SUPERVISORY AND REGULATORY GUIDELINES: 2016
Capital Adequacy
Issued: 15th April, 2005
Revised: 1st December 2016

GUIDELINES FOR THE MANAGEMENT OF CAPITAL AND THE CALCULATION OF CAPITAL ADEQUACY

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I. INTRODUCTION

1. 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 (Chapter 316), and The Central Bank of The Bahamas Act, 2000 (Chapter 351). 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.

2. All licensees are expected to adhere to the Central Bank's licensing and prudential requirements and ongoing supervisory programmes, including periodic onsite inspections, and required regulatory reporting. Licensees are also expected to conduct their affairs in conformity with all other Bahamian *legal requirements.*

II. PURPOSE

3. These Guidelines outline the overall framework adopted by the Central Bank for assessing the adequacy of a bank's capital. The Central Bank aims to ensure that all banks maintain a level of capital that is consistent with the risks to which they are exposed arising from their business activities. The Central Bank endorses the Basel Committee's Paper of June 2006 titled *International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version* (Basel II) and *Basel III: A global regulatory framework for more resilient banks and banking systems"* (Basel III). The Central Bank has adopted the approach recommended by the Basel Committee.

III. APPLICABILITY

4. These Guidelines apply to all banks, and bank and trust companies incorporated in the Bahamas (referred to as "banks; licensees"). These Guidelines do not apply to pure and nominee trust companies, branches of foreign banks, restricted banks and/or trust companies and managed branches. These Guidelines do not alter the minimum capital requirements for licensees outlined in the *General Information and Guidelines for Licence Applications for Banks and/or Trust Companies*.

PART 1 - OVERVIEW

5. Capital is the cornerstone of a bank's strength. It provides a buffer to absorb unanticipated losses incurred by a bank as a result of its activities and, in the event of problems enables the bank to continue operating while those problems are addressed or resolved. The maintenance of adequate capital reserves by a bank can engender confidence in the financial soundness and stability of the bank by providing assurance that the bank will continue to honour its obligations to depositors and creditors.

6. Consistent with Basel II and III, the approach used by the Central Bank for assessing a bank's capital adequacy focuses on the following elements:-

   a. **Credit risk** associated with a bank's on and off- balance sheet exposures;
   b. **Operational risk** arising from inadequate or failed internal processes, people and systems or from external events;
   c. **Market risk** associated with a bank's on and off-balance sheet exposures arising from changes in market prices; and
   d. The **form and quality of capital** held by the bank to support these exposures.

Minimum Capital Adequacy Requirement

7. The Central Bank requires all banks to maintain a capital adequacy ratio of at least 8 percent (exclusive of the capital conservation buffer) at all times. The capital adequacy ratio is calculated by dividing a bank's eligible capital base by its total risk-weighted exposures.

$$\text{CAR} = \frac{\textit{Total Eligible Capital}}{\textit{Credit RWA + Market RWA + Operational RWA}}$$

8. At least seventy-five percent (75%) of the ratio must take the form of Tier 1 capital (i.e. each bank must maintain a minimum ratio of eligible Tier 1 capital to total risk-weighted exposures of 6 percent).

$$\text{Minimum Tier1 Ratio} = 6\% \quad \frac{\textit{Tier 1 capital}}{\textit{Credit RWA + Market RWA + Operational RWA}}$$

9. The predominant form of Tier 1 capital must be met with common equity (i.e. each bank must also maintain a minimum of 4.5 percent of risk-weighted exposures consisting of Common Equity Tier 1 (CET 1) capital.

$$\text{Minimum CET1 Ratio} = 4.5\% \quad \frac{\textit{CET1 Capital}}{\textit{Credit RWA + Market RWA + Operational RWA}}$$

Trigger and Target Ratios

The Central Bank may impose trigger and target ratios on individual licensees, on a case by case basis, as outlined below:

a. Trigger Ratios

10. The trigger ratio is the minimum capital ratio which the Central Bank considers a bank should maintain. Should the ratio fall below this point, the Central Bank will require immediate corrective action by the licensee to restore the capital ratio above the trigger level.

11. The absolute minimum trigger ratio the Central Bank considers to be appropriate is 8% (eligible capital to risk weighted assets). However, where it is judged appropriate, the Central Bank may set a trigger ratio which is significantly above 8% for individual licensees.

12. The Central Bank considers the following factors in the setting of trigger ratios:-

    (a) The characteristics of the bank (size, risk profile, the volatility of its earnings);
    (b) The characteristics of the markets in which it operates (political and economic stability, risk, price volatility, liquidity, etc.);
    (c) Degree of diversification of activities and types of assets;
    (d) The degree of concentration of counterparty exposure in a bank's portfolio;
    (e) The experience and quality of management and other personnel;
    (f) The adequacy of internal systems and controls;
    (g) Shareholder/ controller support and control;
    (h) The degree of supervision by other regulators (i.e. home regulator);

13. In the event of a significant deterioration in a bank's risk profile, the Central Bank may increase the ratio to reflect the increased risk; the converse applies to improvements in a bank's risk profile.

b. Target Ratios

14. The purpose of the target ratio is to act as a warning that the "cushion" of surplus capital resources normally considered adequate to prevent an accidental breach of the trigger has been eroded.

c. Breaches of the Trigger and Target Ratios

15. A breach of the **target** ratio may indicate that a bank is in danger of becoming undercapitalised. In such cases, the Central Bank will discuss a programme of remedial action and a specific timetable with the bank for augmenting capital to the required levels.

16. Any breach of the **trigger** ratio by a bank is taken very seriously by the Central Bank as it indicates that a bank may have insufficient capital to support the risks of its activities and may therefore be unable to meet its licensing requirements under the Banks and Trust Companies Regulation Act, 2000. In such circumstances, the Central Bank will require the cessation of all new lending/ asset business until the capital ratio is restored above the trigger ratio.

d. Implementation of Target and Trigger Ratios

17. The Central Bank will discuss the implementation of target and trigger ratios with banks individually.

Responsibility for Capital Management

18. Beyond the minimum levels of capital specified by these Guidelines, it is the responsibility of the Board of Directors and Senior Management of a bank to make regular assessments of a bank's capital adequacy to ensure that its capital resources are appropriate for the level and nature of all the risks to which the bank is exposed.

19. Banks should have suitable systems in place to identify, measure and manage the risks associated with their activities, and to hold capital which is adequate for their overall risk profile. As part of the process, banks should maintain and implement capital management plans setting out its overall strategy for managing capital resources over time. The capital management plan should be consistent with the bank's overall business plan and should include actions and procedures for monitoring compliance with the required capital adequacy ratios. Target and trigger ratios should be set to alert management of, and avert, potential breaches to the minimum capital ratios.

Reporting

20. All banks must provide the Central Bank with a capital adequacy calculation in the manner prescribed by the Central Bank on a quarterly basis[1]. However, the Central Bank may request more frequent information, particularly where a programme of remedial action is in place (e.g., in the case of breaches of the trigger capital ratio).

21. Licensees are required to maintain adequate capital on a continuing basis, not just on reporting dates.

22. Licensees should immediately notify the Central Bank of any fall, or anticipated fall, below the target or trigger ratios, where applicable.

[1] Commercial banks are required to report on a monthly basis.

PART 2 - DEFINITION OF CAPITAL

Characteristics of Capital

23. In order to be eligible for inclusion in regulatory capital, a bank's capital should have the following characteristics:

    (a) Provide a permanent and unrestricted commitment of funds;
    (b) Be freely available to absorb losses;
    (c) Not impose any unavoidable servicing charges against earnings; and
    (d) Rank behind the claims of depositors and other creditors in the event the bank is wound up.

Components of Capital

24. Total regulatory capital shall consist of the sum of the following elements:

    (a) Tier 1 capital (going-concern capital[2]), which will comprise

        i. Common Equity Tier 1 (CET1) capital
        ii. Additional Tier 1 (AT1) capital

    (b) Tier 2 capital (gone-concern capital[3])

    Note that for each of the categories above, there is an individual set of criteria that the instruments are required to meet before they can be recognised in the relevant category.

Limits and minima

25. Licensees must, at all times, maintain the following minimum ratios:

Ratio	Minimum Level
CET1	4.5% of risk-weighted assets
Tier 1 (CET1 + AT1)	6% of risk-weighted assets
Total Capital (Tier 1 + Tier 2)	8% of risk-weighted assets

For the purpose of determining the capital adequacy ratio of a bank, the total eligible capital base of the licensee shall be the sum of Tier 1 and Tier 2 capital net of regulatory adjustments applied.

Capital Consolidation

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[2] ***'Going-concern capital'*** refers to capital against which losses can be written off while the bank continues to operate.
[3] ***'Gone-concern capital'*** refers to capital that would not absorb losses until such time as a bank is wound up or the capital is otherwise written off or converted to ordinary shares.

26. The Central Bank supervises the capital adequacy of locally incorporated banks (i.e. subsidiaries and stand-alone entities) on both a stand-alone ("solo") and consolidated ("group") basis, covering all banking, securities and other financial subsidiaries within the group (except the subsidiaries engaged in insurance and commercial businesses). Thus, majority-owned or controlled financial entities will be fully consolidated. Generally, a bank should consolidate the financial statements of all of its subsidiaries in accordance with International Financial Reporting Standards for capital adequacy purposes. Exceptions should be approved by the Central Bank.

27. Banks may recognize minority interests that arise from the consolidation of operating subsidiaries to the extent that it effectively covers consolidated risks, meets all the criteria for classification in the relevant Tier (i.e. as CET1, Additional Tier 1 or Total Capital – the sum of all tiers)[4] and the subsidiary that has issued the instrument is a bank. The procedure to identify and calculate the level of a subsidiaries' capital requirement recognised at the consolidated level is specified at Appendix 1.

(a) Ordinary Shares issued by consolidated subsidiaries

28. Minority interest arising from the issue of ordinary shares by a fully consolidated subsidiary of the bank may receive recognition in Common Equity Tier 1 capital only if:
    (i) The instrument giving rise to the minority interest would, if issued by the bank, meet all the criteria for classification as ordinary shares for regulatory capital purposes; and
    (ii) The subsidiary that issued the instrument is itself a bank.[5,6]

29. The amount of minority interest recognized in CET1 capital will be calculated as follows:

    a. Total minority interest meeting the two criteria above minus the amount of the surplus CET1 of the subsidiary attributable to the minority shareholders.
    b. Surplus CET1 of the subsidiary is calculated as the CET1 of the subsidiary minus the lower of: (1) the minimum CET1 requirement of the subsidiary plus the capital conservation buffer (i.e. 7.0% of risk weighted assets) and (2) the portion of the consolidated minimum CET1 requirements plus the capital conservation buffer (i.e. 7.0% of consolidated risk weighted assets) that relates to the subsidiary.
    c. The amount of the surplus CET1 that is attributable to the minority shareholders is calculated my multiplying the surplus CET1 by the percentage of CET1 that is held by minority shareholders.

[4] Refer to eligibility criteria for CET1, Additional Tier 1 and Tier 2 Capital.

[5] For the purposes of this paragraph, any institution that is subject to the same minimum prudential standards and level of supervision as a bank may be considered to be a bank.

[6] Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's common equity (CET1) if the parent bank or affiliate has entered into any arrangements to fund directly minority investment in the subsidiary whether through an SPV or through another vehicle or arrangement. The treatment outlined above, is strictly available where all minority investments in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary.

(b) Tier 1 qualifying capital issued by consolidated subsidiaries

30. Tier 1 capital instruments issued by a fully consolidated subsidiary of the bank to third party investors may receive recognition in Tier 1 capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 capital. The amount of this Tier 1 capital that will be recognized in Additional Tier 1 capital will exclude amounts recognized in Common Equity Tier 1 capital.

31. The amount of capital that will be recognized in Tier 1 capital will be calculated as follows:

    d. Total Tier 1 of the subsidiary issued to third parties minus the amount of the surplus Tier 1 of the subsidiary attributable to the third party investors.
    e. Surplus Tier 1 of the subsidiary is calculated as the Tier 1 of the subsidiary minus the lower of: (1) the minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer (i.e. 8.5% of risk weighted assets) and (2) the portion of the consolidated minimum Tier 1 requirement plus the capital conservation buffer (i.e. 8.5% of consolidated risk weighted assets) that relates to the subsidiary.
    f. The amount of the surplus Tier 1 that is attributable to the third party investors is calculated by multiplying the surplus Tier 1 by the percentage of Tier 1 that is held by third party investors.

(c) Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries

32. Total capital instruments (i.e. Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the bank to third party investors may receive recognition in Total Capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 or Tier 2 capital. The amount of this Total Capital that will be recognized in Tier 2 will exclude amounts recognized in Common Equity Tier 1 capital and amounts recognized in Additional Tier 1 capital.

33. The amount of this capital that will be recognised in consolidated Total Capital will be calculated as follows:

    g. Total capital instruments of the subsidiary issued to third parties minus the amount of the surplus Total Capital of the subsidiary attributable to the third party investors.
    h. Surplus Total Capital of the subsidiary is calculated as the Total Capital of the subsidiary minus the lower of: (1) the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (i.e. 10.5% of risk weighted assets) and (2) the portion of the consolidated minimum Total Capital requirement plus the capital conservation buffer (i.e. 10.5% of consolidated risk weighted assets) that relates to the subsidiary.

i. The amount of the surplus Total Capital that is attributable to the third party investors is calculated by multiplying the surplus Total Capital by the percentage of Total Capital that is held by third party investors.

All items that are deducted from total capital are also excluded from Total Assets in calculating a bank's total on-balance sheet risk-weighted assets.

Definition of Capital

34. A licensee must ensure that any component of capital included in its capital base satisfies, in both form and substance, all applicable requirements for the particular category of capital in which it is included.

Common Equity Tier 1 (CET1)

35. Common Equity Tier 1 capital consists of the sum of the following elements:

(a) Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes (see paragraph 32 below);

(b) Stock surplus (share premium) resulting from the issue of instruments included in Common Equity Tier 1 capital;

(c) Retained earnings, after deducting any interim or final dividends which have been declared by the Board of the reporting bank or banking group entity on any class of shares and any interim losses incurred since the end of the last financial reporting period;

(d) Accumulated other comprehensive income and other disclosed reserves[7];

(e) Common shares issued by consolidated subsidiaries of the bank and held by third parties (i.e. minority interest) that meet the criteria for inclusion in Common Equity Tier 1 capital; and

(f) Regulatory adjustments applied in the calculation of Common Equity Tier 1 (see paragraph 33 below).

Criteria for classification as common shares issued by the bank directly

36. An instrument must satisfy all of the following criteria to be classified as ordinary shares:

[7] There is no adjustment applied to remove from Common Equity Tier 1 unrealized gains or losses recognized on the balance sheet. Unrealized losses are subject to the transitional arrangements set out in paragraph 94 (c) and (d) of the Basel III framework. The Basel Committee will continue to review the appropriate treatment of unrealized gains, taking into account the evolution of the accounting framework.

(a) Represents the most subordinated claim in liquidation of the bank.

(b) The investor is entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).

(c) The principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).

(d) The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.

(e) Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).

(f) There are no circumstances under which the distributions are obligatory. Nonpayment is therefore not an event of default.

(g) Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.

(h) It is the form of issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.

(i) The paid-in amount is recognised as equity capital (i.e. not recognised as a liability) for determining balance sheet insolvency.

(j) The paid-in amount is classified as equity under the relevant accounting standards.

(k) It is directly issued and paid-in[8] and the bank cannot directly or indirectly have funded the purchase of the instrument.

[8] Paid-in capital generally refers to capital that has been received with finality by the institution, is reliably valued, fully under the bank's control and does not directly or indirectly expose the bank to the credit risk of the investor.

(l) The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity[9] or subject to any other arrangement that legally or economically enhances the seniority of the claim.

(m) It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorized by the owners.

(n) It is clearly and separately disclosed as equity on the bank's balance sheet.

Regulatory Adjustments in the Calculation of CET1 Capital

37. A licensee must make the following regulatory adjustments to determine CET1 capital at the solo or consolidated level, as the case may be:

Goodwill and other intangibles

(a) Goodwill, including any goodwill included in the valuation of significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation should be deducted in the calculation of CET1 capital.

(b) All other intangible assets[10] (with the exception of mortgage servicing rights) should be deducted in the calculation of CET1 capital. The full amount is to be deducted, net of any associated deferred tax liability that would be extinguished if the intangible assets become impaired or derecognized under the relevant accounting standards. Mortgage servicing rights should be deducted in accordance with the "Threshold Deductions" section described below.

Deferred tax assets

(c) Deferred tax assets (DTAs) that rely on future profitability of the bank to be realized are to be deducted in the calculation of CET1 capital. Deferred tax assets may be netted with associated deferred tax liabilities (DTLs) only if the DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority. Where these DTAs relate to temporary differences (e.g. allowance for credit losses) the amount to be deducted is set out in the "threshold deductions" section below. All other such assets, e.g. those relating to operating losses, such as the carry forward of unused tax losses, or unused tax credits, are to be deducted in full net of deferred tax liabilities and net of valuation allowance, as described above. The DTLs permitted to be netted against DTAs must exclude amounts that have been netted against the deduction

[9] A related entity can include a parent company, a sister company, a subsidiary or any other affiliates. A holding company is a related entity.
[10] Intangible assets include but are not limited to copyright, patents, intellectual property and capitalized information technology software costs.

of goodwill, intangibles and defined benefit pension assets, and must be allocated on a pro rata basis between DTAs subject to the threshold deduction treatment[11] and DTAs that are to be deducted in full.

(d) DTAs arising from any other source will be required to be deducted from CET1 capital as a prudent measure.

(e) An over installment of tax, or current year tax losses carried back to prior years may give rise to a claim or receivable from the government or local tax authority. Such amounts are generally classified as current tax assets for accounting purposes. The recovery of such a claim or receivable would not rely on the future profitability of the license and would be assigned the relevant sovereign risk weighting.

Cash flow hedge reserve

(f) The amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) should be derecognized in the calculation of CET1 capital. In this regard, positive amounts should be deducted and negative amounts should be added back. This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognized for prudential purposes.

Gain on sale related to securitization transactions

(g) Increases in equity capital resulting from securitization transactions (e.g., capitalized future margin income resulting in a gain on sale) should be deducted in the calculation of CET 1 capital.

Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities

(h) All unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk should be deducted in the calculation of CET1 capital.

Defined benefit pension fund assets and liabilities

(i) Any defined benefit pension fund liabilities, as included in the balance sheet, must be fully recognised in the calculation of CET1 Capital. That is it cannot be increased through derecognizing these liabilities.

(j) For each defined benefit pension fund that is an asset on the balance sheet, the asset should be deducted in the calculation of CET1 net of any associated deferred tax liabilities which would be extinguished if the asset becomes impaired or

[11] Refer to paragraph 30 (o) below "Threshold Deductions".

derecognised under the relevant accounting standards. Assets in the fund to which the licensee has unrestricted and unfettered access may, with the prior approval of the Central Bank, offset the deduction. Such offsetting assets should be given the risk weight they would receive if they were owned directly by the bank.

Investment in own shares (treasury stock)

(k) All of a licensee's investments in its own common shares (treasury stock), whether held directly or indirectly, will be deducted in the calculation of CET1 capital (unless already derecognised under the relevant accounting standards). In addition, any own stock which the licensee could be contractually obliged to purchase should be deducted in the calculation of CET1 capital. The treatment described will apply irrespective of the location of the exposure in the banking book or the trading book. Moreover, banks should look through holdings of index/mutual fund securities to deduct exposures to own shares. However, gross long positions in own shares resulting from holdings of index securities may be netted against short positions in own shares resulting from short positions in the same underlying index. Similarly, banks must deduct investments in their own Additional Tier 1 in the calculation of their Additional Tier 1 capital and must deduct investments in their own Tier 2 in the calculation of their Tier 2 capital.

Reciprocal cross holdings in the capital of banking, financial and insurance entities

(l) Reciprocal cross holdings in common share capital (e.g. Bank A holds shares of Bank B and Bank B in return holds shares of Bank A) that are designed to artificially inflate the capital position of the bank shall be fully deducted in the calculation of CET1 capital.

Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity

(m) The regulatory adjustment described in this section applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank **does not own more than 10% of the issued common share capital of the entity**. In addition:

- Investments include direct, indirect[12] and synthetic holdings of capital instruments. For example, banks should look through holdings of index securities to determine their underlying holdings of capital. If licensees find it operationally burdensome to look through and monitor their exact exposures to the capital of other financial institutions as a result of their holdings of

[12] Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the bank substantially equivalent to the loss in the value of the direct holding.

index securities, the Central Bank may permit banks, subject to prior supervisory approval, to use a conservative estimate.

- Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).

- Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.

- If the capital instrument of the entity in which the bank has invested does not meet the criteria for CET1, AT1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.[13]

- The licensee may, with the prior approval of the Central Bank, temporarily exclude certain investments where these have been made in the context of resolving or providing financial assistance to reorganize a distressed institution.

  a. If the total of all holdings listed in paragraph (m) above in aggregate exceed 10% of the bank's common equity (after applying all other regulatory adjustments in full) then the amount above 10% is required to be deducted, applying a corresponding deduction approach. This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself. Accordingly, the amount to be deducted from common equity is to be calculated as follows:

  b. The total of all of the bank's holdings which in aggregate exceed 10% of the bank's common equity (as per above) multiplied by the common equity holdings as a percentage of the total capital holdings. This would result in a common equity deduction which corresponds to the proportion of total capital holdings held in common equity (i.e. Common Equity Tier 1 capital);

- Similarly, the amount to be deducted from Additional Tier 1 or Tier 2 capital will be calculated as the total of all holdings which in aggregate exceed 10% of the bank's common equity (as per above) multiplied by the Additional Tier 1 or Tier 2 capital holdings as a percentage of the total capital holdings.

[13] If the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant sector of the financial entity, it is not required to be deducted.

- If a licensee is required to make a deduction from a particular tier of capital and it does not have sufficient capital to make that deduction, the shortfall will be deducted from the next higher tier of capital (for example, if an institution does not have sufficient Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1 capital).

- The amounts of such capital investments that are below the threshold (i.e. do not exceed the 10%) and are not deducted shall continue to be risk weighted according to the banking and trading book rules.

Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation[14]

(n) The regulatory adjustment described in this section applies to investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation where **the bank owns more than 10% of the issued common share capital of the issuing entity or where the entity is an affiliate**[15] **of the bank**. In addition:

- Investments comprise:

  a. Direct, indirect and synthetic holdings of capital instruments. For example, banks should look through holdings of index securities to determine their underlying holdings of capital.

  b. Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).

  c. Underwriting positions held for five working days or less can be excluded. Underwriting positions held for longer than five working days must be included.

  d. If the capital instrument of the entity in which the bank has invested does not meet the criteria for Common Equity Tier 1, Additional Tier 1, or Tier

[14] Investments in entities that are outside of the scope of regulatory consolidation refers to investments in entities that have not been consolidated at all or have not been consolidated in such a way as to result in their assets being included in the calculation of consolidated risk-weighted assets of the group.

[15] An affiliate of a bank is defined as a company that controls, or is controlled by, or is under common control with, the bank. Control of a company is defined as (1) ownership, control, or holding with power to vote 20% or more of a class of voting securities of the company; or (2) consolidation of the company for financial reporting purposes.

2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.

e. Licensees may, with the prior approval of the Central Bank, temporarily exclude certain investments where these have been made in the context of resolving or providing financial assistance to reorganize a distressed institution.

- All investments included above that are not common shares must be fully deducted from the corresponding tier of capital. This means the deduction should be applied to the same tier of capital for which the capital would qualify if it were issued by the institution itself (e.g. investments in the Additional Tier 1 capital of other entities must be deducted from the institution's Additional Tier 1 capital).

- If a licensee is required to make a deduction from a particular tier of capital and it does not have sufficient capital to make that deduction, the shortfall will be deducted from the next highest tier of capital (e.g. if an institution does not have sufficient Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1 capital).

- Investments included above that are common shares will be subject to the threshold deductions as described in the next section (o).

Threshold Deductions

(o) The following items will be subject to the capital deductions described in this section:

(i) All of the licensee's holdings in entities where the bank owns more than 10% of common equity (i.e. significant investments in the common shares of unconsolidated financial institutions) of the individual entity will each receive limited recognition when calculating Common Equity Tier 1. The recognition will be capped at 10% of the bank's common equity;

(ii) Mortgage servicing rights (MSRs), including those related to consolidated subsidiaries, subsidiaries deconsolidated for regulatory capital purposes, and the proportional share of MSRs in joint ventures subject to proportional consolidation or equity method accounting; and

(iii)Deferred tax assets arising from temporary differences.

- The amount of the three items that are not deducted in the calculation of Common Equity Tier 1 capital will be risk weighted at 250%.

- Licensees must deduct the amount by which the aggregate of the three items above exceeds 15% of its common equity component of Tier 1 capital (calculated prior to the deduction of these items but after application of all other regulatory adjustments applied in the calculation of Common Equity Tier 1 capital). The items included in the 15% aggregate limit are subject to full disclosure.

- As of 1 January 2018, regulatory adjustments (i.e. deductions and prudential filters) including the amounts above the 15% limit for significant investments in financial institutions, mortgage servicing rights, and deferred tax assets from temporary differences will be fully deducted from Common Equity Tier 1 capital. [16]

Other Adjustments

(p) A licensee shall make any other deductions required under any other guidelines and/or as may be required by the Central Bank.

Additional Tier 1 capital (AT1)

38. Additional Tier 1 capital consists of the sum of the following elements:

(a) Instruments issued by the licensee that meet the criteria for inclusion in Additional Tier 1 capital (and are not included in Common Equity Tier 1);

(b) Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital;

(c) Instruments issued by consolidated subsidiaries of the bank and held by third parties (i.e. minority interests) that meet the criteria for inclusion in Additional Tier 1 capital and are not included in Common Equity Tier 1; and

(d) Regulatory adjustments applied in the calculation of Additional Tier 1 capital.

Criteria for inclusion in Additional Tier 1 capital

39. An instrument must satisfy the following criteria to be included in Additional Tier 1 capital:

A. The instrument is issued and fully paid-in in cash;

B. Subordinated to depositors, general creditors and subordinated debt of the bank;

[16] See Appendix 2 for an illustrative example.

C. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the bank's depositors and/or creditors.

D. Is perpetual, i.e. there is no maturity date and there are no step-ups[17] or other incentives to redeem.

E. May be callable at the initiative of the issuer only after a minimum of five years from the issue date, subject to the following requirements:

   a. A call option can be exercised only with the prior approval of the Central Bank;
   b. The bank shall not create an expectation that the call option will be exercised; and
   c. The bank must not exercise a call option unless:

      (i) The bank replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or
      (ii) The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

F. Any repayment of principal (e.g. through repurchase or redemption) must be with prior approval of the Central Bank and licensees should not assume or create market expectations that supervisory approval will be given;

G. With regard to dividend or coupon discretion;

   a. the bank must have full discretion at all times to cancel distributions/payments;
   b. cancellation of discretionary payments must not be an event of default;
   c. banks must have full access to cancelled payments to meet obligations as they fall due;
   d. cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders;

H. Dividends/coupons on the instrument must be paid out of distributable items;

I. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the credit standing of the bank or the group

[17] A step-up is defined as a call option combined with a pre-set increase in the initial credit spread of the instrument at a future date over the initial dividend (or distribution) rate after taking into account any swap spread between the original reference index. Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread would not constitute a step-up.

J. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law governing the provisions of the capital instrument;

K. Where the instrument is classified as a liability for accounting purposes, it must have principal loss absorption through either: (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write down will have the following effects:
   a. Reduce the claim of the instrument in liquidation;
   b. Reduce the amount re-paid when a call is exercised; and
   c. Partially or fully reduce coupon/dividend payments on the instrument.

L. Neither the licensee nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

M. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

N. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity[18] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.

O. The agreement governing the issuance of the capital instrument shall not be changed without the prior approval of the Central Bank where such proposed changes could impact its eligibility as AT1 Capital.

Regulatory Adjustments to Additional Tier 1 capital

40. A licensee shall apply the following regulatory adjustments in the calculation of AT1 Capital at the solo or consolidated level, as the case may be:

    (a) Where the amount of AT1 Capital is insufficient to cover the amount of deductions required to be made from this category of capital, the shortfall must be deducted from CET1 Capital.

    Investment in own Additional Tier 1 capital

    (b) Investments in the bank's own AT1 capital instruments, whether held directly or indirectly by the bank shall be deducted in the calculation of AT1 Capital. In

[18] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

addition, any AT1 capital instruments, which the reporting bank could be contractually obliged to purchase, shall also be included in the deduction of Tier 1 capital. This adjustment shall apply to exposures in both the banking book and trading books.

Investments (significant and non-significant investments) in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation

(c) These comprise of:

(i) Direct, indirect and synthetic holdings of AT1 Capital instruments in banking, financial and insurance entities. This includes:

- Holdings of AT1 Capital instruments held in the banking book;
- Net long positions[19] in AT1 Capital Instruments[20] held in the trading book; and
- Underwriting positions in AT1 Capital instruments held for more than five working days.

(ii) The amount of such capital investments to be deducted in the calculation of AT1 Capital shall be in accordance with paragraphs (m) and (n) above.

(d) If the bank does not have sufficient Additional Tier 1 capital needed to make the required deductions, the shortfall must be deducted from Common Equity Tier 1 capital.

Tier 2 capital

41. Tier 2 capital includes other components of capital that, to varying degrees, fall short of the quality of Tier 1 capital, but nonetheless contribute to the overall strength of a bank and its capacity to absorb losses. Tier 2 capital (prior to regulatory adjustments) consists of the sum of the following elements:

(a) Instruments issued by the licensee that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital);

(b) Contributed surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;

[19] ***'Net long positions'*** are the gross long positions net of short positions in the same underlying exposures where the maturity of the short positions either match the maturity of the long positions or have residual maturities of at least one year. They include netting positions in physical instruments and derivatives over the same underlying exposure (including those associated with looking through holdings of index securities).

[20] This includes investments in capital instruments resulting from the holdings of index securities. Financial institutions are permitted to net long short positions in the same index security subject to maturity matching provisions.

(c) Instruments issued by consolidated subsidiaries of the licensee and held by third parties (i.e. minority interests) that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital.

(d) Certain loan loss provisions such as general provisions/general loan-loss reserve; and

(e) Regulatory adjustments applied in the calculation of Tier 2 capital.

Criteria for inclusion in Tier 2 capital

42. The objective of Tier 2 is to provide loss absorption on a gone-concern basis. The following sets out the minimum set of criteria for an instrument to meet in order for it to be included in Tier 2 capital:

(a) The instrument is issued and fully paid-in in cash.

(b) The instrument is subordinated to depositors and general creditors of the bank.

(c) Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank creditors.

(d) The instrument must have a minimum original maturity of at least five years and there are no step-ups or other incentives to redeem.

(e) The amount of the instrument that will be eligible for inclusion in Tier 2 capital shall be amortised on a straight line basis as follows:

Years to Maturity	**Amount Eligible for Inclusion in Tier 2 capital**
5 years or more	100 percent
4 years	80 percent
3 years	60 percent
2 years	40 percent
1 year	20 percent
Less than 1 year	0 percent

(f) The instrument may be callable at the initiative of the issuer only after a minimum of five years, subject to the following requirements:

1. To exercise a call option a bank must receive approval of the Central Bank;

2. A bank must not do anything that creates an expectation that the call will be exercised; and
3. Banks must not exercise a call unless:
   (i) They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or
   (ii) The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

(g) The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

(h) The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the credit standing of the bank.

(i) Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.

(j) If the instrument is not issued out of an operating entity[21] or the holding company in the consolidated group (e.g. a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 capital.

Contributed/Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital;

43. Contributed/Stock surplus (i.e. share premium) that is not eligible for inclusion in Tier 1, will only be permitted to be included in Tier 2 capital if the shares giving rise to the contributed/stock surplus are permitted to be included in Tier 2 capital.

General provisions/general loan-loss reserves

44. Provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialize and therefore qualify for inclusion within Tier 2. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded. Furthermore, general provisions/general loan-loss reserves eligible for inclusion in Tier 2 will be limited to a maximum of 1.25 percentage points of credit risk weighted assets calculated under the standardized approach.

[21] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

Regulatory Adjustments to Tier 2 capital

45. Net Tier 2 capital is defined as Tier 2 capital including all regulatory adjustments, but may not be lower than zero. If the total of all Tier 2 deductions exceeds Tier 2 capital available, the excess must be deducted from Additional Tier 1 capital.

46. A licensee shall apply the following regulatory adjustments in the calculation of Tier 2 capital at the solo or consolidated level, as the case may be:

Investment in own Tier 2 capital

(a) Investments in the licensee's own Tier 2 capital instruments, whether held directly or indirectly by the bank, shall be deducted in the calculation of Tier 2 capital. In addition, any investments in the licensee's own Tier 2 capital instruments, in which the bank could be contractually obliged to purchase, shall also be included in the deduction of Total Capital. This adjustment shall apply to exposures in both the banking book and trading books.

Investments (significant and non-significant investments) in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation

(b) These comprise of:

(i) Direct, indirect and synthetic holdings of Tier 2 capital instruments in banking, financial and insurance entities. This includes:

- Holdings of Tier 2 capital instruments held in the banking book;
- Net long positions in Tier 2 capital Instruments held in the trading book; and
- Underwriting positions in Tier 2 capital instruments held for more than five working days.

(ii) The amount of such capital investments to be deducted in the calculation of Tier 2 capital shall be in accordance with paragraphs (m) and (n) above.

(c) If the bank does not have sufficient Tier 2 capital needed to make the required deductions from Tier 2 capital, the shortfall must be deducted from Additional Tier 1 capital.

Additional Reporting Requirements

47. A licensee must ensure that any component of capital included in its capital base satisfies, in both form and substance, all applicable requirements prescribed for the relevant category of capital, in which it is included.

48. The Central Bank may, in writing, require a bank to:

   j. Exclude from its regulatory capital any component of capital that in the opinion of the Central Bank does not represent a genuine contribution to the financial strength of the bank; or
   k. Reallocate to a lower category of capital any component of capital that in the opinion of the Central Bank does not fully satisfy the requirements for the category of capital to which it was originally allocated.

49. A licensee must provide the Central Bank, as soon as practicable, with copies of documentation associated with the issue of Tier 1 and Tier 2 instruments and provide a description of the main features of the capital instrument issued.

50. A licensee must immediately notify the Central Bank prior to any subsequent modification of the terms and conditions of an instrument that may affect its eligibility to continue to qualify as regulatory capital.

PART 3 – CALCULATION FOR THE CAPITAL CHARGE FOR CREDIT RISK: STANDARDIZED APPROACH

51. The Basel Committee provides two alternatives for the implementation of capital charges for credit risk: 1) the Standardized Approach which provides a standardized methodology using the risk ratings assigned by eligible external credit assessment institutions[22] and 2) the Internal Ratings Based Approach which allows banks to implement their own internal ratings system subject to the approval of national supervisors. The Central Bank has opted to utilize the Standardized Approach for determining the capital charge for credit risk.

52. In determining credit risk capital charges, the licensee must apply the prescribed risk-weights to both on-balance sheet and off-balance sheet exposures. Exposures are to be risk weighted net of specific provisions. Risk weights will be based on the risk rating assigned by external credit assessment institutions (ECAIs)[23] deemed eligible by the Central Bank. Appendix 3 outlines the criteria the Central Bank will use in recognizing an ECAI as eligible for capital adequacy purposes. It also outlines key issues related to the use of ratings assigned by eligible ECAIs.

Risk Weight Categories

<u>Claims on Sovereigns</u>

53. Claims on sovereigns and their central banks will be risk weighted as follows:

Credit Assessment of Sovereign	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	0%	20%	50%	100%	150%	100%

54. Using national discretion, the Central Bank will allow a 0% risk weight to be applied to licensees' exposures to The Bahamas Government (or The Central Bank of The Bahamas). Such exposures must be denominated in the domestic currency and funded[24] in the domestic currency.

55. Licensees with exposures (that are funded and denominated in the domestic currency) to other sovereigns (i.e. overseas central governments or central banks) may apply the preferential risk weight assigned to those sovereign exposures by their national supervisors.

[22] These Guidelines follow the methodology used by Standard & Poor's. The use of Standard and Poor's credit ratings is an example only. Credit ratings from Moody's Investors Service and Fitch Ratings can equally be used.
[23] Also called Credit Rating Agencies (CRAs)
[24] That is, where the bank has corresponding liabilities denominated in that domestic currency.

56. For claims on sovereigns that are unrated, the Central Bank will recognize the country risk scores assigned by an Export Credit Agencies (ECAs). To qualify, an ECA must publish its risk scores and subscribe to the Organization for Economic Co-operation and Development (OECD) agreed methodology. Licensees may choose to use the risk scores of ECAs that are recognized by their home supervisor, or the consensus risk scores of ECAs participating in the "Arrangement on Officially Supported Export Credits"[25]. The OECD agreed methodology establishes eight risk score categories associated with minimum export insurance premiums. These ECA risk scores will correspond to the risk weight categories detailed in the table below:

ECA Risk Scores	**0-1**	**2**	**3**	**4-6**	**7**
Risk Weight	0%	20%	50%	100%	150%

57. Licensees should apply a 0% risk weight to claims on the Bank for International Settlements (BIS), the International Monetary Fund (IMF), the European Central Bank and the European Community.

<u>Claims on Non-Central Government Public Sector Entities (PSEs)</u>

58. Using national discretion, claims on domestic PSEs will be assigned a risk weight using the following three criteria:

Domestic PSEs	**Criteria**	**Risk Weight**
Treated as a Sovereign	Claims of domestic PSEs which are guaranteed by central government. The guarantee must be explicit, unconditional, legally enforceable and irrevocable.	0%
Treated as a Bank	Claims of domestic PSEs which are not guaranteed by central government and the PSE does not participate in a competitive market will be assessed an equivalent risk weight as a bank.	See risk weights for claims on banks
Treated as a Corporate	Claims of domestic PSEs which are not guaranteed by central government and the PSE participates in a competitive market will be assessed an equivalent risk weight as a corporate.	100%

[25] The consensus country risk classification is available on the OECD's website (http:/www.oecd.org) in the Export Credit Arrangement web-page of the Trade Directorate.

Claims on multilateral development banks (MDBs)

59. Claims on MDBs will generally be risk weighted in accordance with the table below:

Credit Assessment of Banks (Option 2)	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	20%	50%	50%	100%	150%	50%

60. Claims on highly rated MDBs that meet the following criteria will receive a risk weight of 0%:

a) very high quality long term issuer ratings, i.e. the majority of an MDB's external assessments must be AAA;
b) the MDB's shareholder structure is comprised of a significant proportion of sovereigns with long-term issuer credit assessments of AA- or better, or the majority of the MDB's fund-raising is in the form of paid-in equity/capital and there is little or no leverage;
c) strong shareholder support demonstrated by the amount of paid-in capital contributed by the shareholders; the amount of further capital the MDBs have the right to call, if required, to repay their liabilities; and continued capital contributions and new pledges from sovereign shareholders;
d) adequate level of capital and liquidity (a case-by-case approach is necessary in order to assess whether each MDB's capital and liquidity are adequate); and,
e) strict statutory lending requirements and conservative financial policies, which would include among other conditions a structured approval process, internal creditworthiness and risk concentration limits (per country, sector, and individual exposure and credit category), large exposures approval by the board or a committee of the board, fixed repayment schedules, effective monitoring of use of proceeds, status review process, and rigorous assessment of risk and provisioning to loan loss reserve.

61. The following special MDBs are eligible for a risk weight of 0%:
- International Bank for Reconstruction and Development (IBRD)
- International Finance Corporation (IFC)
- Asian Development Bank (ADB)
- African Development Bank (AfDB)
- European Bank for Reconstruction and Development (EBRD)
- Inter-American Development Bank (IADB)
- European Investment Bank (EIB)
- European Investment Fund (EIF)
- Nordic Investment Bank (NIB)
- Caribbean Development Bank (CDB)
- Islamic Development Bank (IDB)
- Council of Europe Development Bank (CEDB)

Claims on banks

62. No claim on an unrated bank may receive a risk weight lower than a claim on its sovereign of incorporation.

Maturity more than three months

63. Risk weights for all banks will be assigned a risk less favourable than that assigned to claims on the sovereign of that country

64. However, for claims on banks in countries with sovereigns rated BB+ to B- and on banks in unrated countries, the risk weight of 100% will apply. Accordingly, claims on banks (with a maturity of more than three months) will be risk weighted as follows:

Credit Assessment of Sovereign	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight for Banks[26]	20%	50%	100%	100%	150%	100%

Maturity of three months or less

65. A claim will be treated as a short term claim where it has an original maturity of three (3) months or less. Short term claims on banks that are funded and denominated in **domestic currency** (i.e. Bahamian dollars) will be assigned a risk weight of 20% (which is one category less favourable than claims on the Government of The Bahamas or the Central Bank of The Bahamas).

66. A claim will be treated as a short term claim where it has an original maturity of three (3) months or less. Short term claims on banks that are funded and denominated in **foreign currency** will be assigned a preferential risk weight that is one category less favourable than claims on the sovereign, subject to a floor of 20%.

67. Short term claims with (contractual) original maturity under 3 months which are expected to be rolled over (i.e. where the effective maturity is longer than 3 months) will not qualify for the preferential treatment outlined under this part for capital adequacy purposes.

Claims on securities firms

68. Claims on securities firms will be treated as claims on banks provided these firms are subject to supervisory and regulatory arrangements comparable to those under the Basel II framework (including, in particular, risk-based capital requirements). Otherwise, such claims will be risk weighted as claims on corporates (see paragraphs 65 - 68).

[26] Using national discretion, the Central Bank is using Option 1 for claims on banks which are based on the credit assessment of sovereigns.

Claims on corporates

69. The following claims will be subject to a risk weight of 100% without regard to external ratings:
    i. Claims on corporates (excluding venture capital and private equity investment corporations);
    ii. Claims on insurance companies;
    iii. Claims on securities companies that do not qualify for the treatment for claim on banks (as stated in paragraph 64).

70. No claim on an unrated corporate may be given a risk weight preferential to that assigned to its sovereign of incorporation.

71. The Central Bank reserves the right to increase the standard risk weight for unrated claims where it determines that a higher risk weight is warranted by the overall default experience.

72. As part of the supervisory review process (Pillar 2), the Central Bank may also consider whether the credit quality of corporate claims held by individual banks should warrant a standard risk weight higher than 100%.

Claims included in the regulatory retail portfolios

73. Claims that qualify under the regulatory retail portfolio will receive a 75% risk weight. To qualify under the regulatory retail portfolio the exposure must meet the following criteria:

    a. **Orientation Criterion** - The exposure is to an individual person, persons, or small business;
    b. **Product Criterion -** The exposure takes the form of any of the following:
        i. Revolving credits and lines of credit (including credit cards and overdrafts);
        ii. Personal term loans and leases (e.g. installment loans, auto loans and leases, student and educational loans, personal finance, etc.); or
        iii. Small business facilities and commitments.

    Securities (such as bonds and equities), whether listed or not, must be excluded from this category. Mortgage loans must also be excluded to the extent that they qualify for treatment as claims secured by residential property.
    c. **Granularity Criterion –** the Central Bank must be satisfied that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio. Among other things, the maximum aggregate exposures[27] to any one counterparty should not exceed $100,000.

[27] Aggregated exposure means gross amount (i.e. not taking any credit risk mitigation into account) of all forms of debt exposures (e.g. loans or commitments) that individually satisfy the three other criteria. In addition, "to one counterparty" means one or several entities

d. **Low value of individual exposures** ─ the maximum aggregated retail exposure to one counterpart cannot exceed an absolute threshold of $100,000. Small business loans extended through or guaranteed by an individual are subject to the same exposure threshold.

74. Claims that do not satisfy the above criteria will be risk weighted at 100%.

75. In addition, the Central Bank will regularly review the 75% risk weight to ensure that it is not too low based on the default experience for these types of exposures.

76. Past due loans (over 90 days) and claims secured by residential property are **excluded** from the regulatory retail portfolio for risk weighting purposes.

Claims secured by residential property

77. Loans secured by mortgages on residential property (residential mortgage loans) will be risk weighted at 50% provided all the following conditions are met:
    i. The property is or will be occupied by the borrower or is rented; and
    ii. The loan is not past due for more than 90 days.

78. Where a residential mortgage loan does not satisfy the conditions set out at paragraph 73 above, a 100% risk weight should be applied.

79. The Central Bank will maintain under review the default experience with such claims to determine the continuing appropriateness of the concessionary weighting.

Claims secured by commercial property

80. A risk weight of 100% will be applied to claims secured by commercial real estate, which are not past due.

Past Due Loans

Unsecured Portions of Past Due Loans

81. The unsecured portion of any loan (other than a qualifying residential mortgage loan) that is past due for more than 90 days, net of specific provisions, including partial write offs, will be risk-weighted as follows:
    - 150% risk weight when specific provisions are less than 20% of the outstanding amount of the loan.
    - 100% risk weight when specific provisions are no less than 20% of the outstanding amount of the loan.

that may be considered as a single beneficiary (e.g. in the case of a small business that is affiliated to another small business, the limit would apply to the bank's aggregated exposure on both businesses).

Secured Portions of Past Due Loans

82. Banks should apply the same risk weight on the secured portion of past due loans secured by eligible collateral or guarantees (See Appendix 4 – Eligible Collateral), as if they were not past due, provided the credit risk mitigation criteria continues to be satisfied.

83. Past due loans fully secured by collateral not recognized under the Credit Risk Mitigation framework are to be risk-weighted at 150%.

84. Qualifying residential mortgage loans that are past due for more than 90 days will be risk weighted at 100%, net of specific provisions. If such loans are past due but specific provisions are no less than 20% of their outstanding amount, the risk weight of 50% will be applied.

High Risk Categories

85. A risk weight of 150% will apply to venture capital and private equity investments[28].

Securitizations

86. Securitization tranches that are rated between BB+ and BB- will be risk weighted at 350%. Otherwise, the following will be used to risk weight securitizations:

Credit Assessment	AAA to AA- (A-1/P-1)	A+ to A- (A-2/P-2)	BBB+ to BBB- (A-3/P-3)	BB+ to BB-	B+ and Below	Unrated
Risk Weight	20%	50%	100%	350%	Deduction	Deduction[29]

Investments (Shares and Securities)

87. Domestic Securities such as Public Corporation Bonds will be risk weighted at 20% while other domestic securities will be risk weighted at 100%.

88. Foreign Securities and Other Investments will be risk weighted at 100%.

Other Assets

89. Generally, the standard risk weight for all other assets will be 100%.

[28] A venture capital or private equity investment is deemed to be one which, at the time the investment is made, is: a) in a new or developing company or venture; or b) in a management buy-out or buy-in; or c) made as a means of financing the investee company or venture and accompanied by a right of consultation, or rights to information, or board representation, or management rights; or d) acquired with a view to, or in order to, facilitate a transaction falling within (a) to (c).

[29] Where deductions of investments are made, the deductions will be 50% from Tier 1 and 50% from Tier 2 Capital.

90. A 0% risk weight will apply to:
    - Cash;
    - Gold Bullion, held in the institution's own vaults or on an allocated basis to the extent backed by bullion liabilities; and,
    - Exposures collateralized by cash deposits.

91. A 20% risk weight will apply to:
    - Cash items in the process of collection

92. A 100% risk weight will apply to:
    - Collective Investment Scheme Exposures;
    - Premises, plant, equipment and other fixed assets;
    - Investments in equity of other entities and holdings of investment funds (including investments in commercial entities) (where there is no deduction from the licensee's capital base);
    - Gold Bullion – other;
    - Silver Bullion, Precious Metals and Gemstones; and,
    - All other assets not included elsewhere (such as exposures to individuals, other on-balance sheet assets).

Treatment of Off-Balance Sheet Exposures

93. The categories of off-balance sheet items include guarantees, commitments, and similar contracts whose full notional principal amount may not necessarily be reflected on the balance sheet. A bank's total risk-weighted off-balance sheet credit exposures are calculated as the sum of the risk-weighted amounts of all its market-related (i.e. derivative instruments) and non-market related (i.e. non-derivative instruments) transactions.

94. A two-step approach is used in order to derive the risk-weighted amounts of off-balance sheet items as follows:
    l. The nominal principal amounts of off-balance sheet items are multiplied by the credit conversion factors (CCFs); and
    m. The resulting credit equivalent amounts are multiplied by the risk weights applicable to the counterparty.

95. Where the transaction is secured by eligible collateral, guarantee or credit derivative[30], the credit risk mitigation technique detailed under Credit Risk Mitigation shall be used to reduce the regulatory capital charge of the exposure.

96. Licensees should convert off-balance sheet items into credit exposures equivalents through the use of credit conversion factors (CCFs) as follows:

[30] Only two types of credit derivatives, will be eligible for recognition (credit default swaps and total return swaps).

Off-Balance Sheet Exposure	Credit Conversion Factor(CCF)
i. Commitments that are unconditionally cancellable at any time by the bank without prior notice or that effectively provide for automatic cancellation due to the deterioration in a borrower's credit worthiness	**0%**
i. Commitments with an original maturity up to one year ii. Short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralized by the underlying shipment)[31]	**20%**
i. Commitments with an original maturity exceeding one year, including underwriting commitments and commercial credit lines ii. Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions) iii. Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs)	**50%**
i. Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances) ii. Sale and repurchase agreements[32] iii. Asset sales with recourse where the credit risk remains with the bank[33] iv. Forward asset purchases, forward deposits and partly-paid shares and securities,[34] which represent commitments with certain drawdown v. Lending of banks' securities or the posting of securities as collateral by banks, including instances where these arise out of repo-style transactions (i.e. repurchase/ reverse repurchase and securities lending/securities borrowing transactions)[35]	**100%**

[31] A 20% CCF will be applied to both issuing and confirming banks.
[32] A sale and repurchase agreement (repo) is an arrangement whereby a bank sells an instrument to a third party with a commitment to repurchase the asset for an agreed price on demand, or after a stated time, or in the event of a particular contingency. It represents an irrevocable commitment and should be reported as an off-balance sheet item.
[33] These items are to be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.
[34] These items are to be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into.
[35] The calculation of the risk weighted assets where the credit converted exposure is secured by eligible collateral is covered under the section "Collateralized Transactions" of the Credit Risk Mitigation Framework.

97. Where there is an undertaking to provide a commitment on an off-balance sheet item, the lower of the two applicable CCFs is to be applied.[36]

98. Licensees should categorize off-balance sheet exposures into the following standard items below and determine the appropriate CCF(s) to be applied:

<u>Exposures without CRM</u>

This column is completed for exposures, which do not have any allowable credit risk mitigants. The *Credit Equivalent Exposure* column calculates automatically after inputting the *Principal Amount before CCF*.

<u>Exposures with CRM</u>

This section is completed for exposures which have recognized credit risk mitigants. The *Credit Equivalent Exposure pre-CRM* column calculates automatically after inputting the *Principal Amount before CCF*. However, licensees are required to calculate the *Credit equivalent exposures post-CRM* using the rules outlined under Credit Risk Mitigation. Off-balance sheet netting is not allowed.

<u>Over-the-Counter Derivative (OTC) transactions</u>

99. In calculating a bank's risk-weighted off-balance sheet credit exposures arising from market-related transactions for capital adequacy purposes, the bank should include all market-related transactions held in the banking and trading books which give rise to off-balance sheet credit risk.

100. Market related transactions include the following:

n. **Interest rate contracts** – these include single currency interest rate swaps, basis swaps, forward rate agreements, interest rate futures, interest rate options purchased and any other instruments of a similar nature;

o. **Foreign exchange contracts** (including contracts involving gold) – these include cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options purchased, hedge contracts and any other instruments of a similar nature;

p. **Equity contracts** – these include swaps, forwards, purchased options and similar derivative contracts based on individual equities or equity indices;

q. **Precious metal contracts** (other than gold) – these include swaps, forwards, purchased options and similar derivative contracts based on precious metals such as silver and platinum;

[36] For example, an irrevocable commitment with an original maturity of 15 months (50% - CCF) to issue a 6 month documentary letter of credit (20% - CCF) would attract the lower of the CCF i.e. the CCF applicable to the documentary letter of credit – 20% CCF.

r. **Other commodity contracts** (other than precious metals) – these include swaps, forwards, purchased options and similar derivative contracts based on energy contracts, agricultural contracts and any other non-precious metal commodity contracts; and

s. **Other market-related contracts** – these include any contracts covering other items giving rise to credit risk.

101. To calculate the credit equivalent amount for OTC derivative contracts, the Current Exposure Method is to be applied. Under the Current Exposure Method, a bank would sum:

t. The current exposure, which is the total replacement cost (obtained by "marking to market") all of its contracts with positive value; and

u. An amount for potential future credit exposure, which is derived by applying the CCF, according to the residual maturity, to the notional principal amount or face value of the contracts as specified below:

Conversion factor (%) for an exposure	**Type of Contract**				
Residual maturity	**Interest rates**	**FX and Gold**	**Equities**	**Precious metals except Gold**	**Other Commodities**
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
Over one year to five years	0.5%	5.0%	8.0%	7.0%	12.0%
Over five years	1.5%	7.5%	10.0%	8.0%	15.0%

Notes:

- For contracts with multiple exchanges of principal, the factors are to be multiplied by the number of remaining payments in the contract.
- For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. In the case of interest rate contracts with remaining maturities of more than one year that meet the above criteria, the add-on factor is subject to a floor of 0.5%.
- Forwards, swaps, purchased options and similar derivative contracts not covered by any of the columns of this matrix are to be treated as "other commodities".
- No potential future credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

PART 4 – CREDIT RISK MITIGATION

Credit Risk Mitigation

102. Banks may use a number of techniques to mitigate the credit risks to which they are exposed. These techniques include:

a. Collateralization - exposures may be collateralized by first priority claims, in whole or in part with cash or securities.
b. Netting - licensees may agree to net loans owed to them against deposits from the same counterparty.
c. Guarantees and/or credit derivatives - a loan exposure may be guaranteed by a third party; in addition licensees may buy a credit derivative to offset various forms of credit risk.

103. Where these techniques meet the operational requirements for legal certainty as set out at below, credit risk mitigation may be recognised. The revised approach to credit risk mitigation (CRM) under the Basel II Framework allows a wider range of credit risk mitigants to be recognized for regulatory capital purposes.

Legal Certainty

104. In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentation must be met:

v. all documentation used in collateralized transactions and for documenting on-balance sheet netting, guarantees and credit derivatives must be binding on all parties and legally enforceable in all relevant jurisdictions;

w. licensees must conduct sufficient legal review to verify this, and have a well-founded legal basis to reach this conclusion (in a. above); and

x. licensees must undertake such further reviews as may be necessary to ensure continuing enforceability of documentation.

Proportional cover

105. Where the amount collateralised or guaranteed, (or against which credit protection is held), is less than the amount of the exposure, and the secured and unsecured portions are of equal seniority, i.e. the bank and the guarantor share losses on a pro-rata basis capital relief will be afforded on a proportional basis. In this instance the protected portion of the exposure will receive the treatment applicable to the eligible collateral (guarantee/credit derivative) or counterparty, with the remainder treated as unsecured.

General Considerations

106. While the use of CRM techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks) such as legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and

processes to control these risks, including strategy, consideration of the underlying credit, valuation, policies and procedures, systems, control of roll-off risks and management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile. Where the Central Bank is not satisfied that these risks are adequately controlled, it may impose additional capital charges or take other supervisory action pursuant to Pillar 2.

107. No transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.

108. The effects of CRM will not be double-counted. Therefore, the Central Bank will not grant any additional supervisory recognition of CRM for regulatory capital purposes on claims for which an issue-specific rating is used that already reflects that CRM. Principal-only ratings will also not be allowed within the framework of CRM.[37]

109. The requirements under Pillar 3 must also be observed for banks to obtain capital relief in respect of any CRM techniques.

Collateralized Transactions

110. A collateralized transaction is one in which:
- banks have a credit exposure or potential credit exposure; and
- that credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by a counterparty[38] or by a third party on behalf of the counterparty.

111. Where banks take eligible financial collateral (e.g. cash or securities, more specifically defined in Appendix 4), they are allowed to reduce their credit exposure to a counterparty when calculating their capital requirements to take account of the risk mitigating effect of the collateral.

112. A capital charge will be applied to banks on either side of the collateralized transaction: for example, both repos and reverse repos will be subject to capital charges. Likewise, both sides of a securities lending and borrowing transaction will be subject to explicit capital charges, as will the posting of securities in connection with a derivative exposure or other borrowing.

113. Where a licensee, acting as an agent, arranges a repo-style transaction (i.e. repurchase/reverse repurchase and securities lending/borrowing transactions)

[37] For example, if a bank is owed both principal and interest, the assessment must fully take into account and reflect the credit risk associated with repayment of both principal and interest.
[38] In this section "counterparty" is used to denote a party to whom a bank has an on- or off-balance sheet credit exposure or a potential credit exposure. That exposure may, for example, take the form of a loan of cash or securities (where the counterparty would traditionally be called the borrower), of securities posted as collateral, of a commitment or of exposure under an OTC derivatives contract.

between a customer and a third party and provides a guarantee to the customer that the third party will perform on its obligations, then the risk to the bank is the same as if the bank had entered into the transaction as a principal. In such circumstances, a licensee will be required to calculate capital requirements as if it were itself the principal.

114. Under the Basel framework, in calculating regulatory capital for collateralized transactions, banks are permitted to choose between the "Simple Approach" and the "Comprehensive Approach"[39]. For the purposes of calculating risk-weighted assets, licensees must use the Simple Approach exclusively. In the simple approach, the risk weighting of the collateral instrument, collateralizing (or partially collateralizing) the exposure is substituted for the risk weighting of the counterparty.

Pre-conditions

115. Prior to banks receiving any capital relief in respect of any form of collateral, the standards below must be met under the Simple Approach:

a) In addition to the general requirements for legal certainty set out at paragraph 92 above, the legal mechanism by which collateral is pledged or transferred must ensure that banks have the right to liquidate or take legal possession of the collateral, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set forth in the transaction documentation) of the counterparty (and where applicable, of the custodian holding the collateral).

b) Licensees must take all steps necessary to fulfill those requirements under the law applicable to their interest in the collateral for obtaining and maintaining an enforceable security interest, e.g. by registering it with a registrar, or for exercising a right to net or set off in relation to title transfer collateral.

c) Where the credit quality of the counterparty and the value of the collateral have a material positive correlation, the collateral instrument will not be eligible for credit risk mitigation purposes. For example, securities issued by the counterparty, or by any related group entity, would provide little protection and so would be ineligible.

d) Banks must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed, and that collateral can be liquidated promptly.

[39] The simple approach substitutes the risk weighting of the collateral for the risk weighting of the counterparty for the collateralized portion of the exposure (generally subject to a 20% floor) while the comprehensive approach allows for fuller offset of collateral against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral.

e) Where a custodian holds the collateral, licensees must take reasonable steps to ensure that the custodian segregates the collateral from its own assets.

The Simple Approach

Minimum conditions

116. For collateral to be recognized under the simple approach the collateral must be pledged for at least the life of the exposure and it must be marked to market and re-valued with a minimum frequency of six months. Those portions of claims collateralized by the market value of recognized collateral receive the risk weight applicable to the collateral instrument. The risk weight on the collateralized portion will be subject to a floor of 20% (see exceptions outlined below). The uncollateralized portion of a claim will be assigned to the risk weight appropriate to the counterparty.

Exceptions to the Risk Weight Floor

117. Those portions of claims collateralised by the market value of recognised collateral receive the risk weight applicable to the collateral instrument (or the protection provider). To observe the effects of credit risk mitigation, the risk weight on the collateralised portion will be subject to a floor of 50%.[40] The remainder of the claim should be assigned to the risk weight appropriate to the counterparty.

118. Where a transaction is collateralized, a 0% risk weight may be applied where the exposure and the collateral are denominated in the same currency, and either

a. the collateral is cash on deposit[41]; or

b. the collateral is in the form of sovereign/PSE securities eligible for a 0% risk weight, and its market value has been discounted by 20%.

Guarantees and Credit Derivatives

119. Where guarantees or credit derivatives are direct, explicit, irrevocable, legally enforceable and unconditional, and the Central Bank is satisfied that licensees fulfill certain minimum operational conditions relating to risk management processes, licensees are permitted to take account of such credit protection in calculating capital requirements.

120. A range of guarantors and protection providers are recognized. A substitution approach will be applied whereby only guarantees issued by or protection provided by entities with a lower risk weight than the counterparty will lead to reduced capital charges since the protected portion of the counterparty exposure is assigned

[40] On an interim basis, the Central Bank will apply a more conservative treatment when risk weighting the collateral under the simple approach. This position is expected to be revisited.

[41] As defined in a) of Appendix 4 – CRM-Eligible Financial Collateral

the risk weight of the guarantor or protection provider, whereas the uncovered portion retains the risk weight of the underlying counterparty.

Operational requirements common to both guarantees and credit derivatives

121. A guarantee (counter-guarantee) or credit derivative must:

a) represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and incontrovertible;

b) be irrevocable; other than where there is non-payment by a protection purchaser of money due in respect of the credit protection contract. There must be no clause in the contract that would allow the protection provider unilaterally to cancel the credit cover or that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure; and

c) must also be unconditional; there should be no clause in the protection contract outside the direct control of the licensee that could prevent the protection provider from being obligated to pay out in a timely manner in the event that the original counterparty fails to make the payment(s) due.

Additional operational requirements for guarantees

122. In addition to the legal certainty requirements outlined above, in order for a guarantee to be recognized, the following conditions must be satisfied:

a) On the qualifying default/non-payment of the counterparty, the licensee may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the bank, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee. The bank must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counterparty for payment;

b) The guarantee is an explicitly documented obligation assumed by the guarantor; and

c) Except as noted in the following sentence, the guarantee covers all types of payments the underlying obligor is expected to make under the documentation governing the transaction, for example notional amount, margin payments, etc. Where the guarantee covers payment of principal only, interests and other uncovered payments should be treated as an unsecured amount in accordance with paragraph 101 above.

Additional operational requirements for credit derivatives

123. In order for a credit derivative contract to be recognized, the following conditions must be satisfied:

a) the credit events specified by the contracting parties must at a minimum cover:

i. failure to pay the amounts due under terms of the underlying obligation that are in effect at the time of such failure (with a grace period that is closely in line with the grace period in the underlying obligation);

ii. bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events; and

iii. restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e. charge-off, specific provision or other similar debit to the profit and loss account). When restructuring is not specified as a credit event, refer to paragraph 120.

b) If the credit derivative covers obligations that do not include the underlying obligation, item (g) below governs whether the asset mismatch is permissible;

c) The credit derivative shall not terminate prior to expiration of any grace period required for a default on the underlying obligation to occur as a result of a failure to pay;

d) Credit derivatives allowing for cash settlement are recognized for capital purposes insofar as a robust valuation process is in place in order to estimate loss reliably. There must be a clearly specified period for obtaining post-credit event valuations of the underlying obligation. If the reference obligation specified in the credit derivative for purposes of cash settlement is different than the underlying obligation, item (g) below governs whether the asset mismatch is permissible;

e) If the protection purchaser's right/ability to transfer the underlying obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld;

f) The identity of the parties responsible for determining whether a credit event has occurred must be clearly defined. This determination must not be the sole responsibility of the protection seller. The protection buyer must have the right/ability to inform the protection provider of the occurrence of a credit event;

g) A mismatch between the underlying obligation and the reference obligation under the credit derivative (i.e. the obligation used for purposes of determining cash settlement value or the deliverable obligation) is permissible if (1) the reference obligation ranks pari passu with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place; and

h) a mismatch between the underlying obligation and the obligation used for purposes of determining whether a credit event has occurred is permissible if (1) the latter obligation ranks pari passu with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e. the same legal entity) and legally enforceable cross-default or cross acceleration clauses are in place.

124. Partial recognition of the credit derivative will be allowed in instances where the restructuring of the underlying obligation is not covered by the credit derivative, but the other operational requirements in paragraph 119 are met. Partial recognition will be permitted:

a) if the amount of the credit derivative is less than or equal to the amount of the underlying obligation, 60% of the amount of the hedge can be recognized as covered; and

b) if the amount of the credit derivative is larger than that of the underlying obligation, then the amount of eligible hedge is capped at 60% of the amount of the underlying obligation.

125. Only credit default swaps and total return swaps that provide credit protection equivalent to guarantees will be eligible for recognition.

126. However, the credit protection will not be recognized where a banks buys credit protection through a total return swap and records the net payments received on the swap as net income, but does not record offsetting deterioration in the value of the asset that is protected (either through reductions in fair value or by an addition to reserves).

127. Other types of credit derivatives will not be eligible for recognition at this time[42].

Range of Eligible Guarantors (Counter-Guarantors)/Protection Providers

128. Credit protection given by the following entities will be recognized:

a) sovereign entities[43], PSEs, banks[44] and securities firms with a lower risk weight than the counterparty;

[42] Cash funded credit linked notes issued by the bank against exposures in the banking book which fulfill the criteria for credit derivatives will be treated as cash collateralized transactions.
[43] These include the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Community, as well as those MDBs currently referred to in paragraph 11.
[44] This includes other MDBs.

b) other entities rated A- or better. This would include credit protection provided by parent, subsidiary and affiliate companies when they have a lower risk weight than the obligor.

Risk Weights

129. The protected portion is assigned the risk weight of the protection provider. The uncovered portion of the exposure is assigned the risk weight of the underlying counterparty.

130. Materiality thresholds on payments below which no payment is made in the event of loss are equivalent to retained first loss positions and must be deducted in full from the capital of the bank purchasing the credit protection.

Currency Mismatches

131. Where the credit protection is denominated in a currency different from that in which the exposure is denominated - i.e. there is a currency mismatch - the amount of the exposure deemed to be protected (G_A) will be reduced by the application of a haircut H_{FX}, i.e.

$$\mathbf{G_A = G \times (1 - H_{FX})}$$

where:

G_A = value of credit protection adjusted for currency mismatch
G = nominal amount of the credit protection
H_{FX} = haircut appropriate for currency mismatch between the credit protection and underlying obligation.

The standard supervisory haircut of 8% will be applied where the exposure and collateral are denominated in different currencies based on a 10-business day holding period (assuming daily marking to market).

Sovereign Guarantees and Counter-Guarantees

132. As discussed in Paragraph 50, licensee's may apply a lower risk weight to exposures on the sovereign (or central bank) where the bank is incorporated and where the exposure is denominated in domestic currency and funded in that currency. This treatment is also extended to portions of claims guaranteed by the sovereign (or central bank), where the guarantee is denominated in the domestic currency and the exposure is funded in that currency. A claim may be covered by a guarantee that is indirectly counter-guaranteed by a sovereign. Such a claim may be treated as covered by a sovereign guarantee provided that:

a) the sovereign counter-guarantee covers all credit risk elements of the claim;
b) both the original guarantee and the counter-guarantee meet all operational requirements for guarantees, except that the counter-guarantee need not be direct and explicit to the original claim; and

c) the Central Bank is satisfied that the cover is robust and that no historical evidence suggests that the coverage of the counter-guarantee is less than effectively equivalent to that of a direct sovereign guarantee.

PART 5 – CALCULATION FOR THE CAPITAL CHARGE FOR OPERATIONAL RISK

Definition of Operational Risk

133. Operational Risk is defined in the Central Bank's ***Guidelines for the Management of Operational Risk*** (November 2013) as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes legal risk, but excludes other risks such as strategic and reputational risk.

Measurement Methodologies

134. The following measurement methodologies[45] are allowed by the Central Bank to calculate operational risk capital charges:

   A. the Basic Indicator Approach; and
   B. the Standardised Approach.

135. The Basic Indicator Approach is the default approach. Licensees are encouraged to move from the Basic Indicator Approach to the Standardised Approach as they develop more sophisticated operational risk management systems and practices. Licensees should choose an approach that is appropriate for their risk profile.

136. A licensee will not be allowed to revert to a simpler approach once it has been accepted for a more advanced approach, without supervisory approval. However, if the Central Bank determines that a licensee using a more advance approach no longer meets the qualifying criteria for this approach, it may require the licensee to revert to a simpler approach, until it meets the conditions specified by the Central Bank for returning to a more advanced approach.

A. THE BASIC INDICATOR APPROACH

137. Licensees using the Basic Indicator Approach must hold capital for operational risk equal to the average over the previous three (3) years of a fixed percentage (denoted as alpha, i.e., "**α**") of positive annual gross income[46]. Figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator when calculating the average.[47] The charge may be expressed as follows:

$$K_{BIA} = [\sum (GI_{1...n} \text{ x } \alpha)]/n$$

[45] The Central Bank will not allow the Advanced Measurement Approach at this time.

[46] Licensees should use the gross income data from the previous three completed financial years for which audited financial statements have been prepared. Where audited financial statements are not available, unaudited figures may be used.

[47] If negative gross income distorts a licensee's Pillar 1 capital charge, the Central Bank will consider appropriate supervisory action under Pillar 2.

Where:

$\mathbf{K_{BIA}}$ = 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

$\boldsymbol{\alpha}$ = 15%

138. Gross income is defined as net interest income plus net non-interest income. It is intended that this measure should:

a. be gross of any provisions (e.g. for unpaid interest);

b. be gross of operating expenses, including fees paid to outsourcing service providers;[48]

c. exclude realized profits/losses from the sale of securities in the banking book;[49] and,

d. exclude extraordinary or irregular items, as well as income derived from insurance.

Qualifying Criteria

139. As the Basic Indicator Approach is a point of entry for capital calculation for operational risk, no specific criteria is attached to its use. However, licensees using this approach are expected to comply with the Central Bank's ***Guidelines for the Management of Operational Risk***.

B. THE STANDARDISED APPROACH

140. In the Standardised Approach, licensees' activities are divided into eight (8) business lines: corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage. The business lines are defined in further detail in Appendix 5 - Mapping of the Business Lines.

141. Within each business line, gross income is a broad indicator that serves as a proxy for the scale of business operations and thus the likely scale of operational risk exposure within each of these business lines. Under the Standardised Approach, gross income is measured for each business line, not the whole institution; i.e., in corporate finance, the indicator is the gross income generated in the corporate finance business line.

[48] In contrast to fees paid for services that are outsourced, fees received by licensees that provide outsourcing services shall be included in the definition of gross income.

[49] Realised profits/losses from securities classified as "held to maturity" and "available for sale", which typically constitute items in the banking book (e.g., under certain accounting standards), are also excluded from the definition of gross income.

142. The capital charge for each business line is calculated by multiplying gross income by a factor (denoted as beta, i.e., "β") assigned to that business line. Beta serves as a proxy for the industry-wide relationship between the operational risk loss experience for a given business line and the aggregate level of gross income for that business line.

143. The total capital charge is calculated as the three-year average[50] of the simple summation of the regulatory capital charges across each of the business lines in each year. In any given year, a negative capital charge (resulting from negative gross income) in a business line will be given a nil capital charge. Additionally, where the total capital charge across all business lines within a given year is negative, the numerator for that year will be zero. The total capital charge for operational risk, under the Standardised Approach, shall be calculated as follows:

$$\mathbf{K_{TSA}=\{\Sigma_{years\ 1\text{-}3}\ max\ [\Sigma\ (GI_{1\text{-}8}\ x\ \beta_{1\text{-}8}),\ 0]\}/3}$$

Where:

$\mathbf{K_{TSA}}$ = the capital charge under the Standardised Approach

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

$\boldsymbol{\beta_{1\text{-}8}}$ = a fixed percentage

The values of the betas for each business line are detailed below.

Business Lines	Beta Factors
Corporate Finance (β1)	18%
Trading and Sales (β2)	18%
Retail Banking (β3)	12%
Commercial Banking (β4)	15%
Payment and Settlement (β5)	18%
Agency Services (β6)	15%
Asset Management (β7)	12%
Retail Brokerage (β8)	12%

Qualifying Criteria

144. To qualify for use of the Standardised Approach, a licensee must satisfy the Central Bank that, at a minimum:

- its board of directors and senior management, as appropriate, are actively involved in the oversight of the operational risk management framework;
- it has an operational risk management system that is conceptually sound and is implemented with integrity; and

[50] Licensees should use the gross income data from the previous three completed financial years for which audited financial statements have been prepared.

- it has sufficient resources in the use of the approach in the major business lines, as well as the control and audit areas.

145. The Central Bank will have the right to insist on a period of initial monitoring of a licensee's Standardised Approach, before it is used for regulatory capital purposes.
146. A licensee must develop specific policies and have documented criteria for mapping gross income for current business lines and activities into the standardised framework. The criteria must be reviewed and adjusted for new or changing business activities, as appropriate. The principles for business line mapping are set out in Appendix 6 – Principles for Business Line Mapping.
147. Licensees using the Standardised Approach must also meet the following additional criteria:

    a. The licensee must have an operational risk management system with clear responsibilities assigned to an operational risk management function. The operational risk management function is responsible for developing strategies to identify, assess, monitor and control/mitigate operational risk; for codifying firm-level policies and procedures concerning operational risk management and controls; for the design and implementation of the firm's operational risk assessment methodology; and for the design and implementation of a risk-reporting system for operational risk.

    b. As part of the licensee's internal operational risk assessment system, the licensee must systematically track relevant operational risk data, including material losses by business lines. Its operational risk assessment system must be closely integrated into its risk management processes. Its output must be an internal part of the process of monitoring and controlling the licensees operational risk profile. For instance, this information must play a prominent role in risk reporting, management reporting, and risk analysis. The licensee must have techniques for creating incentives to improve the management of operational risk throughout the company.

    c. There must be regular reporting of operational risk exposures, including material operational losses, to business unit management, senior management and to the board of directors. The licensee must have procedures for taking appropriate action according to the information within the management reports.

    d. The licensee's operational risk management system must be well documented. The licensee must have arrangements in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operational risk management system, which must include policies for the treatment of non-compliance issues.

    e. The licensee's operational risk management processes and assessment system must be subject to validation and regular independent review. These reviews must include both the activities of the business units and/or the operational risk management function.

f. The licensee's operational risk assessment system (including the internal validation processes) must be subject to regular review by internal and external auditors and/or the Central Bank.

PART 6 – CALCULATION FOR THE CAPITAL CHARGE FOR MARKET RISK

148. This Part applies to all public banks, and bank and trust companies incorporated in the Bahamas, that have a trading book (see paragraphs 146 and 147 below) and meets the ***de minimis threshold*** as follows:

i. The licensee's market risk positions should be ≥ to 5% of the total on- and off-balance sheet assets; or
ii. The licensee's market risk positions is equal ≥ US$100 million, and
iii. In the case of a licensee that is jointly regulated by the Central Bank and the Securities Commission of The Bahamas, the licensee's market risk positions is equal to or exceeds US$25 million.

149. Banks with market risk positions that do not meet the de minimis threshold (i.e. (i) to (iii) above) are exempt from complying with the market risk capital requirements.

Definitions

150. A ***trading book*** consists of positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio should be actively managed. Positions held with trading intent are those held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, and may include for example proprietary positions, positions arising from client servicing (e.g. matched principal broking) and market making. Licensees should have a policy that specifies what items are allocated to its trading book.

151. A ***financial instrument*** is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Financial instruments include both primary financial instruments or cash instruments and derivative financial instruments.

MARKET RISK CAPITAL REQUIREMENTS

Capital Requirement

152. The Central Bank requires all licensees, with the exception of pure trust companies, restricted licensees and foreign branches to maintain a capital adequacy ratio of at least 8 percent at all times. Certain licensees may be required to hold higher minimum capital levels based on their risk profile. Licensees must hold capital against all marked-to-market interest rate related instruments, equities

and associated derivatives arising from positions held in the trading book. In addition, licensees' capital must be held against all foreign exchange and commodity risks position that are held in both the banking and trading books.

153. In cases where licensees undertake significant market risk in the course of their business strategy, capital should be allocated specifically to support this risk. Should the Central Bank, through its risk assessment process conclude that the market risk exposure of a licensee is high relative to current capital, it will discuss this concern with senior management of the licensee. Depending on the circumstances, the Central Bank may require a licensee to strengthen its capital position or reduce its level of market risk exposure.

Measurement Approach

154. Given the nature, scope and complexity of banks operating from and within The Bahamas, the Central Bank has determined that banks subject to the market risk capital requirements should use the Basel Standardized Approach. The standardized methodology uses a "building-block" approach. Although the Central Bank employs the standardised approach for regulatory purposes, we agreed to allow licensees to utilize internal models approach when reporting to their head office.

155. The capital charge for each risk category is determined separately. Each risk category is aggregated to derive a Total Market Risk Capital Charge, which is applied against the capital level of the licensee. Within the interest rate and equity position risk categories, separate capital charges for specific risk and the general market risk arising from debt and equity positions are calculated. ***Specific risk*** is defined as the risk of loss caused by an adverse price movement of a debt instrument or security due principally to factors related to the issuer. ***General market risk*** is defined as the risk of loss arising from adverse changes in market prices. For commodities, options, and foreign exchange, there is only a general market risk capital requirement. Details on the standardised method of calculation are set out in the *Guidance Notes for the Completion of the Market Risk Reporting Forms.*

156. To complement the above risk measurement techniques, licensees should also measure their vulnerability to loss in stressed market conditions in both their banking and trading book portfolios by conducting stress tests, incorporating extreme but plausible assumptions for the relevant risk factors and giving special considerations to positions that may be difficult to liquidate or offset in stressful situations. The Board and senior management should consider the results of stress tests when establishing and reviewing strategies policies and limits for market risk.

Reporting Requirements

157. Once a bank has a trading book that is consistent with the definition under Sections 146 and 147 above, and meets the ***de minimis*** threshold, the bank will be required to report on its trading book activities using the market-risk related forms in the Excel Reporting System (ERS).

158. In addition, all licensees are required to report in the ERS, their interest rate risk exposures and foreign currency exposures in the **Interest Rate Sensitivity** and the **Investments by Currency Type** forms respectively, on a quarterly basis or a frequency otherwise determined.

APPENDICES

APPENDIX 1
Minority Interest Illustrative Example

This appendix illustrates the treatment of minority interest and other capital issued out of subsidiaries to third parties, which is set out in paragraphs 21 to 23.

Bank P Balance Sheet		**Bank S Balance Sheet**	
Assets		**Assets**	
Loan to Customers	100	Loan to Customers	150
Investment in CET1 of Bank S	7		
Investment in AT1 of Bank S	4		
Investment in the T2 of Bank S	2		
Total	**113**	**Total**	**150**
Liabilities and Equity		**Liabilities and Equity**	
Depositors	70	Depositors	127
Tier 2	10	Tier 2	8
Additional T1	7	Additional T1	5
Common Equity	26	Common Equity	10
Total	**113**	**Total**	**150**

The balance sheet Bank P shows that in addition to loans to its customers, it owns 70% of the common shares of Bank S, 80% of the additional Tier 1 capital of Bank S and 25% of the Tier 2 capital of Bank S. The ownership of the capital of Bank S is therefore as follows:

Capital Issued by Bank S			
	Amount issued to Parent (Bank P)	**Amount issued to third parties (Minority Interest)**	**Total**
Common Equity	7	3	10
Additional Tier 1	4	1	5
Tier 1	**11**	**4**	**15**
Tier 2	2	6	8
Total Capital	**13**	**10**	**23**

The consolidated balance sheet of the banking group is set out below:

Consolidated Balance Sheet	
Assets	
Loan to customers	250
Liabilities and Equity	
Depositors	197
Tier 2 capital issued by subsidiary to third party (i.e. minority interest)	6
Tier 2 capital issued by Parent	10

AT1 capital issued by subsidiary to third party (i.e. minority interest)	1
AT1 capital issued to Parent	7
CET1 issued by subsidiary to third party (i.e. minority interest)	3
CET1 issued by Parent	26
Total Capital	**250**

For illustrative purposes, Bank S is assumed to have risk weighted assets of 100 against the assets valuing 150. In this example, the minimum capital requirements of Bank S and the subsidiary's contribution to the consolidated requirements are the same since Bank S does not have any loans to Bank P. This means that it is subject to the following minimum (plus capital conservation buffer) requirements and has the following surplus capital.

Minimum and surplus capital of Bank S			
	Minimum plus capital conservation buffer	**Capital Available**	**Surplus**
CET1 (4.5+2.5=7.0)	7 (=7.0% of 100)	10	3 (=10-7.0)
Tier 1	8.5 (=8.5% of 100)	15 (=10+5)	6.5 (=10+5-8.5)
Total Capital	10.5 (=10.5% of 100)	23 (=10+5+8)	12.5 (=10+5+8-10.5)

The following table illustrates how to calculate the amount of capital issued by the Bank S is to be included in consolidated capital, following the calculation procedure set out in paragraphs 21 to 23.

Bank S: amount of capital issued to third parties included in consolidated capital					
	Total amount issued (a)	**Amount issued to third parties (b)**	**Surplus (c)**	**Surplus attributable to third parties (i.e. amount excluded from consolidated capital) (d) =(c) * (b)/(a)**	**Amount included in consolidated capital (e) = (b) – (d)**
CET1	10	3	3	0.90	2.10
Tier 1	15	4	6.5	1.73	2.27
Total Capital	23	10	12.5	5.43	4.57

The following table summarizes the components of capital for the consolidated group based on the amounts calculated in the table above. Additional Tier 1 is calculated as the difference between CET1 and Tier 1, while Tier 2 is the difference between total capital and Tier 1.

	Total amount issued by Parent (all of which is to be included in consolidated capital)	**Amount issued by subsidiaries to third parties to be included in consolidated capital**	**Total amount issued by Parent and subsidiary to be included in consolidated capital**
CET1	26	2.10	28.10
AT1	7	0.17 (=2.27-2.10)	7.17
Tier 1	**33**	**2.27**	**35.27**
Tier 2	10	2.30 (=4.57-2.27)	12.30
Total Capital	**43**	**4.57**	**47.57**

APPENDIX 2
The 15% of common equity limit on specified items (threshold deductions)

1. This Appendix is meant to clarify the calculation of the 15% limit on significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities); mortgage servicing rights, and deferred tax assets arising from temporary differences (collectively referred to as specified items).

2. The recognition of these specified items will be limited to 15% of Common Equity Tier 1 (CET1) capital, after the application of all deductions. To determine the maximum amount of the specified items that can be recognised*, banks and supervisors should multiply the amount of CET1** (after all deductions, including after the deduction of the specified items in full) by 17.65%. This number is derived from the proportion of 15% to 85% (i.e. 15%/85% = 17.65%).

3. As an example, take a bank with $85 of common equity (calculated net of all deductions, including after the deduction of the specified items in full).

4. The maximum amount of specified items that can be recognised by this bank in its calculation of CET1 capital is $85 × 17.65% = $15. Any excess above $15 must be deducted from CET1. If the bank has specified items (excluding amounts deducted after applying the individual 10% limits) that in aggregate sum up to the 15% limit, CET1 after inclusion of the specified items, will amount to $85 + $15 = $100. The percentage of specified items to total CET1 would equal 15%.

*The actual amount that will be recognised may be lower than this maximum, either because the sum of the three specified items are below the 15% limit set out in this appendix, or due to the application of the 10% limit applied to each item.

**This is a hypothetical amount of CET1 used only for the purposes of determining the deduction of the specified items.

APPENDIX 3
External Credit Assessment Institutions (ECAIs)

1. Under the Standardized Approach, banks are able to rely on the credit assessments prepared by ECAIs. For such ratings to be used for capital adequacy purposes, the ECAI must first be recognized as eligible by the Central Bank. An appropriate mapping of the ratings of individual ECAI ratings will also be determined by the Central Bank.

2. Licensees must use the chosen ECAIs and their ratings consistently for each type of claim, for both risk weighting and risk management purposes. Licensees will not be allowed to "cherry-pick" the assessments provided by different ECAIs and to arbitrarily change the use of ECAIs.

The Recognition Process

3. The Central Bank will determine on a continuing basis whether an ECAI meets the criteria (provided below). The IOSCO Code of Conduct Fundamentals for Credit Rating Agencies will also be referenced when determining ECAI eligibility. The assessments of ECAIs may be recognized on a limited basis, e.g. by type of claims or by jurisdiction. The supervisory process for recognizing ECAIs will be made public to avoid unnecessary barriers to entry.

Eligibility Criteria

4. An ECAI must satisfy each of the following six criteria:

Objectivity: The methodology for assigning credit assessments must be rigorous, systematic, and subject to some form of validation based on historical experience. Moreover, assessments must be subject to ongoing review and responsive to changes in financial condition. Before recognizing an assessment methodology for any market segment, the Central Bank must be satisfied that at a minimum, rigorous back testing was conducted, covering a period of least one year but preferably three years.

Independence: An ECAI should be independent and should not be subject to political or economic pressures that may influence the rating. The assessment process should be as free as possible from any constraints that could arise in situations where the composition of the board of directors or the shareholder structure of the assessment institution may be seen as creating a conflict of interest.

International Access/Transparency: Individual assessments must be available to both domestic and foreign institutions with legitimate interests and on equivalent terms. The individual assessments, the key elements underlining the assessments and whether the issuer participated in the assessment process should be publicly available on a non-selective basis, unless they are private assessments. In addition, the general procedures, methodologies and assumptions for arriving at assessments used by the ECAI should be publicly available.

Disclosure: An ECAI should disclose the following information: its code of conduct; the general nature of its compensation arrangements with assessed entities; its assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessments, e.g. the likelihood of AA ratings becoming A over time.

Resources: An ECAI should have sufficient resources to carry out high quality credit assessments. These resources should allow for substantial ongoing contact with senior and operational levels within the entities assessed in order to add value to the credit assessments.

Credibility: In addition to fulfillment of the above criteria, the extent to which an ECAI's credit assessments are relied upon by independent third parties (investors, insurers, trading partners) is reviewed in judging its credibility. Additionally, credibility is underpinned by the effectiveness of internal procedures aimed at preventing the misuse of confidential information. To be eligible, for recognition, an ECAI does not have to assess firms in more than one country.

The mapping process

5. The Central Bank will assign eligible ECAIs' assessments to the risk weights available under the risk weighting framework outlined in this document, i.e. deciding which assessment categories correspond to which risk weights. The mapping process would be objective and result in a risk weight assignment consistent with that of the level of credit risk reflected in the tables above (for the respective risk weight category). It would cover the full spectrum of risk weights.

6. In conducting the mapping process, the Central Bank will consider factors such as:

    a. the size and scope of the pool of issuers that each ECAI covers,
    b. the range and meaning of the assessments that it assigns, and
    c. the definition of default used by the ECAI.

7. Banks must disclose ECAIs that they use for the risk weighting of their assets by type of claims, the risk weights associated with the particular rating grades as determined by the supervisor through the mapping process as well as the aggregated risk-weighted assets for each risk weight based on the assessments of each eligible ECAI.

Multiple Assessments

8. If there is only one assessment by an ECAI chosen by a licensee for a particular claim, that assessment should be used to determine the risk weight of the claim.

9. If there are two assessments by ECAIs chosen by a licensee which map into different risk weights, the higher risk weight will be applied.

10. If there are three or more assessments with different risk weights, the assessments corresponding to the two lowest risk weights should be referred to and the higher of those two risk weights will be applied.

Issuer versus Issue Assessment

11. Where a licensee invests in a particular issue that has an issue-specific assessment, the risk weight of the claim will be based on this assessment. Where the claim is an investment in an issue that has not been specifically assessed, the bank can rely on a specific credit assessment of an issued debt or on a credit assessment of the issuer. The following general principles will apply:

    a) Credit Assessment of a specific debt: In circumstances where the borrower has a high quality credit assessment (with a risk weight lower than that which applies to an unrated claim) on a specific debt, and the unassessed claim ranks *pari passu* or senior to claims with the high quality assessment in all respects, then the high quality assessment can also be applied to the unassessed claim. If not, then the high quality credit assessment cannot be used and unassessed claims will receive the risk weight for unrated claims.

    b) Credit Assessment of the issuer: In circumstances where the borrower has a high quality credit assessment, which applies to senior unsecured claims on that issuer; then other unassessed claims of a highly assessed issuer will be treated as unrated. However, If either that issuer or a single issue has a low quality assessment (with a risk weight equal to or higher than that which applies to unrated claims), then an unassessed claim on the same issuer will be assigned the same risk weight as is applicable to the low quality assessment.

    c) Other unassessed claims of a highly assessed issuer will be treated as unrated.

12. Whether licensees intend to rely on an issuer- or an issue-specific assessment, the assessment must take into account and reflect the entire amount of credit risk exposure (principal and interest where applicable) that banks have with regard to all payments owed to them.

13. In order to avoid any double counting of credit enhancement factors, no supervisory recognition of credit risk mitigation techniques will be taken into account if the credit enhancement is already reflected in the issue specific rating.

Domestic currency and foreign currency assessments

14. Where unrated exposures are risk weighted based on the rating of an equivalent exposure to that borrower, the general rule is that:
    a. foreign currency ratings would be used for exposures in foreign currency; and

b. domestic currency ratings, if separate, would only be used to risk weight claims denominated in the domestic currency.

Level of Application of the Assessment

15. External assessments for one entity within a corporate group cannot be used to risk weight other entities within the same group.

Unsolicited Ratings

16. Licensees should only use solicited ratings from eligible ECAIs. However, there may be the potential for ECAIs to use unsolicited ratings to put pressure on entities to obtain solicited ratings. Where such behaviour is identified, the Central Bank will consider whether to continue recognizing such ECAIs as eligible for capital adequacy purposes.

Recognized ECAIs

17. The following ECAIs will be recognized for capital adequacy purposes:
- Moody's Investors Service;
- Standard and Poor's (S&P); and,
- Fitch Ratings.

18. The ratings of the respective ECAIs are to be mapped as follows:

Short Term Rating

Rating Grade	S&P	Fitch	Moody
1	A-1	F-1	P-1
2	A-2	F-2	P-2
3	A-3	F-3	P-3
4	Other	Other	Other

Long term Rating

Rating Grade	S&P	Fitch	Moody's
1	AAA to AA-	AAA to AA-	Aaa to Aa3
2	A+ to A-	A+ to A-	A1 to A3
3	BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3
4	BB+ to B-	BB+ to B-	Ba1 to B3
5,6	Below B-	Below B-	Below B3
	Unrated	Unrated	Unrated

19. The list of eligible ECAIs will be updated subject to applicants satisfying the eligibility criteria outlined above.

Short Term / Long Terms Assessments

20. For risk-weighting purposes, all short-term assessments are deemed to be issue-specific. They can only be used to derive risk weights for claims arising from the rated facility. They cannot be generalized to other short-term claims, except under the following conditions:

    a) The general preferential treatment for short-term claims (i.e. Maturity less than three months) applies to all claims on banks of up to three months original maturity when there is no specific short-term claim assessment.

    b) When there is a short-term assessment and such an assessment maps into a risk weight that is more favourable (i.e. lower) or identical to that derived from the general preferential treatment, the short-term assessment should be used for the specific claim only. Other short-term claims would benefit from the general preferential treatment.

    c) When a specific short-term assessment for a short term claim on a bank maps into a less favourable (i.e. higher) risk weight, the general short-term preferential treatment for interbank claims cannot be used. All unrated short-term claims should receive the same risk weighting as that implied by the specific short-term assessment.

21. In no event can a short-term rating be used to support a risk weight for an unrated long-term claim. Short-term assessments may only be used for short-term claims against banks and corporates.

22. If a short-term rated facility attracts a 50% risk-weight, unrated short-term claims cannot attract a risk weight lower than 100%. If an issuer has a short-term facility with an assessment that warrants a risk weight of 150%, all unrated claims, whether long-term or short-term, should also receive a 150% risk weight, unless the bank uses recognized credit risk mitigation techniques for such claims.

23. When a short-term assessment is to be used, the institution making the assessment needs to meet all of the eligibility criteria for recognizing ECAIs.

24. The table below provides a framework for banks' exposures to specific short-term facilities, such as a particular issuance of commercial paper:

Short Term Ratings		
S&P / Moody's	**Fitch**	**Risk Weight**
A-I /P-I[51]	F1	20%
A2/P-2	F2	50%

[51] The notations follow the methodology used by Standard & Poor's, Moody's Investors Service and Fitch Ratings. The A-1rating of Standard & Poor's includes both A-1+ and A-1- and the F rating of Fitch ratings includes both the modifiers "+" and "-".

Short Term Ratings		
S&P / Moody's	**Fitch**	**Risk Weight**
A3/P3	F3	100%
Others[52]		150%

[52] This category includes all non-prime and B or C ratings.

APPENDIX 4
Eligible Collateral

The following collateral instruments are eligible for recognition:

- Cash (as well as certificates of deposit or comparable instruments issued by the lending bank) on deposit with the bank which is incurring the counterparty exposure,[53]
- Gold,

Rated debt securities

- Debt securities rated by a recognised external credit assessment institution where these are either:
    - at least BB- when issued by sovereigns; or
    - At least BBB- when issued by other entities (including banks and securities firms); or
    - At least A-3/P-3 for short-term debt instruments.

Unrated debt securities

- Debt securities not rated by a recognised external credit assessment institution where these are either:
    - Issued by another bank; and
    - Listed on a recognized stock exchange; and
    - Classified as senior debt; and
    - Issued by a bank that has other rated issues of the same seniority rated at least BBB- or A-3/P-3 by a recognised external credit assessment institution; and
    - The bank holding the securities as collateral has no information to suggest that the issue justifies a rating below BBB- or A-3/P-3 (as applicable); and

      The Central Bank is sufficiently confident about the market liquidity of the security.

[53] When cash on deposit, certificates of deposit or comparable instruments issued by the lending bank are held as collateral at a third-party bank in a non-custodial arrangement, if they are openly pledged/assigned to the lending bank and if the pledge/assignment is unconditional and irrevocable, the exposure amount covered by the collateral (after any necessary haircuts for currency risk) will receive the risk weight of the third-party bank.

APPENDIX 5
Mapping of Business Lines

Business Line	Major Business Segment	Activity Groups
Corporate Finance	Corporate Finance	Mergers and acquisitions, underwriting, privatisations, securitisation, research, debt (government, high yield), equity, syndications, IPO, secondary private placements
	Municipal/Government Finance	
	Merchant Banking	
	Advisory Services	
Trading & Sales	Sales	Fixed income, equity, foreign exchanges, commodities, credit, funding, own position securities, lending and repos, brokerage, debt, prime brokerage
	Market Making	
	Proprietary Positions	
	Treasury	
Retail Banking	Retail Banking	Retail lending and deposits, banking services, trust and estates
	Private Banking	Private lending and deposits, banking services, trust and estates, investment advice
	Card Services	Merchant/commercial/corporate cards, private labels and retail
Commercial Banking	Commercial Banking	Project finance, real estate, export finance, trade finance, factoring, leasing, lending, guarantees, bills of exchange
Payment and Settlement[54]	External Clients	Payments and collections, funds transfer, clearing and settlement
Agency Services	Custody	Escrow, depository receipts, securities lending (customers) corporate actions
	Corporate Agency	Issuer and paying agents
	Corporate Trust	
Asset Management	Discretionary Fund Management	Pooled, segregated, retail, institutional, closed, open, private equity
	Non-Discretionary Fund Management	Pooled, segregated, retail, institutional, closed, open
Retail Brokerage	Retail Brokerage	Execution and full service

[54] Payment and settlement losses related to a bank's own activities would be incorporated in the loss experience of the affected business line.

APPENDIX 6
Principles for Business Line Mapping

a) All activities must be mapped into the eight (8) business lines in a mutually exclusive and jointly exhaustive manner.

b) Any activity (banking or non-banking) which cannot be readily mapped into the business line framework, but which represents an ancillary function to an activity included in the framework, must be allocated to the business line it supports. In the event that more than one business line is supported through the ancillary activity, an objective mapping criteria must be consistently adopted and the reasoning behind adopting that criterion recorded by the Bank.

c) When mapping gross income, if an activity cannot be mapped into a particular business line then the business line yielding the highest capital charge must be used. The same business line equally applies to any associated ancillary activity.

d) Licensees may use internal pricing methods to allocate gross income between business lines, provided that total gross income for the licensee (as would be recorded under the Basic Indicator Approach) still equals the sum of gross income for the eight business lines.

e) The mapping of activities into business lines for operational risk capital purposes must be consistent with the definitions of business lines used for regulatory capital calculations in other risk categories, i.e., credit and market risk. Any deviations from this principle must be clearly explained and documented.

f) The mapping process used must be clearly documented. In particular, written business line definitions must be clear and detailed enough to allow third parties to replicate the business line mapping. Documentation must, among other things, clearly explain any exceptions or overrides and be kept on record.

g) Processes must be in place to define the mapping of any new activities or products.

h) Senior management is responsible for the mapping policy (which is subject to the approval of the board of directors).

i) The mapping process to business lines must be subject to independent review.