CENTRAL BANK OF TRINIDAD AND TOBAGO:-

Comments on the Basel Committee's

Third Consultative Paper (CP3)

INTRODUCTION

The Central Bank of Trinidad and Tobago lauds the Basel Committee's attempts to streamline a bank's[1] capital requirement with both its level of risk and its management of risk. Nevertheless, the Central Bank of Trinidad and Tobago maintains that the overall complexity of Basel II makes it especially difficult for developing countries, which lack the requisite data, market sophistication, and supervisory capacity, to implement. It should be noted too that there are many developing countries that have only just recently adopted the 1988 Capital Accord, therefore moving to a more complex system by 2006 may not be attainable.

Following the Second Consultative Paper (CP2), the Central Bank of Trinidad and Tobago had surveyed its licensed financial institutions to solicit their views on the proposed new Capital Accord (Basel II). The responses were as expected with most domestically owned licensees stating that the Standardized Approaches (SA) for credit risk and operational risk were probably the most feasible alternatives in the short to medium term. The local subsidiaries of foreign owned internationally active banks however, indicated that they would most likely adopt the Internal Ratings Based (IRB) approach for credit risk and the Advanced Measurement Approach (AMA) for operational risk.

The Basel Committee has stated that Basel II is intended for implementation by internationally active banks, however there is the concern that that this differential treatment would place domestic banking institutions at a competitive disadvantage. The results of the third Quantitative Impact Study show that those institutions that implement the advanced IRB approach for credit risk and AMA for operational risk are likely to have lower capital requirements. By contrast, the implementation of the simpler Standardized approaches for credit and operational risk is expected to raise significantly the capital requirements of domestic banks. In this regard, the Central Bank of Trinidad and Tobago in the near future intends to conduct a Quantitative Impact Study to ascertain the impact of Basel II on licensees' capital requirements.

[1] The word bank as used in this paper refers to all licensed commercial banks and non-bank financial institutions of the Central Bank of Trinidad and Tobago, unless otherwise stated.

The Central Bank of Trinidad and Tobago has also noted with keen interest the position of the US authorities with respect to Basel II. The Federal Reserve's Vice Chairman, Roger Ferguson, has stated that the United States only expects 20 of their internationally active banks to implement Basel II. All other banking organizations would remain under Basel I. It is anticipated that this announcement may have implications for the implementation of Basel II as envisaged by the Basel Committee.

PILLAR 1: MINIMUM CAPITAL REQUIREMENTS

Standardized Approach for Credit Risk

Several banks in Trinidad and Tobago have significant exposures to countries in the Caribbean region. Apart from Trinidad and Tobago debt which would attract a risk weight of 20% and exposures to the Bahamas, Barbados, Bermuda and the Cayman Islands which would be risk rated at 50%, credit exposures to all other Caribbean territories would attract a risk weight of 100% or 150%. This is in sharp contrast to the 1988 Accord, in which sovereign debt is risk weighted at 0%. As a consequence, under Basel II capital requirements for these institutions would rise significantly to cater for the risk in regional sovereign debt. **Associated with this, is the wider concern that the higher capital requirements required for exposures to most Caribbean economies would result in a reduction in capital flows to high-risk regional economies from developed and other developing countries** which would impede further the development of markets within the region.

The application of the Standardized approach relies on the existence of external credit rating agencies. At present there are no credit rating agencies in the Caribbean and several Caribbean countries remain un-rated. Establishing a credit rating agency in the Caribbean is likely to place a financial burden on supervisory agencies and licensed financial institutions in the region, given that these institutions would be expected to be stakeholders in such an enterprise in order to lend credibility to such an agency. Moreover, despite an increase in capital market activity in the region, these markets remain to a large extent undeveloped, consequently one must consider whether there is sufficient capacity in the region to render the establishment of such an agency a feasible undertaking.

Operational Risk

The expected increase in capital requirements for credit risk would be further exacerbated by the imposition of a capital charge for operational risk equivalent to 15% of gross income using the Basic Indicator Approach, or ranging from 12% to 18% of gross income depending on the business line using the Standardized Approach. However, for the complex Advanced Measurement Approach (AMA), which foreign owned licensees have indicated that they may adopt, the offsetting impact of insurance mitigation on operational risk is recognized up to a limit of 20% of the total operational risk capital charge. No similar treatment is given to insurance mitigation under the simpler approaches. The recognition of insurance under the AMA approach may result in our foreign owned internationally active banks requiring lower operational risk capital charges than their small domestic banking institutions. **The Basel Committee should therefore reconsider allowing some offsetting capital adjustment 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 by the non-recognition of insurance under the simpler approaches**. In cases where a small domestic bank has suffered material losses due to fraud or systems failure, the supervisory agency can then chose not to adjust for insurance mitigation in the calculation of the institution's capital charge for operational risk.

Valuation of Collateral

The Central Bank also appreciates that the additional capital that may be required due to application of the Standardized approaches to credit and operational risk may be offset to some extent by the recognition and treatment of collateral under Basel II. Basel II proposes an expanded range of collateral, guarantees, and credit derivatives that banks using the standardized approach may recognize. The standardized approach expands the range of eligible collateral beyond OECD sovereign issues to include most types of financial instruments, while setting out several approaches for assessing the degree of capital reduction based on the market value of the collateral instrument. **Our main concern is that developing countries often lack the sophisticated markets needed to accurately value collateral, which may present difficulties in calculating the offsetting capital reduction**.

Treatment of Residential Mortgages and Past due Loans

Nevertheless, the Central Bank is in agreement with some of the innovations in the proposed new accord especially, the proposed treatment of past due loans and residential mortgages under the Standardized approach. The treatment requires that loans considered past due be risk weighted at 150%, unless a threshold amount (e.g. 20%) of specific provisions has already been set aside by the bank against that loan. The risk weight for residential mortgage exposures is being reduced to 35% compared to 50% in the current accord.

Internal Ratings Based (IRB) Approach for Credit Risk

The main concern with the IRB approach is that the data and system requirements appear onerous for most of our domestic banks. Further, the IRB approach requires that supervisory agencies have the technical competence and capability to assess banks' internal models, skills that may be in short supply in our region. Therefore, the implementation of the IRB approach would require that banks and supervisory agencies allocate tremendous resources to acquire the systems and/ or expertise to successfully implement this approach.

PILLAR 2:SUPERVISORY REVIEW

In principle, the Central Bank agrees with Pillar 2 of the proposed new accord, which deals with the supervisory review process. However it should be emphasized that for Pillar 2 to be effective, an adequate legislative/ supervisory framework must be in place. For instance, banking legislation should contain provisions that allow the supervisory authority to require a licensee to hold capital in excess of the minimum capital requirement. However, while this measure provides the supervisor with some discretionary authority, determining the amount of additional capital needed may prove difficult in the absence of quantitative benchmarks or limits. Consequently, the supervisory agency may be better poised to ensure that a licensee does not assume excessive risk if it were to establish prudential limits for certain risk exposures (e.g. foreign currency lending, asset/liability mismatches, and credit concentrations), with which licensees must comply. Such rules or prudential limits should be adequately supported by the legislative/ regulatory framework.

Banking legislation must also contain adequate measures that would empower the supervisory authority to act in a timely manner to avert a crisis or enforce compliance. In the case of Trinidad and Tobago, it is recognized that a key enforcement mechanism, Cease and Desist Orders, may be ineffective as a prompt corrective measure since current banking legislation requires that a hearing be held prior to the issue of such orders. The Central Bank has therefore proposed an amendment to legislation requiring that the hearing be held **subsequent to** the issue of the cease and desist order. This will allow the Central Bank to curtail at an early stage any activity of a licensee, which in its opinion, is unsafe or unsound or in breach of banking legislation.

The Central Bank has also sought to enhance its supervisory powers by proposing an amendment to legislation that gives the Central Bank the authority to impose civil money penalties on licensed financial institutions that fail to comply with provisions in banking statutes. Currently, penalties take the form of fines and imprisonment, which can only be imposed by the Court.

PILLAR 3: MARKET DISCIPLINE

The Central Bank is pleased that the Basel Committee is striving to ensure that disclosure standards with respect to the new accord focus on capital adequacy and do not conflict with broader accounting disclosure standards. Nevertheless, the Central Bank intends to carefully consider any proposed standards regarding public disclosures of the capital adequacy of individual licensed financial institutions. In small economies such as ours, such disclosures must be carefully managed so as to avoid any disruptive impact on the financial system.

CONCLUSION

Notwithstanding the innovations in the proposed new accord, developing countries remain caught '*between a rock and a hard place'*. With respect to credit risk it is evident that our domestic banks lack the data and systems needed to implement the IRB approach by 2006. On the other hand, the SA though simpler to implement still requires a substantial amount of market information on the rating of sovereigns, corporates, securitized assets and the value of collateral, data most Caribbean territories may be hard pressed to obtain. Consequently, implementing the SA, while probably less costly than the IRB approach, would also require a significant amount of resources from supervisory agencies and licensed financial institutions. In the case of the latter, capital requirements are expected to be higher, moreso for regionally active domestic banks, in spite of the expanded range of collateral recognized under Basel II.

Adoption of the SA may therefore lead to: -

1. Rapid financial innovations as licensees attempt to reduce their exposures to regional economies that attract higher capital requirements but are however unable to substitute such exposures with investment grade debt; and
2. Flight to better quality assets and a commensurate reduction in capital flows to regional economies from both developed and developing countries.

In light of the difficulty countries such as ours are likely to experience with respect to implementing the proposed new accord, the Central Bank of Trinidad and Tobago proposes that the Basel Committee:-

1. Postpone the implementation date for Basel II for these countries.

2. Develop criteria that would allow regional economies to ascribe preferential treatment for intra-regional capital flows. This is necessary to permit deepening of capital markets within the region.

Further, the failure to recognize the risk mitigating impact of insurance under the Basic Indicator and Standardized Approaches would unduly penalize small domestic banking institutions that generally tend to have lower inherent operational risk by virtue of the simplicity of their business. **Therefore, the Basel Committee should therefore reconsider allowing some offsetting capital adjustment for insurance mitigation under these simpler approaches**.

Finally, the success of Pillar 2 resides with the strength of the legislative and regulatory framework. Supervisors must have at their disposal adequate powers in banking legislation to require licensees to hold capital in excess of the minimum requirement and to intervene at an early stage to correct deficiencies at licensed institutions. Concomitantly, the supervisory authority should establish prudential regulations or limits to deal with certain high-risk exposures with which all licensees must comply. Such regulations would serve to reduce regulatory forbearance and lend objectivity to the supervisory review process.

Central Bank of Trinidad and Tobago
July 18, 2003