British Virgin Islands Financial Services Commission
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BVI Financial Services Commission
Response to the
Basel Committee on Banking Supervision New Capital Accord

The BVI Financial Services Commission ("Commission") supports the Basel Committee on Banking Supervision's effort to revise the capital adequacy framework for banks. The Commission believes that the new framework will foster a strong emphasis on risk management in banking systems around the world, and that in so doing it should also increase the efficiency of the financial system. That is, Basel II reflects the direction in which bank supervision should evolve in a more integrated global financial system. Nevertheless, the Commission would like to state its concerns regarding the New Capital Accord ("NCA"):

Resources
One of the obvious concerns for the BVI a small-open economy is lack of availability of resources that will be required to implement the NCA. It is important to note that the BVI is small-open economy that is highly dependent on external resources to meet its shortage in the supply of labour. Like other jurisdiction in the Caribbean the pool of people with the skill set required for banking supervision much more the implementation of the NCA is extremely limited. Without even considering the impact of migration to the Canada, UK, and the US, it is very unlikely that such resources will be accessible in the Caribbean. We should also expect that when the Commission and other regulatory agencies across the Caribbean commence the rollout and implementation of Basel II, the private sector in the region with target supervisory staff with very attractive compensation package that are unlikely to be matched by the Commission and other such agencies in the Caribbean.

2-Tiered Capital Structure for the Banking Sector
The Commission wishes to emphasise the point that the NCA should not work to the disadvantage of small-open economies such the BVI and other countries in the Caribbean, small financial systems and small banks. Different capital rules in large and small countries must not be allowed to give a competitive advantage to bigger banks which might have financial stability implications in smaller countries where banks may not have the same flexibility to choose between classifying risks. In the BVI and other Caribbean countries with branches and subsidiaries of internationally-active banks, these foreign banks are more likely to opt of the Internal Ratings Based Approach to take advantage of the greater risk sensitivity and flexibility whereas domestic banks are likely

to continue to use Basel I with a gradual move towards the Standardized Approach under Basel II. Since the IRB Approach imposes a higher penalty for low-grade credit that the Basel I or the Standardized Approach under Basel II, there is the possibility that internationally-active banks may "cheery-pick" and even scale-down the lending to some firms/borrowers. The lack of economic diversification will make it extremely difficult for banks to diversify risks, as most firms / borrowers will exhibit more or less the same risk profile. At the same time in meeting/ filling the gap in excess demand for low-grade domestic credit, domestic banks will have less stringent capital requirements. Furthermore, if this excess demand for loans is not met by the domestic banking sector, near-bank or non-bank institutions may step in and given the level of regulation applicable to the non-bank/ near-banking sector the Commission believes this could result in regulatory arbitrage.

The Use of External Credit Assessment Institutions (ECAI)
While the Commission is conscious of the lack of an alternative to the use of ECAI to assign ratings for the purposes of assessing banks' capital adequacy, the Commission wants to reiterate the point that in the BVI like other Caribbean countries credit rating agencies are non-existence. Given the lack of penetration of ECAIs in the BVI, the Commission is of the view it should not at this time establish criteria for recognizing ECAIs as eligible for the purposes of assigning ratings for the assessment of banks' capital. The Commission believes that by establishing such criteria it would be playing a leading role in creating a market for the ECAIs in the BVI. Furthermore, the Commission believes that ECAIs in some instances may not have access to the relevant information when providing credit ratings.

Since the majority of BVI and other Caribbean islands' corporations and banks are unrated, Basel II would place Caribbean banks at a disadvantage to banks in G10 countries which are likely to be lending to rated entities. The Commission believes this would impose a higher capital charge for banks in the BVI and the Caribbean region. The Commission fears that financially sound banks in the BVI and the rest of the Caribbean will never meet the investment grade ratings and as such will never fall in the 20% bucket.

External Debt
The Caribbean region has a relatively high level of dependency on external debt and in recent years, several Caribbean government and even private sector firms have gone directly to the international market for funding. This raises two concerns: First, sovereign debt denominated in foreign currency will fall in a higher risk bucket than sovereign debt denominated in domestic currency. Second, most Caribbean islands will fall below investment grade credit ratings. The Commission is of the view that these two factors could result in reduction in the supply of international credit to the Caribbean region.

Operational Risk
Under Basel II banks are required to hold capital for operational risk. Under the Basic Indicator Approach which domestic banks in the Caribbean region are more likely to adopt, banks are required to hold capital equal to a fixed percentage (denoted by alpha) of average gross income over the previous three years. The Commission is of the view that

this method of determining the level of capital for operational risk purposes will impose a penalty on larger institutions.

Credit Risk Mitigation

The Commission supports the broadening of the number of eligible collateral under Basel II. However, the Commission is of the view that the lack of well developed asset markets in the Caribbean will make it extremely costly to estimate market value of collateral given the requirement for valuation every six (6) months.

Small-open Economies with International Financial Centres (SEIFiCs)

The Commission is of the view that SEIFiCs such the BVI, Bahamas and the Cayman Islands which over the past 2 to 3 years have imposed additional regulatory requirements on banks and other financial services could see a migration of businesses to G10 countries.

Suggestions/Recommendations

First, it may be useful for the BCBS Implementation Group to consider developing a set of basic templates in Excel that supervisory agencies in the Caribbean and other small-economies to capture the information required under the Basel II Standardized Approach.

Second, the Financial Stability Institute (FSI), BCBS and ASBA should collaborate to work with the supervisory agencies in the Caribbean in conducting a QIS in the Region. To make the survey meaningful, participating banks could assume medium to low ECAI ratings and unrated.