. Supervisors should review and evaluate bank's internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

- Does the bank have a credible framework?
- Is risk management appropriate to risk profile and business plan?
- Is Board/Senior Management fully engaged?
- Is the risk assessment comprehensive?
- Is the analysis forward-looking?
- How does the bank's internal capital differ from regulatory capital?

Principle 2 cont'd

Further considerations:

- How has the ICAAP been derived and compiled?
- Does the bank have a good track record of effective risk monitoring and control?
- Review assumptions and methodologies
- Consider sensitivity of results to adverse circumstances

What We Expect to See in the Annual Submission of the ICAAP

- Executive summary
- Risk Identification
- Risk Appetite
- Discussions of Pillar I and Pillar II Risks
  - Key risks, how were they measured, how were they assessed/what were the exposures, what is the proposed capital add-on (by the bank) if necessary.
- Stress testing
  - Framework, Assumptions
    - Loan Book, Investment Book
- Evidence of Use Test

Principles 3 and 4

3. Supervisors should expect banks to **operate above the minimum regulatory capital ratios** and should have the ability to require banks to hold capital in excess of the minimum.

4. Supervisors should seek to **intervene at an early stage** to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Pillar 2 – The Way Forward

1. Consultative Paper on ICAAP
2. Amend Corporate Governance Guidelines
3. Amend Ladder of Supervisory Intervention Framework
4. Issue Draft Guidelines on Consolidated Supervision

PILLAR 3 – MARKET DISCIPLINE

Overview of Market Discipline

- Pillar 3 is a fundamental component of the Basel II Framework, which seeks to achieve greater transparency through disclosures by banks in order to allow market participants to better assess the organization's capital and capital adequacy, risk exposures and the risk assessment practices.
- The purpose of market discipline is to complement the minimum capital requirements and the supervisory review process.
- Bank's disclosures should be consistent with how senior management and the board of directors assess and manage the risks of the bank.

Rationale for Enhanced Capital Disclosures

- Promote safety and soundness in banks and financial systems
- Support and enhance bank's capital assessment and internal assessment (Pillar 1)
- Support and enhance the Supervisory Review Process (Pillar 2)

Rationale for Enhanced Capital Disclosures Cont'd

- Allow market participants to assess a bank's capital adequacy
- Provide market participants with information about bank's ability to absorb losses
- Provide market participants with information about a bank's risk profile and risk appetite (giving insight on the stability of the bank and the sensitivity of its earnings potential to changes in market conditions)

DISCLOSURE REQUIREMENTS

Inclusive of Qualitative and Quantitative Disclosures

Scope of Application

Qualitative

- Name of the top corporate entity
- For accounting and regulatory purposes, outline differences in the basis of consolidation
- All restrictions or major impediments on transfer of funds or regulatory capital

Quantitative

- Aggregate amount surplus capital of insurance subsidiaries
- Aggregate amount of capital deficiencies in all subsidiaries
- Aggregate amount of the firm's total interests in insurance entities, which are risk weighed

Composition of Capital

- Amount of Tier 1 capital; separate disclosures of:-
  - Paid-up share capital / common stock
  - Reserves
  - Minority interests in the equity of subsidiaries
  - Innovative instruments
  - Other capital instruments
  - Surplus capital from insurance companies
  - Regulatory calculation differences deducted from Tier 1 capital
  - Other amounts deducted from Tier 1 capital, including goodwill and investments

Composition of Capital Cont'd

- Summary of the terms and conditions of main features of capital instruments
- Total amount of Tier 2 capital
- Other deductions from capital
- Total Eligible capital

Capital Adequacy

- Summary discussion of the bank's approach to assessing capital adequacy to support current and future activities

- Capital requirements for:-
  - *Credit Risk*
  - *Market Risk*
  - *Operational Risk*

- Total and Tier 1 Capital Ratio

Risk Exposure Assessment

- Risks to which banks are exposed and the techniques that banks use to identify, measure, monitor and control those risks

- Several key banking risks are considered:-
  - *Credit Risk*
  - *Market Risk*
  - *Interest Rate Risk and Equity Risk in the Banking Book*
  - *Operational Risk*

Considerations

1. Disclosure Policy
2. Frequency of Disclosures
3. Related Guidance Notes
4. Compliance Statement
5. Medium of Disclosure
6. Verification and Validation of Disclosures

The Way Forward

- External Auditors and the Bank's licensees participated in two surveys conducted by Central Bank on Market Discipline during 2012 and 2013, respectively.

- The Draft Minimum Disclosure Guidelines will be issued for Consultation in 2014.

- Proprietary and Confidential Information

- Basel III – Composition of capital disclosure requirements

Basel III: An Overview

Characteristics of Capital

- A bank’s capital should have the following characteristics:-
  - Provide a permanent and unrestricted commitment of funds;
  - Be freely available to absorb losses;
  - Not impose any unavoidable servicing charges against earnings; and
  - Rank behind the claims of depositors and other creditors in the event the bank is wound up.

Current Capital Requirements

- In line with the Basel Capital Accord, 1988, the Central Bank focuses on the following elements for capital adequacy purposes:-
  - credit risk associated with a bank's on and off- balance sheet exposures; and
  - form and quality of capital held by the bank to support these exposures.

Measurement of Eligible Capital Base (Guidelines)

A bank's eligible capital base is currently assessed in three tiers: -

Tier 1 + Tier 2 + Tier 3 = Total Capital

- Tier 1: Permanent Capital
- Tier 2: Supplementary Capital
- Tier 3: Trading Book Capital

Basel III – What is it?

- Basel III is a comprehensive set of measures 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

- The reforms target:
  - bank-level, or micro-prudential supervision
  - system-wide, or macro-prudential, risks

What about Basel II?

- Basel III does **not** replace Basel I or Basel II – but rather it supplements these two standards
- As with Basel II, Basel III remains a 'risk-based' capital regime
- The CBOB seeks to build a framework to fully implement Basel II – bearing in mind the requirements for Basel III

The New Elements

AREAS	MAIN BASEL III COMPONENTS
▪ Capital reform (including quality and quantity of capital, risk coverage, leverage ratio, capital buffers) ▪ Liquidity reform (short-term and long-term ratios) ▪ Other elements relating to general improvements to the stability of financial system	▪ Capital Definition ▪ Capital Conservation Buffer ▪ Countercyclical Capital Buffer ▪ Leverage Ratio ▪ Liquidity Coverage Ratio ▪ Minimum Capital Standards

Changes to the Capital Adequacy Framework

Focus on Common Equity – Core Tier 1 ratio as the key ratio

Harmonized regulatory adjustments (deductions) to be made from CET1

Greater detail of public disclosures

Comparison of Capital Rules

Minimum Capital Adequacy Requirement

T1 (4%)
+
T2 (4%)
+
T3

→ Total Capital (8%)

Current Capital Requirements

CET1 (4.5%) + Add T1 (1.5%)
=
T1 (6%)
+
T2 (2%)

→ Total Capital (8%)

Proposed (New) Capital Requirements

Measurement of Eligible Capital Base

CBOB Current Guidelines	Basel III Framework	
Tier 1 (Core Capital)	*New Tier 1 (Going – concern Capital)*	
i. Permanent Capital	**1. Common Equity Tier 1**	**2. Additional Tier 1**
• Ordinary share capital issued and fully paid. • Perpetual non-cumulative preference shares **ii. Reserves** **iii. Current year's retained profits;** and	• Common shares meeting the criteria for classification as common shares for regulatory purposes. • Stock surplus (share premium) resulting from the issue of instruments included in CET1 • Retained earnings	• Instruments that meet the criteria for inclusion in Additional Tier 1 capital (and are not included in CET1) • Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital

Measurement of Eligible Capital Base

CBOB Current Guidelines	Basel III Framework	
Tier 1 (Core Capital)	*New Tier 1 (Going – concern Capital)*	
iv. Minority interests	**1. Common Equity Tier**	**2. Additional Tier 1**
Adjustments: • Goodwill and other intangible assets; • Current year's losses; and Any holdings of own shares (treasury shares)	• Accumulated other comprehensive income and other disclosed reserves. • Common shares issued by consolidated subsidiaries and held by third parties (i.e. minority interest) that meet the criteria for inclusion in CET1 • Regulatory adjustments applied in calculation of CET1	• Instruments issued by consolidated subsidiaries and held by third parties that meet the criteria for inclusion in Additional Tier 1 capital and are not included in CET1 • Regulatory adjustments applied in the calculation of Additional Tier 1 capital

Measurement of Eligible Capital Base

CBOB Current Guidelines	Basel III Framework
Tier 2 (Supplementary Capital)	***Tier 2 Capital (Gone-concern Capital)***
• Fixed Asset Revaluation Reserves; • Other Asset Revaluation Reserves; • General Provisions; • Hybrid (debt/equity) instruments; • Subordinated Term Debt; • Minority interests **<u>Adjustments:</u>** • Eligible general provisions limited to 1.25% of RWAs • Subordinated debt limited to 50% of Tier 1 capital • Amortization on tier 2 subordinated debt • Excess Tier 2 limited to 100% of Tier 1 capital	• Instruments that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital) • Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital • Instruments issued by consolidated subsidiaries and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital • Certain loan loss provisions • Regulatory adjustments applied in the calculation of Tier 2 capital.

OTHER KEY PARTS OF BASEL III

Capital Buffers

Create buffers in good times that can absorb shocks in periods of stress

- In addition to the minimum capital requirements for CET1, T1 and Total Capital, two types of buffers are introduced:
    - *Capital Conservation Buffer; and*
    - *Countercyclical Buffer.*

Capital Conservation Buffer

- Designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred.
- This buffer is to be set at 2.5%, comprised of CET1, is to be established **above** the regulatory minimum capital requirement.
- The buffer will be phased in between 1 January, 2016 and year end 2018 becoming effective on 1 January, 2019 at incremental levels of 0.625% of RWA.

Minimum Capital Conservation Standards

Common Equity Tier 1 Ratio	Minimum Capital Conservation Ratios *(expressed as % of earnings*)*
4.5% - 5.125%	100%
>5.125% - 5.75%	80%
>5.75% - 6.375%	60%
>6.375% - 7.0%	40%
>7.0%	0%

** Earnings is defined as distributable profits calculated prior to the deduction of elements subject to restriction on distributions.*

Source: p. 56 – Basel III: A global regulatory framework for more resilient banks and banking systems

Countercyclical Buffer

- To help protect against losses incurred in the banking sector which can be potentially large when a downtown is preceded by a period of excess credit growth, which can destabilize the banking sector and contribute to a downturn in the economy.
- This buffer aims to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate.
- This buffer can range between 0% to 2.5%, at the discretion of national supervisors.

Leverage Ratio

- The Leverage Ratio is designed to constrain leverage build up in the banking sector

- Ratio calculated as a minimum of 3% of Total Tier 1 Capital to Total Exposure/Assets
  - Calculation is based on definition of Tier 1 Capital and total exposures (on- and off-balance sheet)
  - Leverage ratio is being tested from 2013 to 2017 (it is envisaged this ratio will be formalized as a Pillar 1 requirement in 2018 to assess how it will interact over the economic cycle)

Liquidity Coverage Ratio

- The Liquidity Coverage Ratio (LCR) requires banks to maintain sufficient high quality liquid assets to cover net outflows over a 30-day stress situation.
  - Stock of high-quality liquid assets / Total net cash outflows over the next 30 calendar days
- LCR will be complemented by the Net Stable Fund Ratio (NSFR) which requires banks to fund certain proportion of assets that mature after one year with liabilities that mature after one year
  - Available amount of stable funding / Required amount of stable funding
- Implementation for LCR and NSFR not envisaged until 2015 and 2018 respectively

Basel III: The Phase-in Process

2013	2014	2015	2016	2017	2018	2019

Phase-in of minimum CET1 ratio
3.5% 4.0% 4.5%

Phase-in of deduction from CET1
20% 40% 60% 80% 100%

Phase-in of minimum Tier 1 capital ratio
4.5% 5.5% 6.0%

Total Capital ratio
8.0% 8.0% 8.0%

Phase-in of capital conservation buffer

Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital (phased over a 10-year period beginning 2013)

Expectations for Banks

- Consultative Papers - under Basel III requirements
- Full Quantitative Impact Study (QIS) to test capital impact of proposed rules
  - Transparency
  - Data Quality
- Enhanced ERS Reporting Forms
  - Parallel Run on Pillar I and Basel III areas: Best efforts Basis for 2 consecutive quarters. The parallel run will include 5 quarters of reporting. All banks would have to report at least two quarters of clean data.
- Live Implementation

Further Considerations

- Development of a framework for domestic systemically important banks (i.e. D-SIBs) is under review. This will be a key part of the Basel III rules, to help address systemic risks due to: -
  - Inter-linkages; and
  - Common exposures across institutions

- To strengthen the enforceability of our enhanced capital rule for Basel III, the CBOB is considering issuing Capital Regulations, supplemental to its Guidelines.

- The Commercial Banks have already begun the phasing out of capital instruments that no longer qualify as CET1, Additional T1 or Tier 2 capital. A similar phase-in exercise of CET1 will be imposed on the international licensees.

Further Considerations cont'd

- CBOB presently considering implementation of the Capital Conservation Buffer (CCB) and the Countercyclical Capital Buffer (CCCB). While the CCB is required under Basel III, the CCCB may be imposed at national discretion.

- The Bank is also considering the application of a Leverage Ratio (formerly our Gearing Ratio which was set at ≥ 5% Capital /Total Assets).

- It is contemplated that the Liquidity Coverage Ratio and the Net Stable Fund Ratio will be phased-in at a later stage (i.e. 2015/2016).

QUESTIONS & ANSWERS

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