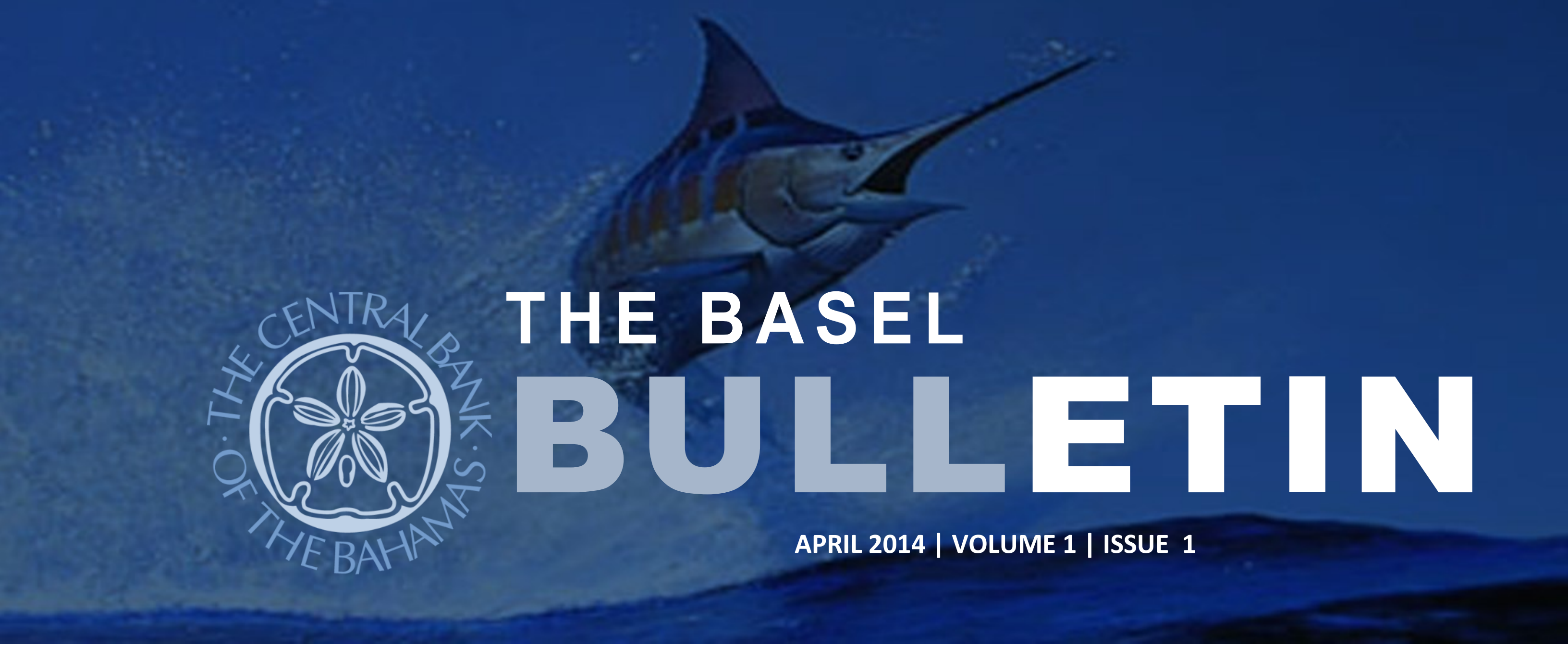

THE BASEL BULLETIN

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Basel: An Introduction

Over the past six years the Basel Committee on Banking Supervision (the Committee) has been extremely active in issuing new standards and guidelines in order to address what was viewed as shortcomings of the Basel framework exposed by the global financial crisis.

In response, the Central Bank of The Bahamas has fully embarked on a Basel program that comprises elements of Basel II and III frameworks. The **International Convergence of Capital Measurement and Capital Standards: a Revised Framework** also known as **'Basel II',** is a set of international standards and best practices that defines the minimum capital requirements for internationally active banks. Under the framework, banks have to maintain a minimum level of capital, to ensure that they can meet their obligations; they can cover unexpected losses, and can promote public confidence.

Basel II is more risk sensitive than its predecessor as it seeks to better align capital requirements to the risks of loss in a bank. It is intended to foster a strong emphasis on risk management and to encourage ongoing improvements in banks' risk assessment capabilities. The Central Bank has established a foundation for some of the preconditions for Basel II implementation, particularly Pillar 2, through the Risk Based Supervisory Framework. The use of this framework is vital for the smooth integration of the elements of Basel II and III within this jurisdiction, as there is a restructuring of the approach to risk and regulation in the financial sector.

Basel III is part of the Committee's continuous efforts to enhance the banking regulatory framework. It builds on the Basel II Framework as a result of the global financial crisis of 2007/2008. It seeks to strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector and improves the banking sector's ability to absorb shocks arising from financial and economic stress. Through capital reform, The Central Bank will be phasing in the Basel III capital requirements of Common Equity Tier 1 capital, leverage ratio and the introduction of a capital conservation buffer and a counter-cyclical capital buffer.

The Central Bank's Basel implementation program is designed to be appropriate to the types of banks and the scale of their operations within The Bahamas. Through the adoption of supervisory policies and systems and building on the foundation of a Risk Based Supervisory Framework currently in place, a comprehensive and phased-in approach to a full Basel II and elements of Basel III roll-out is envisaged over a thirty-six month timeline.

The Basel Committee

The Basel Committee on Banking Supervision (the Committee) was established by the G10 (Group of Ten countries) in 1974. These 10 countries (now 11) are the rich and developed countries namely: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

The Committee was designed as a forum for regular cooperation between its member countries on banking supervisory matters. Its aim is to enhance financial stability by improving supervisory know-how and the quality of banking supervision worldwide.

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From the Desk of The Inspector

The Central Bank of The Bahamas ('Central Bank') is pleased to issue this first edition of The Basel Bulletin, a periodic newsletter designed to inform industry stakeholders of the continuing initiatives and progress relative to the implementation of the Basel II and III frameworks.

We recognize the importance of effective communication with the industry in keeping with the objectives of our Basel Program that seek to promote more robust risk measurement techniques, bringing regulatory capital in line with banks' internal risk profiles and encouraging enhanced risk management systems.

In this edition of the Bulletin, we highlight the work completed to date by the Basel Project team, and the progress of the Caribbean Region as a whole in its Basel II implementation. Also featured, is the development of the Domestic Systemically Important Bank (D-SIBs) framework, an overview of Macro-prudential tools and planned upcoming initiatives. We look forward to your feedback and input as we move further on the Basel roadmap.

Sincerely,

Abhilash D. Bhachech
Inspector of Banks & Trust Companies

Questions or comments may be addressed to:

Policy@centralbankbahamas.com

Basel Readiness Survey

The Central Bank is presently conducting a Basel Readiness Survey to be completed by all public banks and bank and trust companies, as part of the Central Bank's Basel II and III Implementation Program. The purpose of the survey is two-fold. Firstly, it seeks to assess licensees' readiness for implementation of the Basel II and III approaches; and second, to provide useful input into the development and enhancement of the Basel framework in The Bahamas.

In preparation for this exercise, targeted banks were asked to identify and name a person within the institution who would be the bank's designated Basel Coordinator. The designated individual should be primarily involved in or sufficiently aware of the bank's Basel II and III implementation plans. The primary role of the Basel Coordinator will be to serve as the institution's key liaison with the Central Bank for the project, particularly for disseminating or soliciting information.

For the purposes of data collection and analysis, licensees responding to the survey will do so via an online platform. The Central Bank recognizes that in a number of cases licensees may not be in a position to provide a response to all questions, so banks will be asked to respond on a best efforts basis. In this survey, special emphasis was placed on understanding the various stages of implementation, recognizing the fact that some banks are subsidiaries of larger international banks who are subject to and have implemented more advanced approaches. Attention was also given to obtain the banks' views and feedback on the various Basel II and III approaches.

To achieve this objective, the Basel Readiness Survey was divided into six short sections. The first section is aimed at gathering information on the bank's business and product profiles. The second section is intended to understand steps taken for Basel II implementation. The third and fourth sections focus on evaluating licensees' familiarity and understanding of the standardised and advanced approaches under Basel II. The fifth section covers Basel III areas, particularly with regard to banks' capital structure. The final section is specifically directed toward obtaining banks' general views on Basel implementation and any material challenges faced in that regard.

Basel II: Areas of National Discretion

Basel II proposals set out a number of areas where national supervisors will need to determine the specific definitions, approaches, or thresholds they wish to adopt in implementing the proposals. The criteria used by supervisors in making these determinations should draw upon domestic market practice and experience, and be consistent with the objectives of the Basel II framework.

In considering the various areas of national discretion, the Central Bank conducted a benchmark of several regional and non-regional jurisdictions to assist in the formulation of proposed positions for each area. More specifically, credit and operational risks are the main areas of focus of national discretion. There are some 30 areas, which will require comment from the industry. Twenty-seven areas relate to credit risk and the remaining to operational risk.

The Central Bank encourages industry stakeholders to play an active role in commenting on and reviewing the consultative document which will be published—recognizing the varying levels of impact that same will have on regulated entities. Therefore, during the third quarter of 2014, subsequent to receiving feedback from our Basel Readiness Survey, a consultative document will be published on the proposed provisions relative to the areas of national discretion as outlined in the Basel II framework.

Credit risk

Areas for national discretion primarily include: -

- the risk weight of individual claims for Sovereigns, Banks and Public Sector Entities (PSEs), among others;
- external credit assessment, that is, the recognition of Credit Rating Agencies such as Moody's, Standard and Poor's, etc.;
- implementation considerations such as using unsolicited ratings the same way solicited ratings are used; and
- mitigation strategies, that is, the recognition of a list of core market participants for repo-style transactions and consideration given to apply a haircut to repo-style transactions (based on certain conditions), among others.

Operational risk

Areas for national discretion focus on: -

- the standardized approach ('SA'), that is, to allow banks to adopt this approach based on certain qualifying criteria as well as the Central Bank adopting a more conservative treatment of *negative* gross income.
- the alternative standardized approach ('ASA') whereby if the Central Bank allows this approach, the bank should be able to show how the ASA provides an improved basis by avoiding double counting of risk; and

As a result of this exercise, the feedback from the industry will assist the Central Bank in the formulation of Basel II rules relevant for our domestic context.

Our Communication Strategy

As a part of the Central Bank's Basel implementation plan, the Project Team has created an ongoing communication strategy to ensure that the industry is kept abreast of developments. In addition to this Basel newsletter, the Central Bank will be issuing consultative papers to seek the public and stakeholder views/comments on specific policy issues related to the Basel II and III frameworks.

The customary consultation period is ninety days (90), however, this may be adjusted depending on the complexity of the issue (s) being considered or the exigencies of the Central Bank. It is intended that these consultative papers will be released in phases throughout the life of the project (i.e. 2014 to 2016). However, occasionally the Project Team may find it necessary to release more than one consultative paper at the same time.

Licensees are encouraged to provide their feedback!

Domestic Systemically Important Banks (D-SIBs)

In November 2011, following the aftermath of the financial crisis, the Basel Committee ('the Committee') issued rules on the assessment methodology for global systemically important banks (G-SIBs) and their additional loss absorbency requirements. These additional requirements are over and above Basel III requirements and are intended to limit cross-border negative externalities on the global financial system and economy associated with G-SIBs.

Similarly, it was felt that there are many banks that are not significant from an international perspective, but nonetheless, have an important impact on their domestic financial system and economy. The Committee in 2012 developed a set of principles to address externalities posed by domestic systemically important banks (D-SIBs). A D-SIB is a bank whose distress or failure could have serious detrimental impact on either the financial system or the economy within the country in which the bank operates.

The D-SIB framework complements the G-SIB framework, and comprises a set of twelve (12) principles which focus on the assessment methodology and the higher loss absorbency requirements (HLA) for D-SIBs. The framework is less prescriptive than the G-SIB framework, and allows for an appropriate degree of national discretion by the national supervisory authority; who is best placed to evaluate the impact of failure on the local financial system and the local economy. National authorities will assess the impact of a D-SIB's failure on the domestic economy, having regard to four bank-specific factors: size, interconnectedness, substitutability/financial institution infrastructure (including considerations related to the concentrated nature of the banking sector), and complexity. In addition, national authorities can consider other measures/data that would inform these bank-specific indicators within each of the above factors, such as size of the domestic economy.

In our local context, the identification of D-SIB banks is perhaps more broadly apparent, in that we are able to distinguish those banks who meet all of these bank-specific factors. For instance, the banking sector of The Bahamas consists of approximately ninety-one (91) public banks; of which eight (8) are domestic clearing or commercial banks and eighty-three (83) are offshore banks. The domestic sector is highly concentrated and as a group, are significant players in the domestic economy, with three (3) of the largest banks controlling two-thirds of the assets. These banks are funded primarily by deposits, provide the domestic retail and commercial banking platforms and hold almost all of the domestic banking assets in consumer/commercial loans and mortgages. Given the criteria for the D-SIB framework, any one bank or possibly all of the domestic systemically important banks in this jurisdiction, would be identified from this group of commercial banks.

As a jurisdiction, The Bahamas will now have to formalize its national assessment methodology for D-SIBs. The Committee has given an implementation timeline of 2016 to 2019. This will be a key part of the Basel III rules, to help address systemic risks due to, inter-linkages and common exposures across institutions. It is anticipated that the Basel II and III regimes, plus our existing capital regime (i.e. trigger/target ratios) would provide for capital adequacy and higher loss absorbency.

Caribbean Region Making Good Progress on Basel II Implementation

The regional approach to Basel II implementation was successfully launched in 2013 and in this regard, the Technical Working Group (TWG) appointed by the Caribbean Group of Banking Supervisors (CGBS) has been making good progress. In the latter part of 2012, the CGBS in conjunction with eight countries/regulators requested assistance from the Caribbean Regional Technical Assistance Centre (CARTAC) to implement Basel II in the Caribbean. Prior to the request, several efforts were made to implement Basel II in the region with some success. CARTAC Short Term Experts (STX) and Long Term Expert (LTX) worked in collaboration with the various authorities in developing and reviewing Basel II capital Guidance as follows: Credit Risk, Credit Risk Mitigation and Securitization (**Central Bank of Trinidad and Tobago**) ; Market Risk (**Central Bank of Barbados**) ; Interest Rate Risk in the Banking Book (**The Central Bank of The Bahamas)**; Pillar II – Supervisory Review Process (**Bank of Jamaica)**; Operational Risk (**Eastern Caribbean Central Bank)**; Pillar III – Market Discipline (**British Virgin Islands Financial Services Commission)**; National Discretions (**Cayman Islands Monetary Authority)**; Prudential Information Reporting Form (**Turks and Caicos Islands Financial Services Commission)**. The implementation process also involved the training of Banking Supervisors. To date two workshops have been held in Kingston Jamaica, May 2013 (Pillars I & II and Train-the-Trainer Workshop) and Trinidad and Tobago, September 2013 (Pillar III, Risk-based Supervision and Consolidated Supervision). The implementation process is being managed by the TWG established by the Caribbean Group of Banking Supervisors. The TWG is chaired by the Central Bank of Barbados.

Macro-Prudential Tools

The financial crisis has prompted new regulatory reforms with the aim of building stronger and safer global financial systems, and to ensure its resilience to shocks. Overall, Basel III provides for a combination of capital and liquidity standards that enhance the existing regulatory frameworks. It also adds a macro-prudential overlay that seeks to address the stability of the financial system as a whole rather than only its individual parts.

While the Basel III framework provides for some macro-prudential regulatory tools, namely, the capital conservation buffer, countercyclical buffer and systemic bank capital surcharges, there are several other macro prudential tools available to address pro-cyclicality and systemic risk. These policy instruments can be grouped into three types of measures:

Credit-related, i.e., caps on the loan-to-value (LTV) ratio, caps on the debt-to-income (DTI) ratio, caps on foreign currency lending and ceilings on credit or credit growth;

Liquidity-related, i.e., limits on net open currency positions/currency mismatch (NOP), limits on maturity mismatch and reserve requirements;

Capital-related, i.e., countercyclical/time-varying capital requirements, time-varying dynamic provisioning, and restrictions on profit distribution.

Macro-prudential instruments are typically introduced with the objective of reducing systemic risk, either over time or across institutions or markets. Therefore, authorities use a variety of policy tools to address systemic risk in their financial sector.

At a national level, the Central Bank of The Bahamas ('the Central Bank') presently employs a number of macro-prudential instruments, which complement other macro-prudential policies established by the Central Bank to mitigate systemic risk. Measures include: the Loan-to-Value (LTV) ratio, the Debt-to-Income (DTI) ratio, liquidity requirements/buffers, limits on Interbank Exposures, and limits on Open FX Positions or Currency Mismatches. Specifically, these tools are used to mitigate strong credit growth, risk arising from system wide credit concentration and interconnectedness, systemic liquidity risks and risks related to foreign currency and cross border exposure. The Central bank is also considering the implementation of the Capital conservation buffer and the Countercyclical Capital Buffer. Whether or not additional macro-prudential tools will be introduced will involve a look at our economic/financial conditions to align them with the best available macro-prudential measures available to optimize their impact and minimize disruptions or losses from the risks identified.

In conclusion, the global macro prudential regulatory framework is at an early stage in its development and as such there are several areas that require fine-tuning including issues posed by regulatory or cross-border arbitrage, data gaps that prevent a more careful analysis of the cross-sectional dimension of systemic risk, and the side effects of applying macro prudential instruments. The relationship between macro prudential policy and micro prudential regulation also needs to be further clarified in order to ensure close coordination between the oversight of the whole financial system and that of its individual components in order to adequately capture systemic risk.

A Look at Upcoming Initiatives

Action Items - Tasks	Phases	2014				2015			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Publish Consultative Paper on Areas of National Discretion	P-1								
Publish Consultative Paper under Pillar 1 – Credit Risk and Operational Risk	P-1								
Publish Consultative Paper under Pillar 2 – Supervisory Review (ICAAP)	P-1								
Publish Consultative Paper under Pillar 3 – Minimum Disclosures	P-1								
Publish Consultative Paper under Basel III – Capital Structure	P-1								
Conduct training sessions on New Reporting Forms	P-1								
Conduct QIS for Pillar 1 Requirements	P-1								
Host Industry Session on Pillar 1 Requirements and ICAAP	P-1								
Arrange Meetings with select Licensees on ICAAP	P-1								