



**QUARTERLY LETTER TO ALL
SENIOR OFFICIALS**

02/10
11th August 2010

Dear Senior Official,

We begin this letter by returning to the issue of firms' compliance with **Report of Examination (RoE)** findings, particularly reputational risk management issues, which we touched upon in our last letter. It is important that both senior management and the Board of Directors (the Board) ensure that adequate resources are deployed to implement action plans aimed at addressing identified deficiencies, and that gaps are closed quickly. Going forward, we require that the Board provide an attestation in the Annual Corporate Governance Certificate that all material deficiencies identified in a firm's RoE have been brought to the Board's attention by senior management and were appropriately addressed. With respect to material deficiencies identified, but not remediated, the Board is required to provide a **credible action plan, along with timetables**, to address these issues. In addition, compliance with Central Bank directives and RoE findings should be a standard agenda item for Board meetings, and we will be closely monitoring this issue in the course of our on-site examination of firms.

Our second point is a clarification with respect to the **payment of dividends**. Regulation 3 of the Banks and Trust Companies (Payment of Dividends) Regulations, 2005, mandates that a firm **must** obtain the prior approval of the Governor to declare or pay out dividends on **shares of any class** during a financial year, where such dividends are in excess of the firm's prior financial year's net profits, as reported in the annual audited statement of its accounts, pursuant to section 8 of the Banks and Trust Companies Regulation Act, 2000. No distinction is made with respect to the categories/class of shares. Accordingly, we expect firms to comply fully with this requirement by submitting such requests for approval, along with required documentation.

The next topic clarifies our position relative to the appropriate **risk-weight assigned to equity-based consumer loans**, as set out in our *Guidelines for the Management of Capital and the Calculation of Capital Adequacy* (the Capital Adequacy Guidelines). The Capital Adequacy Guidelines require that firms apply the following risk-weights to various loan categories:

Types of Loans	Risk Weighting
Cash Secured Loans (with Legal Right of Set-off)	0%
Residential Mortgages	50%
Equity-based Consumer Loans	100%
Non-performing Loans net of Specific Provisions	100%

Firms should note that the Basel I Capital Accord, the framework currently applicable in The Bahamas, makes a clear distinction between the treatment of residential mortgages and equity-based consumer loans, which attract respective risk weights of 50% and 100%. This different treatment, which remains in the Basel II Capital Framework, reflects the higher risk-assessment of equity-based consumer loans relative to residential mortgages. However, if an equity-based consumer loan is granted through a mortgage rewrite, so that the consumer continues to make a single monthly payment, then the 50% risk-weight should be applied.

You will recall that some months ago we foreshadowed the development and implementation of a **risk-based supervision framework (RBF)**. The RBF allows us to focus appropriately on the most material concerns – as far as the risks posed by firms are concerned – and facilitates the integration of the off-site supervision process, based on the financial analysis of the prudential position of firms with the conclusions of the on-site examinations, which focus predominantly on control issues. We have completed the development and initial piloting of the RBF, which included a desktop assessment of the domestic commercial banks in The Bahamas – our most systemically important institutions. This exercise took account of the results of our off-site supervision of prudential norms, the latest on-site examination reports, the outputs of our quarterly supervisory meetings with the firms, and a range of materials received from the firms, including risk reports and external auditors’ management letters etc. We are now considering how best to communicate our assessments to the firms and to use the results of our assessments in the design of supervisory programmes, as well as to guide further on-site investigative work by supervisory staff.

Going forward, our intention is to undertake a preliminary risk assessment of all firms by the end of the year – starting with the most material international firms – as well as a more simplified approach for lower impact firms. Like other risk-based regulators, we will be using the risk assessment framework to assist in the implementation of a focused examination programme for the banking and trusts sector as a whole, and as the central basis for our regulatory discussions with our firms. To support the roll out of this important development across the industry, we will be organising a number of seminars in the next quarter, which will provide more detail on the framework and its implications for our supervisory interactions with firms. We will write to you separately, once we have firmed-up our plans for these seminars.

During the quarter, we also undertook a new survey of market risk exposures, for a more targeted pool of firms. We thank you for your valuable feedback in the survey, which will allow us to gain a better understanding of the nature of our licensees' trading books, their market risk management and measurement methodologies and to identify firms with material market risk. This will assist us in developing appropriate market risk requirements for this jurisdiction. We will provide feedback on our findings and their implications in our next quarterly update.

In terms of revisions to existing guidelines, as we previously indicated, we were reviewing our *Guidelines for the Management of Large Exposures* to ensure that they remain consistent with international best practices and standards for monitoring and control of large credit exposures, given the financial crisis, which brought this issue to the forefront of the international regulatory agenda. Our review is now complete and we expect to issue a revised document for consultation in the next few weeks.

Liquidity risk management continues to be an area of focus, as recent global events confirm that these activities, at many financial institutions, require improvement. Deficiencies observed include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, and a lack of meaningful cash flow projections and liquidity contingency plans. So far, we have not seen these weaknesses extended to our firms in The Bahamas. Nevertheless, we have been looking at the new Basel Committee's *Principles of Sound Liquidity Risk Management*, issued in 2008, which significantly expands on previous guidance issued by the Basel Committee to take account of financial market developments and lessons learned from the financial crisis. We are considering revisions to our own *Guidelines for the Management of Liquidity Risk* to incorporate appropriate aspects of the revised Principles into the policy framework governing the management and supervision of liquidity risk. Areas that are likely to be strengthened, which we intend to put forward for consultation later this year, are those of contingency planning, the role of senior management and the Board of Directors in ensuring robust controls are in place for liquidity management and expanded expectations in our review of firms' liquidity risk management frameworks. Along these lines, we are extending the liquidity reporting requirements—that are now only applicable to international firms—to the domestic commercial banks, which will achieve greater consistency in the approach to liquidity assessment across banks. Other more prescriptive aspects of the Basel proposals, such as a considerable narrowing of the definition of liquidity, are still under discussion. We are not intending, at this stage, to implement these—although we are closely monitoring the international debate on these issues.

On the domestic legislative front, many of you will have read recent commentary in the press on a number of legislative changes, including amendments to the Banks and Trust Companies Regulation Act, 2000, which have been debated in Parliament, and which should be brought into force later this month. We have informed you of these changes in the past, but broadly, we believe that these changes will strengthen the regulatory framework and will give the Central Bank

more flexibility and wider powers to address supervisory issues and will also remove some requirements, which, in today's business environment, appear to be impractical.

We can also report that, after consultation with industry representatives, the Government recently agreed to a reduction in the application and annual fees for Private Trust Companies (PTC), now set at \$5,000, to \$3,500 and \$2,500, respectively, which will bring The Bahamas more in line with main competitor jurisdictions. The necessary adjustments to the PTC regulations are being prepared and we will inform you when the revised fees are brought into effect.

In our ongoing efforts to improve the efficiency of our internal systems, and therefore our timeliness in reviewing and responding to our clients, you will soon notice that our communications to you will request that you quote back a twenty (20)-digit number (prefixed by "ICN-"). The code relates to the originating correspondence or request under discussion. This is a formality you will already be in the habit of observing in your communications with our Exchange Control Department, and for which your continued cooperation will be needed.

Finally, we would also like to inform you of planned improvements in our reporting platform. We are now building an interface between the now familiar **Quarterly Reporting System (QRS)** platform and our data reporting and analysis FAME platform, which should lessen the reporting burden of firms when complete. This will also feature an extension of liquidity and interest rate risk reporting to the domestic commercial banks to ensure overall consistency in risk oversight for the system.

Any questions regarding this letter should be directed to:

The Inspector of Banks and Trust Companies
Bank Supervision Department
Central Bank of The Bahamas
Market Street
P.O. Box N 4868
Nassau, Bahamas
Tel: (242) 302-2615
Fax (242) 356-3909
Email: policy@centralbankbahamas.com

Sincerely,

Stanislaw J. Bereza
Inspector