Best Practices in Assessing, Reporting and Policy Making in Financial Stability – The Basel II Approach

Assessing Macro-Prudential Vulnerabilities and Policy Frameworks in a Regional Context

Hosted by The Central Bank of Barbados (CBB)
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Presentation Outline

- Background
- Capital Adequacy Assessment
- Enhance Supervisory Review Process
- Market Discipline

Role of Capital and Supervision in Financial Stability

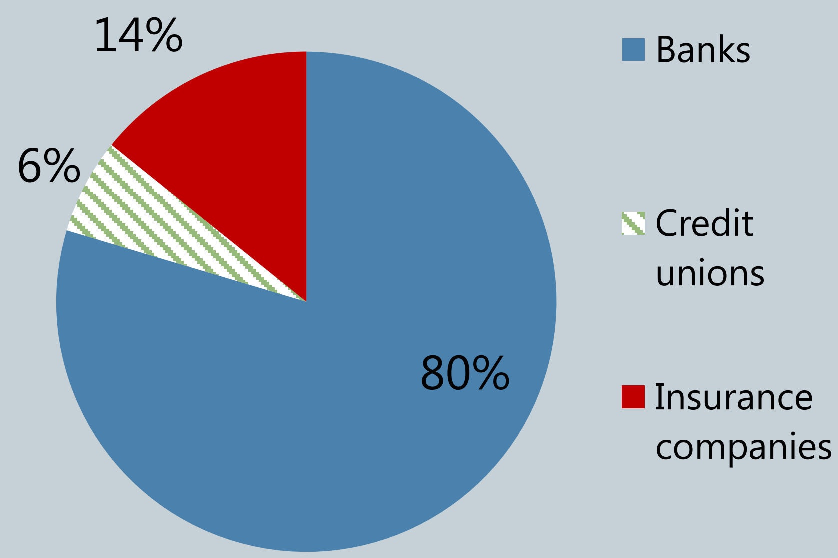
"A sound capital and supervisory framework for the insurance sector is essential for supporting financial stability"…

Mark Carney (Governor Bank of England/Chairman FSB)

Why The Focus (Primarily) on Banks?

- The financial system of the Caribbean amounts to 1195% of the region's GDP, with offshore institutions accounting for 1080% and onshore banks 91%.
- Banks are major players in the onshore financial system.
- The Bahamas and Barbados have the largest financial sectors, with total assets 74 times and 12 times the size of their respective economies, owing mostly to massive offshore sectors.

Assets of the Financial System
(In percent of total assets)



Sources: Each supervisory authority/Nita Thacker IMF 2012

BASEL I Capital Framework

- BIS published Consultation paper in Dec 1987 "a capital measurement system" commonly referred to as the Basel Accord

- Approved by G10 Governors and released to banks in July 1988

- Deadline for implementation December 1992

- Minimum levels of capital (RAR - 8%) for:
  - Credit Risk (major focus)
  - Market Risk (based on 1996 amendment)
    - http://www.bis.org/publ/bcbs24.pdf - "Amendment to the Capital Accord to incorporate Market Risks, BCBS, 1996"
  - Operational Risk

Banking Supervision under BASEL I

- CAMELS focus
- Predominantly Ratio driven
- One size fits all – 8% RWA
- Not sufficiently risk sensitive
- Certain risks not considered
- Focus on the solo bank vs. Consolidated supervision framework
- Focus on micro-prudential vs. macro-prudential
- Risk-based supervisory framework not formalized

Banking Supervision under BASEL II

- Pillar I - Bank's own assessment of capital requirements
  - Calculation of min capital requirement
    - Credit risk
    - Market risk
    - Operational risk
  - Minimum capital requirement closer to bank's actual risk
  - Total capital ratio must be no lower than 8%
- Revised Prudential Information Reporting Forms
- PIR is risk weighted
- Banks provide more granular data on investments and loans
- Stress testing of banks/banking systems / 6% tier I capital – some banks required to raise additional capital

Banking Supervision under BASEL II

- Pillar II – Supervisory Review Process
- **Four principles of supervisory review:**
  - **Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.**
  - **Supervisors should have a process to review bank's strategies, governance, risk management processes/ICAAP, and set minimum capital requirements for each bank**
  - **Supervisors should have the ability to monitor compliance with an expectation that banks should operate above the minimum regulatory capital ratios**
  - **Supervisors should have powers to intervene at an earlier stage to prevent capital from falling below the minimum levels required.**

BMA
BERMUDA MONETARY AUTHORITY

Banking Supervision under BASEL II

- Pillar II – Supervisory Review Process
- **Banks required to make annual submission of ICAAP/ embedded "use test"**
- **Banks are required to:**
  - **set risk appetite,**
  - **conduct self assessment of pillar I and Pillar II risks,**
  - **develop and report on methodology to measure concentration risks, business strategy risks, reputational risks, interest rate risk in the Banking Book etc.**
- **Banks required to conduct stress tests, assess impact on solo bank and consolidated group**

Banking Supervision under BASEL II

- Pillar III – Market Discipline
  - Promote safety and soundness in banks and financial systems
  - Support and enhance banks capital assessment and internal assessment (pillar 1)
  - Support and enhance the Supervisory Review Process (pillar 2)
  - Public disclosure allows market participants to assess bank's capital adequacy and can provide strong incentive for banks to conduct business in a safe and sound manner
  - Public disclosures provides market participants with information about bank's ability to absorb losses
  - Market participants are provided with information about a bank's risk profile and risk appetite (these provide info on the stability of the bank and sensitivity of earnings potential to changes in market conditions)
- Which pillar to implement first?

Basel II Implementation in the Region
Participating Countries

- The Bahamas
- Trinidad and Tobago
- Jamaica
- British Virgin Islands
- Barbados (In Process – Effective date 2015)
- Eastern Caribbean Central Bank (ECCB)
- Cayman Islands (Implemented Pillars I and II)
- Bermuda (Implemented Basel II effective January 1, 2009)

Basel II Consultants and Work Packages

- Consultants / Experts – April 2013 to October 2014
  - Credit Risk, Credit Risk Mitigation and Securitization (Trinidad and Tobago)
  - Market Risk Amendment (Barbados)
  - Pillar II – Supervisory Review Process (Jamaica)
  - Operational Risk (ECCU/ECCB)
  - Reporting Forms (Turks and Caicos)
  - Market Discipline (British Virgin Islands)
  - Interest Rate Risks in the Banking Book (the Bahamas)
  - National discretions (Cayman Islands)
  - Pre-conditions :
    - Consolidated Supervision and
    - Risk based Supervision
- Recommended Approach – Standardized

THANK YOU