The New Capital Accord – Issues for the Bahamas

(Excerpted from the Central Bank of The Bahamas' 2003 Annual Report)

Current Status of The Bahamas

In 1992, The Bahamas implemented the 1988 Basel Capital Accord (Basel I). The Central Bank monitors compliance with Basel 1 on a quarterly basis as part of the review of the financial condition. To date, however, the 1996 amendments to Basel 1 related to Market Risk and Netting Arrangements have not yet been introduced. However, a capital charge for market risk is scheduled to be introduced in 2004 after appropriate studies are carried out to determine the licensees for which market risk is a material consideration. Due to Bahamian exchange control requirements and the limited capital markets activities of banks in The Bahamas, the Bank expects that domestic retail banks will be below the Basel I materiality thresholds for market risk.

Additionally, the liability driven nature of international/offshore banking in The Bahamas has led to capitalization levels which are considerably higher than the 8% minimum risk asset ratio requirement. Therefore, for the majority of Bahamian licensees, the introduction of Basel 2, which mandates an additional capital charge for operational risk, should not reduce the capital ratios of offshore/international licensees to levels of concern.

B. Specific Basel II Issues for The Bahamas

Pillar 1 – Minimum Capital Adequacy

The New Capital Accord provides countries with over 40 embedded options for implementation at national discretion. The Central Bank recognizes the complexity involved and thus the need to develop specific expertise in the New Accord.

Pillar 2 – Supervision Review

The Bahamas supports the introduction of Pillar 2 into the new capital adequacy framework. The implementation of pillar two should not be a major challenge for the Central Bank of The Bahamas as The Banks and Trust Companies Regulation Act, 2000 (BTCRA) empowers the Inspector to require a licensee to augment its capital should the need arise. The ability of the Central Bank to require additional capital has been the practice since the inception of banking supervision and has been well accepted by licensees. However, to strengthen this practice and to increase transparency, the Central Bank is considering the use of target and trigger minimum capital ratios which at the onset will be communicated to the licensees.

Additionally, the onsite examination function has initially concentrated on banks' compliance with AML measures in The Bahamas, corporate governance and safety and soundness issues. Implementation of Basel 2 will require that supervisors regularly review the process by which banks self- assess their capital adequacy, the risk position of the bank, the resulting capital levels and the quality of capital held. These requirements will result in an overview of the current methodology in place and the concerned examination templates. The role of the external auditors in the Basel II environment will also be reviewed and a final position will be taken in consultation with the Bahamas Association of Certified Accountants in due course.

Pillar 3 – Market Discipline

Market discipline through disclosure of both quantitative and qualitative information is an important mechanism for reducing the potential for moral hazard by allowing enhanced monitoring of the bank's activities by its shareholders and depositors. As such, The Central Bank supports the introduction of this pillar. The more sophisticated and dynamic the market, the better disclosure serves as a disciplining measure. The Bahamas' international market is therefore well suited for such a mechanism as market participants and stakeholders tend to be financially aware and educated.

The Bahamas currently requires that audited financial accounts are made available to the public. Accounts are published in the local gazette and should be available to the bank's customers upon request. However, additional work will be required in order to ensure full compliance with Pillar 3. The Bahamas is currently drafting a minimum disclosure guideline for licensees which is consistent with the disclosure requirements of Basel II, in terms of both the frequency and content of disclosures. The external auditors' role with regards checking and auditing of additional disclosures will have to be considered. Several domestic retail banks are already disclosing certain financial information on a voluntary quarterly basis. However, as there will be a semi annual disclosure requirement for all public licensees and a quarterly disclosure requirement for all large retail banks, extra operational costs may result for the licensees. .

The Bahamas has a second challenge as it serves as a host jurisdiction for banks from many different countries. The nature of offshore banking dictates that the bank's clients are not resident in The Bahamas. Therefore, The Bahamas must consider the best means of ensuring that critical financial information reaches those various overseas markets so that it can serve as a disciplining mechanism for the bank. The Internet is likely to be the most cost effective and efficient means of achieving this goal. The Bank is considering the use of its website as a repository for its licensees' financial information. The Bank is also currently considering the models provided by the United States Federal Reserve's National Information Centre and those used by some OFCs.

Calculation of the Operational Risk Capital Charge

The basic indicator approach, which uses gross income to determine the capital charge for operational risk, also poses some concern for the Central Bank of The Bahamas. The Bank expects that most institutions will use this method to assess operational risk charges. However, The Basel Committee was advised of The Bahamas' concern regarding the apparent penalty attracted by banks with high gross income in business lines such as consumer lending.

Earlier proposals of the Basel Committee placed the charge for operational risk in Pillar 2, thereby giving national regulators the discretion to allocate specific capital charges for operational risks, based on the relevant country circumstances. The Committee was advised that while The Bahamas agreed that a specific charge was appropriate for operational risks, the Pillar 2 treatment seemed a better alternative to the current proposal of a specific charge in Pillar 1.

Market Risk

The market risk component of Pillar 1 has not substantially changed from the 1996 amendments to Basel I. As mentioned earlier, the adoption of market risk into the capital adequacy structure for licensees is being studied.

C. Consideration of the Various Approaches

First, as a host jurisdiction for a number of US and EU country banks, The Central Bank of The Bahamas must pay attention to the positions taken by these countries. The Bank has observed that the United States has indicated that only about 10 to a maximum of 20 banks are likely to use the Advanced Internal Ratings Based (IRB) approach in 2006. The EU appears to be taking the position that its banks will be allowed flexibility in terms of options under the new accord. Therefore, it will be necessary for The Bahamas, even in the short-term, to become familiar with all approaches of the Basel 2, as some licensees will be using the more advanced approaches, as required by their head offices.

The international banks in The Bahamas, whose parent institutions adopt the advanced approaches in 2006 may be in a strong position to implement the IRB approach in the short-term as much of the underlying data (probability of default, exposure at default, loss given default, and M) relate to the home country, and in most instances would be the same as or similar to the parent bank. Second, the outright application of even the standardized approach poses particular challenges for The Bahamas, as it will require the approval of ratings agencies (where they exist) as they relate to the licensees and will require enhanced co-ordination with home country supervisors.

D. The Likely Approach of The Bahamas

The Bahamas will probably allow its licensees to use a range of approaches as appropriate to their size and complexity, while also taking into account the approaches of their parent banks, where applicable. The Bahamas, along with other Caribbean banking supervisors will be undertaking a quantitative impact study to determine the effects of Basel II on the respective banking systems, to inform regional decisions on the approved methodologies for calculating capital adequacy. However, it is expected that for stand-alone licensees which are solely incorporated in The Bahamas and where the Bahamas serves as home regulator, the simplified standardized and standardized approaches appear to be the most suitable approach in the short term. Transition to more advanced approaches may be permitted after an initial two-year period.

The Central Bank will have to give approval to those subsidiaries and branches where the parent bank plans to implement a more advanced approach on a consolidated basis throughout the banking group. The Central Bank would need to ensure that the home supervisor is capable and willing to provide adequate consolidated supervision of the group. This would include home country supervisor approval for the global use of models and the back testing of models throughout an international bank group. As an alternative, the Central Bank could require those affected licensees to implement a dual capital adequacy approach (i.e. one for head office and another for The Bahamas). This would result in differences in required regulatory capital.

However, because of the high minimum initial capital requirements in The Bahamas which have resulted in high capital adequacy ratios, the Bank does not expect the use of a less risk-sensitive approach, such as a simplified standardized approach, to result in reallocations of capital or competitive inequalities between stand alone banks and Bahamian subsidiaries of foreign banks. Additionally, it is expected that some licensees may opt not to invest in a more expensive system to more efficiently measure regulatory capital because they are required to maintain the high minimum levels in any event.