



QUARTERLY LETTER TO ALL
SENIOR OFFICIALS

02/11
18th July 2011

Dear Senior Official,

As many of you are aware, this will be the last supervisory letter from me as I am completing my assignment this month. I arrived in The Bahamas during one of the most challenging periods for the banking and trust sector, both here and internationally. While the period of uncertainty is by no means over, I believe that a strong foundation is being built for the future development of the industry. It is my hope that the channels of communication that have been developed will allow us to maintain a strong regulatory regime that, while conforming with evolving and demanding international standards, is proportionate and responsive to the needs of local industry. I am particularly grateful for the support and hard work of the industry in responding to our supervisory initiatives aimed at building resilience in the domestic and offshore sectors, as well as maintaining and enhancing our reputation as a stable well-regulated jurisdiction—an assessment that was fully endorsed in the latest Moody's credit report on The Bahamas.

We are now well into the 2011 hurricane season and, as in previous years, we wish to underscore how vitally important it is to be cognizant of your business continuity and disaster preparedness plans. This provides the ideal opportunity for firms to review the **Business Continuity Guidelines** to ensure full compliance with its requirements.

While on the subject of **guidelines**, you will recall that, in the latter part of last year, we took a decision to waive the "group applicant requirement" of the licensing regime for applicants seeking a restricted bank and/or trust company licence, provided that the licence is restricted to conducting business with or seeking/accepting deposits from the primary shareholder(s) and his/her or their "immediate family". Following a period of consultation with the industry, we have also now agreed to allow these types of firms to benefit from our existing arrangements for managed licensees. Therefore, we have withdrawn the **Guidelines with Respect to the Requirement for the Continuation of the Management of Restricted Banks and Trust Companies (currently without a physical presence)** and replaced it with the **Guidelines for Managed Licensees**, which reflects the concession outlined. However, we wish to emphasise that this concession is available only to new entrants.

We have also revised and reissued the **Guidelines on the Relationship Between External Auditors of Licensees and the Central Bank**, to make them fully consonant

with the **Banks and Trust Companies Regulation (Amendment) Act, 2010**, which came into force in September last year, and the **Banks and Trust Companies (Auditors) (Facts and Matters of Material Significance) Regulations, 2011**, which entered into force on May 2, 2011. You should also be aware of the **Guidance Notice on the Supervision of Nominee Activities of Subsidiaries and Related Companies of Banks and Trust Companies**, issued on April 18, 2011, which expands and clarifies the Central Bank's policy on the annual filing requirements of nominee trust licensees.

Earlier this year, we implemented our new **Excel Reporting System (ERS)**, with the first set of quarterly reports submitted for end-March 2011. It is important that firms submit comprehensive returns on a timely basis, to enable us to undertake our assessments and to have an accurate account of the size of the industry and other developments. To help in this area, we are planning to host several sessions for ERS compilers, in the near future. We will utilize the discussions from these sessions to produce a FAQ document, which will be made available on the Bank's website.

As you are aware, one of our long-standing objectives has been to develop an appropriate regulatory framework for monitoring market risk. Two previous surveys indicated that more than 95% of our licensees were not actively trading for customers or themselves, but were relying on their home offices to provide such services. However, there is still a view that we need to incorporate this element in our capital requirements. In further preparation for the implementation of this framework, we have included new forms in our **ERS** suite to capture these activities, which will then facilitate the creation of a common capital charge for joint licensees of the Central Bank and the Securities Commission. Again, we are still refining our approach on this issue to ensure that it is consistent with international standards, and will communicate with you separately as the exercise progresses.

Another ongoing work stream for the Bank is the enhancement of our stress-testing model to include liquidity and interest rate risk in the banking book. While this exercise is currently limited to the domestic commercial banks, it is our intention to broaden the coverage to the high impact international firms. We do not anticipate, at this time, any additional reporting requirements, as our suite of ERS forms has already been modified to include the necessary data.

To date, we have completed full risk assessment of twenty-three (23) international firms, since the rollout of the **Risk-based Supervision Framework (RBSF)** last year. We continue to make steady progress on completing the risk assessment communication letters by our target date of end-July, 2011. As previously foreshadowed, for the balance of this year, we plan to extend the full risk assessment to include the commercial banks, which we initially accessed via a desktop risk assessment. Development of a simplified risk matrix framework to cover firms categorized as having a low material impact, also continues. Consistent with our commitment to ensure that our supervisory framework takes into account differences in the scale and materiality of our firms, we intend to utilize a desktop risk assessment for these types of firms, similar to the initial exercise for the domestic

commercial banks. As such, the level of engagement will be less intense and we will only need to approach these firms if questions arise during our in-house effort.

We would like to expand and clarify the Bank's position on a series of **corporate governance** issues, which have been the subject of discussions with industry representatives over the past few months. The first issue relates to the Bank's prohibition of the Senior I (SOI) or II (SOII) serving as the Compliance Officer (CO) and Money Laundering Reporting Officer (MLRO) of a firm, which we set out in our last quarterly letter and incorporated into the revised **Corporate Governance Guidelines**. Specifically, the industry requested that the Bank consider granting a waiver of this rule for smaller licensees. Following discussions with industry representatives, and having due consideration to any reputation risk and other supervisory concerns, the Bank has agreed to relax this requirement for:

- a. restricted licensees; and
- b. other licensees, provided they are able to demonstrate to the Bank that there is sufficient independence, i.e., that there is no client interfacing relationship role assumed by the SOI/SOII; all business is introduced by the group as eligible introducer; and the SOI/SOII are in a position to act independently, if so warranted. Where a waiver is granted in this instance, the licensee will be required to submit an annual formal attestation by the Board that these conditions continue to apply.

Along similar lines, the industry also requested withdrawal of the rule that the SOI/SOII may not serve as an Independent Non-Executive Director (INED) for any licensee. Based on international best practices, the Bank maintains that there is a need to ensure sufficient independence for INEDs and that in every jurisdiction major challenges would emerge if these roles were combined with an executive position, particularly in a competitor. However, to minimise any potential disruption, the Bank has decided to "grandfather" current arrangements, where an SOI/SOII is serving as a director on an unrelated licensee. In the future, the Bank will not permit any incumbent SOI/SOII to serve as the INED for another licensee.

We turn next to a set of **reputation risk** issues, which we think also warrant clarification of the Bank's expectations. First, the Bank maintains that complete and current **due diligence documents** must be obtained for all client account relationships. While we acknowledge that there will be cases where it may be difficult to obtain documentation for some accounts, firms are nevertheless expected to demonstrate, via appropriate notation on their files by a senior officer, that, notwithstanding the absence of current due diligence documentation, these relationships have been reviewed and assessed in accordance with the firm's risk-rating framework and that the risks associated with the relationships are acceptable. Firms should also document the rationale for the risk assessment conclusions, as well as measures being taken to mitigate assumed risk posed by the gaps in the due diligence documentation.

Second, the **monitoring of accounts for suspicious transactions** should not be based on a fixed \$15,000 threshold since this is set for 'occasional transactions' or certain types of accounts listed in Section 3 of the Financial Transactions Reporting Regulations (FTRR) and not for suspicious transactions monitoring, in general. Instead, we encourage firms to automate their manual monitoring systems. In setting monitoring parameters, such systems should take into account relationship factors, including the risk-rating, anticipated account activity, types of products affiliated with the account, country of residence, etc. In monitoring clients' account activities, firms should also give attention to the intended "use of funds" flowing out of clients' accounts, to ensure full compliance with AML/CFT legislation.

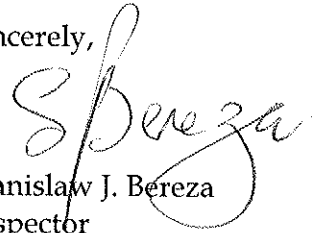
The third issue relates to the issuance of **General Powers of Attorneys (GPA)** in favour of the beneficial owners of or other third parties connected to managed companies. The Bank is of the view that GPAs could be used for illicit transactions (such as terrorism financing or ATM purchases) for which a firm's staff or nominee companies (as officers and directors) could be held responsible, potentially resulting in reputation risk exposure to the licensee and the jurisdiction. As well, the use of a GPA by the beneficial owner or third party could result in the managed company being held to be a sham, resulting in the piercing of the veil of the managed company with respect to tax and legal issues, thereby undermining the purpose for which the managed company was established and potentially exposing a licensee to legal action by the beneficial owner. Given these circumstances, the Bank's position is that licensees should refrain from granting GPAs on behalf of managed companies for the conduct of business transactions in general, but particularly in instances where a licensee provides officers and directors to a managed company. Where a licensee chooses to issue GPAs, the Bank expects that the licensee will have appropriate risk control and mitigation measures in place.

A fourth and related issue concerns the **preparation of financial statements for managed companies**. While not mandated by legislation, the failure to prepare financial statements could result in the less than timely detection of fraudulent, unauthorised or other irregularities. There is a risk that any losses could accrue to the licensee, particularly where the licensee provides officers and directors to the managed companies. In keeping with best practices, the Bank encourages licensees to have annual financial statements prepared by in-house client accountants for all managed companies to ensure that the companies' financial transactions are properly recorded, as well as timely identification and resolution of any potentially improper transactions. The financial statements should be acknowledged and agreed by the beneficial owner of the managed companies. Alternatively, licensees may wish to provide periodic (at least annually) portfolio statements for all managed companies, which should also be acknowledged and agreed by the beneficial owners of the managed companies.

In closing, I wish you all the very best for the future. Any questions regarding this letter should be directed to:

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Sincerely,

A handwritten signature in black ink, appearing to read "S. Bereza". The signature is written in a cursive style with a large, looping initial "S".

Stanislaw J. Bereza
Inspector