Comments of the Caribbean Group of Bank Supervisors (CGBS) on the Third Consultative Paper on the New Capital Accord

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1. Introduction

Similar to the development of the 1988 Capital Accord, the Caribbean region was not actively involved in the architecture of the proposed New Accord, but note that the region's exclusion may have been due to the fact that Basel II was primarily designed for and is being implemented by internationally active banks. The Basel Committee has acknowledged that non-G10 countries would not be prepared for full Basel II adoption (specifically Pillar I) by the stipulated end-2006, due to resource and other constraints. However, the CGBS notes that even within G-10 countries, there will not be full Basel II adoption by end 2006, as certain countries, the USA, for example, has already stated that only twenty (20) of its banks would adopt Basel II.

The Basel Committee has also stated its expectation that there will be full adoption of Pillars II and III of the new Accord by end 2006 by **all non-G10 countries**, despite the fact that some aspects of these may not be possible or practicable for emerging economies of the Caribbean, given the uniqueness of the region's banking environment.

In the above regard, the CGBS wishes, at the outset, to request that the Committee explicitly state in the finalized Accord and in all its official documents, a clear indication of those areas not applicable to developing/emerging nations; and also explicitly indicate that the 2006 deadline is not intended especially for small open emerging market economies. Given the fact that developing non-G-10 countries will not be prepared for full Basel II implementation by the stipulated 2006 deadline, **the Committee should consider explicitly allowing these sovereigns to continue under Basel I (or to adopt Basel I where this has not yet taken place), while developing the supervisory infrastructure to facilitate the eventual adoption of the New Basel II Accord.** This is of critical importance when viewed in the context of the modus operandi of international multilateral lending agencies, which tend to assess the strength of banking/financial systems in relation to established global standards and practices. In this regard, it is more than likely that adoption of the new Accord well past 2006 could have an adverse interpretation by such agencies and could lead to unfavourable assessments by them.

The region is also concerned that little consideration appears to have been given to the difficulty of implementation of Basel II in **small open economies** and that no representative of such a grouping was included on the working group to review and/or address practical implementation issues. The CGBS wishes to emphasise the point that problems and issues faced by small open economies have a level of uniqueness that is significantly different from those faced even by large developing countries. It would therefore be our further recommendation that the Basel Committee put in place a suitable mechanism to ensure that legitimate concerns of such groupings (which form a not insignificant part of the international membership) are factored into all newly developing global standards.

Notwithstanding the above, the CGBS fully understands and endorses the need to adopt and implement internationally acceptable global banking standards, to ensure the region's full integration in the global financial markets, including being able to compete for capital inflows. In addition, we view adoption as a means of deepening and strengthening the developmental process being undertaken throughout the region, which is geared towards building robust, stable and resilient banking systems, within the context of sound risk management systems, a strong but flexible legislative framework and deeper, more efficient capital markets to facilitate trading and timely valuation of financial instruments, absence of which would retard our ability to implement the recommendations within a reasonable timeframe.

2. Current Position of The Region

The Region has largely implemented the 1988 Current Accord (Basel I) except for the 1996 amendments for market risks, which stipulate capital charges for market exposures and netting arrangements in the trading book. On a whole, we are now at an advanced stage of implementing these 1996 amendments, wherever applicable.

Presently, banks in some jurisdictions operate with a capital buffer for risks other than credit risk. For example, in Jamaica the Supervisory Authority has, several years ago, set minimum capital requirements at two hundred basis points above the Basel recommended 8% minimum risk asset ratio requirement, and as an additional buffer Jamaican banks must maintain a 6% primary capital requirement. Similar initiatives are replicated across the region. Meanwhile, policy directives issued by the Bahamian Authorities have resulted in the diversification of the balance sheets of international/off shore banks into high quality financial instruments, which has led to capitalization levels considerably higher than the 8% minimum risk ratio requirement. As such, the introduction of additional capital charges for operational and market risks in the banking book should not severely impact these banks. However, notwithstanding the foregoing, the introduction of Basel II, could result in increased capital levels for banks which operate close to the minimum capital requirement.

3. Pillar I – Minimum Capital Requirements

Pillar 1differs from the 1988 Accord to the extent that it has modified the definition of risk weighted assets from two primary aspects:

1. Substantially changing the treatment of credit risks; and
2. The introduction of explicit capital charges in relation to operational risks.

However, we note that the minimum capital ratio (8%) and the components of capital (Tier 1 and 2) have remained unchanged as well as the treatment of market risk in the trading book.

3.1. Credit Risk Measurement

As indicated in the Accord, the advanced approaches to credit risk measurement were designed to provide meaningful assessment of risks at **the largest, most complex banking organizations and thus are clearly not designed for banks in small unsophisticated developing economies**. Most of the regional jurisdictions host a myriad of domestic subsidiaries/branches of internationally active and offshore banks. These banks have indicated the likelihood of their adoption of the advanced Internal Ratings Based (IRB) approaches for the measurement of credit risk. However, for domestically owned licensees the Standardised Approach (SA) would be the most feasible alternative.

The resultant two-tiered capital regime coupled with the varying options for national treatments embedded in the New Accord could therefore present difficulties re harmonization among different host jurisdictions, create opportunities for regulatory arbitrage and serious practical implementation challenges for regulators.

An additional implication of this is that rated borrowers with more favourable risk-weights in the region could borrow at lower costs from internationally active banks that have adopted advanced credit risk measurement approaches rather than from domestic banks adopting the Standardised Approach. This would place domestic banks at a competitive disadvantage in lending to high quality borrowers in our region.

From a practical perspective, the region would not be in a position to implement and monitor the IRB approaches in the short-to medium term, given the following factors: -

- The majority of our local banks have relatively uncomplicated risk profiles and non-complex balance sheet structures (with the absence of a predominance of derivative and other complex financial instruments from our market) and hence would not warrant such advanced risk measurement techniques;
- The Regional capital market is shallow with relatively small transaction volumes and as such, valid market prices and valuations are in some instances difficult to obtain;
- The requisite resources (both technological and human resources) for implementation of advanced measurements are scarce and costly to acquire for both local banks and the Supervisory Authorities alike. Further,

the cost of implementing such measures currently would materially outweigh the benefits.

Nonetheless, the preferred Standardised Approach also poses significant challenges and difficulties that would prevent its adoption by year-end 2006. Whilst it is being proposed that risk weights will still be determined by category of borrower, the assessment of the credit-worthiness of such borrowers, and hence the risk profile, will be largely dependent on external credit rating agencies. Our primary concerns surrounding the use of external credit rating agencies are outlined below:

- Our region currently has no credit rating agency, although plans are in train for the establishment of such a regional body. It is however doubtful that the proposed Caribbean rating agency will be able to satisfy Basel II qualifying criteria by end 2006. Further, given the size of banks' corporate clients and the volume of credit typically required by corporates domiciled in small developing economies, it is still to be proven that it would be economically feasible for rating agencies to engage in the rating of the majority of regional companies. There is also the issue of credibility and acceptance of such a regional agency by the international capital markets and multilateral agencies which may very well lead to multiple ratings and the attendant cost. Alternatively, to gain acceptance, any regional agency may have no option but to form an alliance with the externals thus perpetuating their dominance.
- It could be difficult to ensure consistent ratings since these agencies are unregulated and the rationale for their risk assessments is largely unobservable.
- External rating agencies will become extremely influential, exerting an even more direct impact on the lending decisions of international banks. That is, they will now not only be able to influence the risk assessment of these institutions for extending credit but, in addition, determine the capital that supervisors require banks to maintain in order to extend credit. The

alternative of using export credit rating agencies would not improve the situation as the bases of their ratings lack transparency.

In addition to the above, adoption of the Standardised Approach would in most instances involve: -

- Further legislative changes
- Upgrading of banks' information systems
- Overhaul of prudential reporting regimes
- Training of bank staff and regulatory personnel

We however re-iterate that the region is committed to the further development and deepening of our capital market and financial system to meet the challenges of the increasingly dynamic financial environment in which we operate.

The Region has noted the extension of the recognition of credit risk mitigants beyond OECD sovereign issues to include financial instruments in general, while setting out several approaches for assessing the degree of capital reduction based on the market value of the collateral instrument. Presently, we are facing challenges in pricing given the absence of a deep bond market and hence the absence of a long-term yield curve. This would present difficulties in calculating the offsetting capital reduction.

The issue of paramount concern is the negative impact that the new credit risk measures under Pillar I, may have on commercial lending flows to the region. Internationally active banks lending to our region with mostly lower rated and unrated sovereigns and corporates would end up with significantly higher capital requirements. The higher capital charges associated with this high risk weighting would almost certainly divert credit from our region and other developing regions and place such credit at prohibitive costs. The end result could be that long-term investment flows into developing countries are discouraged or that their debt and capital funding are unduly prejudiced, possibly leading to longer and deeper business cycles, with deleterious impacts for monetary and banking system stability. Further, this may lead to concentration risks as banks may only extend low risk credits to higher rated sovereigns and corporates which are predominantly domiciled in developed regions. **We therefore posit the view that the new Accord does not incorporate the benefits of international diversification of asset portfolios.** This is supported by empirical studies, which have proven that there is a higher correlation among the economic indicators of developed countries vis-à-vis that of the developed and emerging economies. **Indeed, the argument for treating with credit extension to emerging economies at a lower risk category than is currently proposed, are similar to those which guided the Basel Committee's decision to treat with credit extension to small and medium enterprises (SMEs) as a lower risk category. The region therefore strongly recommends and requests the Committee's review of its position on this issue.**

3.2. Operational Risks

Similar to the credit risk measurement techniques, subsidiaries of internationally active banks in the region have indicated their likelihood of adopting the Advanced Measurement Approach (AMA). However, the simpler Basic Indicator and Standardised approaches would be the primary approaches adopted by the region. This is due to the absence of the requisite database and infrastructure within our banks to facilitate the capture of loss data.

While we will seek to adopt the Basic Indicator and/or Standardised approaches, the following concerns are noted:

1. We agree with some positions that have been posited to the Committee, that operational risk exposures tend to be specific to each institution and should therefore have perhaps been included in Pillar II (to allow for supervisory discretion of alpha and beta through thorough individual assessment of each institution's risk posture), **and not Pillar I**.

2. The fixed alpha and beta charges (capital charges) relating to the Basic and Standardised approaches respectively, appear arbitrary (as the basis for these charges is not clearly enunciated or substantiated), and are not risk sensitive. **In this regard, we recommend and request that the Basel Committee takes steps to make the Basic Indicator and Standardised operational risk charges more risk sensitive.** This could be achieved by scaling the alpha and beta factors (for e.g. alpha =15% in CP3) by some other indicator (e.g. delta), which would be based on operational control and risk management factors. Consequently, a bank with a strong control environment as determined by the Supervisor, would have a lower delta factor and thus lower capital charge for operational risk. Alternatively, a menu of different alpha factors may be offered at national discretions. To ensure transparency, the national supervisor should be required to disclose the factor that would be used in determining the delta methodology for scaling the alpha factor.

3. Gross income as a proxy of scale of operations may be a disadvantage for banks, which operate with high margins (as is typical of regional banks in our limited markets).

4. The offsetting impact of insurance mitigation on operational risk is not allowed under the simpler approaches. The recognition of insurance only under the AMA approach may result in foreign owned internationally active banks requiring lower operational risk capital charges than their small domestic banking institutions, despite the fact that domestic banks may operate in less complex operational risk environments. It is therefore recommended and requested that the Basel Committee reconsider allowing an adjustment factor for insurance under the Basic Indicator and Standardized approaches, given that less complex banking organizations that are likely to adopt the simpler approaches, may be **unduly** penalized in the process. In cases where a small domestic bank has suffered

material losses due to fraud or systems failure for example, the supervisory agency can then opt **not** to adjust for insurance mitigation in the calculation of the institution's capital charge for operational risk.

4. Pillar II – Supervisory Review

In principle, the region agrees with Pillar II, which emphasizes the supervisor's role in ensuring that banks have effective risk management systems in place for the measurement of capital. Pillar II requires an effective supervisory process viz.,

1. Flexible Legislative Framework
2. Effective on-site and off-site monitoring
3. Standards of best practices and guidelines
4. Skilled human resources
5. Appropriate technological architecture.

Whilst the requisite legislative framework is not fully in place within all regional jurisdictions, we **are** committed to effecting the legal reform necessary to facilitate full compliance with Pillar II. In this regard, legal amendments have been proposed or already promulgated to entrench into law, not only minimum capital requirements, but also powers to issue directions and 'cease and desist' orders to ensure compliance in a prompt and timely manner.

Onsite and off-site reviews have focused not only on credit and investment quality reviews and compliance with statutory requirements, but very significantly on banks' risk management systems and processes. Going forward, the scope of these reviews is being expanded to ensure a more comprehensive assessment of **all** risk exposures. Concomitantly, the goal will be to ensure that banks develop the capability to assess their overall capital adequacy in relation to their risk profile, perform stress testing and institute daily monitoring and reporting of capital adequacy. However, the foregoing will undoubtedly place additional pressure on existing resources. At the preliminary planning stage, there is a need to educate and train supervisory and industry personnel on Basel II as well as to issue standards of best practice and guidelines to bolster the existing risk management and corporate governance framework.

5. Pillar III – Market Discipline

The region also welcomes Pillar III as we recognize that disclosures and increased transparency can only lead to more efficient markets and reduce the potential for moral hazard by allowing enhanced monitoring of the bank's activities by its various stakeholders.

At present, disclosures to the public are largely done through annual audited financial statements, as well as the periodic publishing of financial data and prudential indicators by the supervisory authorities[1]. We note that this latter is still not a feature of jurisdictions worldwide, and commend its adoption by such jurisdictions that have not yet put it in place. Further, the adoption of International Accounting Standards (IAS), which entails more onerous reporting requirements for companies, has resulted in wider disclosures.

Notwithstanding the foregoing, in order to effectively implement Pillar III requirements, the region will engage in on-going dialogue with the industry and national accounting bodies to agree on the scope and content of additional disclosures consistent with the peculiarities of our financial system. Subsequent to the consultative process, additional disclosure requirements, where necessary, would be entrenched into law.

6. Conclusion

The proposed new accord provides a more complex definition and measurement of the capital ratio and as such, jurisdictions in the Caribbean region will have to develop the expertise and systems to, not only measure and quantify

[1] For example, Jamaica publishes financial data of supervised entities on a quarterly basis, along with system and sector prudential indicators.

operational risk, but to integrate this with measures for credit and market risks to appropriately determine capital levels consistent with the risk profile of banks. This will require significant modifications to our existing legislative and regulatory framework.

Domestic banks lack the sophistication, data and systems to implement the IRB approach to determine capital charges in relation to credit risk by 2006. On the other hand, the SA requires substantial market information on the ratings of sovereigns, corporates, securitized assets and the value of collateral - data which is not readily available in most Caribbean territories. In addition, whilst the SA may be less costly than the IRB approach, its implementation would require that supervisory authorities and licensed financial institutions nonetheless expend significant resources. Further, capital requirements are expected to be higher, particularly for active domestic banks, in spite of the expanded range of collateral recognized under Basel II.

Capital charges in relation to operational risk should be transferred to Pillar II. Further, the relatively high alpha and beta factors combined with the failure to recognize the risk mitigating impact of insurance under the Basic Indicator and Standardised Approaches will unduly penalize small domestic banking institutions that generally tend to have lower inherent operational risk by virtue of the simplicity of their operations.

Given the implications of Basel II, the region is committed to:

1. Pursuing the implementation of international best practices, supervisory and regulatory standards throughout the financial system.

2. Promoting the adherence to high corporate governance standards within supervised financial institutions.

3. Enhancing legislation and regulations to strengthen the supervisory mechanism and market discipline.

4. Facilitating and encouraging banks to improve their risk management capabilities in order to enhance their ability to identify, monitor, control and manage risk exposures and maintain capital levels commensurate with risk profiles.

7. Recommendations

The Caribbean Group of bank Supervisors also recommends that:

1. The Basel Committee should clearly indicate the avenues by which the region can actively participate and benefit from the Working Committee established to assist non G-10 supervisors and banks in the transition to the New Accord.

2. The Committee should enunciate the lack of relevance of some aspects of Basel II to emerging economies and the need for an extended timetable for implementation. Basel II should therefore not now be used as a yardstick by the multilateral agencies in their assessment of these countries' financial sectors.

3. Credit extension to emerging economies should be assigned a lower risk category than is currently proposed, similar to the approach taken to treat with extensions of credits to SMEs as a lower risk category.

4. Operational risk measurements should be transferred from Pillar I to Pillar II to allow for greater Supervisory discretion. In this regard, we also suggest that the Basel Committee takes steps to make the

Basic Indicator and Standardised operational risk charges (alpha and beta factors) more risk sensitive (refer Section 3.1.2). Alternatively, the Basel Committee should reconsider allowing an adjustment factor for insurance under the Basic Indicator and Standardised approaches given that less complex banking organizations that are likely to adopt the simpler approaches may be unduly penalized in the process.