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31st July, 2003

Mr. Jaime Caruana
Chairman
Basel Committee on Banking Supervision
Bank of International Settlements
Basel, Switzerland

Dear Mr. Caruana:

Re: Bahamas Response to Basel 2

The Central Bank of The Bahamas is optimistic about the implementation of Basel 2. We note that the Basel 2 offers a number of advantages over the current Basel Capital Accord in terms of risk sensitivity, in particular. We are encouraged by the use of external credit ratings agencies to determine credit risk weights for sovereigns, other counterparties and financial instruments as opposed to the current OECD versus Non-OECD distinction. However, while there are advantages to the implementation of the new Accord, we anticipate important challenges related to resources and training and the need for enhanced home-host country supervisory co-operation for offshore banking centres like The Bahamas.

A. Current Status of The Bahamas

The Bahamas is committed to implementing a capital adequacy regime which is appropriate to the maintenance of a strong international banking centre. This commitment is evidenced by the fact that The Central Bank of The Bahamas, under the provisions of the Banks and Trust Companies Act 2000, mandates capital standards for licensees which are consistent with the Basel Capital Accord.

The Bahamas implemented the 1988 Basel Capital Accord (Basel 1) in 1992 and currently applies to 187 licensees which hold banking and banking and trust licences. The Central Bank monitors compliance with Basel 1 on a quarterly basis as part of the



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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, we expect that domestic/retail banks, will be below the Basel 1 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. This is due mainly to the Central Bank's policy that a portion of a bank's balance sheets should be diversified in high quality, liquid financial instruments which attract low risk weights. 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 2 Issues for The Bahamas

Pillar 1 – Minimum Capital Adequacy. It has been observed that the New Capital Accord provides countries with over 40 embedded options for implementation at national discretion. The Central Bank of The Bahamas is excited about the ability to tailor the Accord to our needs, but 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 may wish to consider the use of target and trigger minimum capital ratios which should be communicated to the licensee from the onset.



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Additionally, the onsite examination function has initially concentrated on banks' compliance with AML measures in The Bahamas, corporate governance and safety and soundness issues. Basel 2 requires that supervisors should 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 a regular formal review or audit (in addition to the current reconciliation and checking process) of the capital adequacy returns by either the Central Bank or the external auditors of the licensee for completeness and accuracy with reference to the internal records of the licensee. The Central Bank will have to assess via onsite examination, the systems and records by which licensees routinely monitor their capital adequacy between reporting dates. The onsite and offsite functions will then need to make a judgement on the adequacy of capital held in relation to the risk profile of the licensee. The examination templates for examiners would need to be amended to focus more on the internal capital adequacy monitoring of the licensee, and to carry out sample capital adequacy calculations. The external auditors should be required to perform at least one formal review of the capital adequacy forms of the licensee each year, depending on the frequency of examination for licensees.

For banks, principle one has the greatest impact in terms of additional costs and corporate governance. Banks will have to set capital targets and carry out stress testing of the adequacy of capital. Banks will have to institute formal daily internal monitoring and reporting of capital adequacy.

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. We note that the more sophisticated and dynamic the market, the better disclosure serves as a disciplining measure. The Bahamian offshore 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 the Basel



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2, in terms of both the frequency and content of disclosures. The additional disclosure requirements will require some form of checking/auditing by banks' external auditors if the disclosures are to be credible. The scope and content of commentary by management or the board will need to be agreed between the Central Bank of the Bahamas and the external auditors. There will be an extra cost as disclosures will have to be on a semi annual basis for all public licensees and on a quarterly basis for larger retail banks. The disclosures as shown in Pillar three are quite extensive. Along with the extra cost to banks there will be resource and expertise considerations for local audit firms as certain disclosures (eg. market risk and interest rate risk in the banking book) are not currently made.

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 Central Bank is considering the use of its website as a repository for its licensees' financial information. We are 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. We expect that most institutions will use this methodology to assess operational risk charges. However, we are concerned that this approach penalizes banks with the high gross income in business lines such as consumer lending. In The Bahamas, we have found that certain banks operate with higher margins due largely to the wide spreads charged on consumer lending which makes up the majority of the asset book. Therefore, gross income may not be the most suitable proxy for the size of bank and thus the potential for operational risk.

Earlier proposals of the Basel Committee placed the charge for operational risk in Pillar 2, thereby giving the national regulator the discretion to allocate specific capital charges for operational risk based on the relevant country circumstances. While we agree that a specific charge is appropriate for operational risk, this Pillar 2 treatment seems a better alternative to the current proposal of a specific charge in Pillar 1.



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Alternatively, on the issue of operational risk, we suggest that the Basel Committee takes steps to make the basic indicator operational risk charge more risk sensitive. This can be done by scaling the alpha factor ($\alpha = 15\%$ in CP3) by some other indicator (say delta (Δ)) which is based on operational control and risk management factors. The aim is to consider operational risk mitigating factors. This is similar to the approach taken to consider credit risk mitigation techniques. Therefore, a bank which has a strong control environment, as determined by the supervisor, would have a lower delta factor and thus a lower capital charge for operational risk. Alternatively, a menu of different alpha factors may be offered at national discretion. To ensure transparency, the national supervisor should be required to disclose the factors that would be used in determining the delta methodology for scaling the alpha factor.

Market Risk. We note that the market risk component of Pillar 1 has not substantially changed from the 1996 amendments to Basel 1. As mentioned earlier, The Bahamas has not implemented a capital charge for market risk. A review of licensees will need to be conducted to determine those licensees which undertake activities which generate material market risk. In addition, new reporting systems will have to be developed and additional training for Bank Supervision staff will be needed to appropriately measure and monitor this component of the Capital Accord.

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 USA has stated that only about 10 to a maximum of 20 banks are likely to use the Advanced 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 of our licensees will be using the more advanced approaches, as required by their head offices.

The offshore banks in The Bahamas, whose parent institutions adopt the advanced approaches in 2006 may be in strong position to implement the IRB approach in the short-term as much of the underlying data (PD, EAD, LGD and M) relate to the home country, and in most instances would be the same as or similar to the parent bank.



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Second, the outright application of even the standardized approach poses particular challenges for The Bahamas. The adoption of the standardized approach will require the approval of ratings agencies of over 40 countries (where they exist). This will require enhanced co-ordination with home country supervisors.

D. The Likely Approach of The Bahamas

We expect that the Bahamas will 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 2 on our banking systems. This study will inform our decisions on the approved methodologies for calculating capital adequacy.

However, we expect that for those stand-alone banking 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 need to provide 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 entire group. This would include home country supervisor approval for the global use of models and the backtesting 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, we do not expect the use of a less risk-sensitive approach (i.e. simplified standardized) to result in reallocations of capital or competitive inequalities between stand alone banks and Bahamian subsidiaries of foreign banks. Additionally, we expect that some licensees may opt not to invest in a more



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expensive system to more efficiently measure regulatory capital because they are required to maintain the high minimum levels in any event.

We trust that our comments have been helpful and we thank the Basel Committee for the opportunity to contribute to the development of sound banking practices.

Sincerely,

Richard G. Ellis
Inspector of Banks and Trust Companies

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