• Background
• Basel Implementation Road Map
• Basel II Expectations
  – Pillar 1: Standardized Approach
  – Pillar 2: Supervisory Review
  – Pillar 3: Market Discipline
• Basel III Expectations
Conceptual Framework for Basel II Accord

Basel II Structure

Three Pillars

Pillar 1 (P1)
Minimum Capital Requirements

Credit Risk
Market Risk
Operational Risk

Pillar 2 (P2)
Supervisory Review Process

Banks review own Capital adequacy Supervisors evaluate bank’s assessments

Pillar 3 (P3)
Market Discipline

Increased disclosure Partial consequence of more reliance on internal assessments
The Central Bank’s Basel II and III Implementation Road Map:

- Provides a high level overview of Basel II and III frameworks;
- Discusses the scope of application of Basel II and III for licensees in this jurisdiction;
- Sets out indicative timelines for Basel II and III implementation for licensees;
- Highlights the key areas of transition and regulatory requirements under the new framework; and
- Discusses next steps (i.e. implementation phases).
Preliminary Initiatives which set the foundation for Basel Implementation Program

- Implemented Market Risk Amendments to Basel I (PI)
- Issued Consultation Paper on the Guidelines for the Management of Op Risk (P1)
- Introduced Risk Based Supervisory Framework in 2010 (P2)
- Impose Target and Trigger Ratios (P2)
- Impose Stress Testing on Commercial Banks (P2)
- Require publication of Audited Accounts (P3)
- Conducted Minimum Disclosure Surveys (P3)
- Align Capital Structure of Commercial Banks with revised definition for Tier 1 and Tier 2 Capital (B3)
• Mobilized a Project Team comprising some 17 persons from Bank Supervision Department (BSD)

• The Project has a governance structure comprising:-
  – Steering Committee,
  – A Project Coordinator
  – An Advisory Board,
  – Regional Consultancy support through CARTAC
  – A dedicated Consultant (to be identified)
  – Six technical working groups that have been given specific high-level mandates covering the requirements of Basel II and III.
Basel III does not replace Basel II but complements that framework.
Key Drivers of the Basel Program

• Basel II significantly provides for more risk sensitive capital requirements and it takes into account operational risk of banks apart from credit and market risks.

• Basel II promotes strong risk management practices by providing capital incentives for banks having better risk management practices.

• Basel II provides for use of assessment of risk provided by banks’ internal systems as inputs to capital calculations.

• Basel II provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and national regulators to select the approaches that are most suitable for them.
Key Drivers of the Basel Program

• Basel III provides a fundamental tightening of the definition of capital, with a strong focus on the common equity Tier 1 component.

• Basel III promotes the build-up of capital buffers in good times that can be drawn down in periods of stress, as well as clear capital conservation requirements to prevent the inappropriate distribution of capital.

• Basel III introduces a leverage ratio, which has system-wide benefits by preventing the excessive build-up of debt across the banking system during boom times.

• Basel III improves the banking sector’s ability to absorb shocks arising from financial and economic stress.

• Basel III improves risk management and governance.
The scope of application for the Basel II and III Implementation Program will be directed at locally incorporated unrestricted (public) banks and bank & trust companies.

Currently there are 70 licensees that report under the Basel I capital measurement framework. It is intended that these licensees would migrate to Basel II and III as appropriate.

While the parent banks in the home jurisdictions may apply advanced approaches for Basel II, their subsidiaries within this jurisdiction will be subject to the simpler approaches.
The Central Bank started the Basel III initiatives earlier with the Commercial Banks, who were required to bring their capital structure in line with the minimum capital rules under Basel III.

All banks however will be held to the Basel III standards for Capital Structure.

The Central Bank will determine the scope of applications for other elements of Basel III.
Exceptions

The Central Bank will apply some elements of Pillar 2 around improved risk management and disclosure requirements to following types licensees:-

- Pure Trust Companies
- Branches of Foreign Banks

In addition, these classes of licenses will also be subject to meeting the requirements of the Basel Committee’s Sound Practices for Operational Risk Management.
Timelines and Implementation

• The entire program runs from Q3 2013 to Q4 2015.

• “Go Live” Implementation scheduled for Q1 2016

• The Program is divided into three separate but overlapping phases.
Timelines and Implementation

Phase 1
Q3 2013 – Q4 2014

Phase 2
Q1 2014 – Q4 2015

Phase 3
Q3 2014 – Q4 2015
• The first phase which commenced in July 2013, primarily focuses on the Pillar 1 Capital Measurement and Pillar 3 – Minimum Disclosure Requirements as well as amending the definition of Minimum Regulatory Capital in accordance with Basel III.

• This phase will also include a Quantitative Impact Study (QIS) for Pillar 1 requirements.

• The second phase of implementation will start in Q1 of 2014 with the primary focus around Pillar 2 – Supervisory Review requirements. During this phase the Central Bank will issue its framework on the ICAAP that banks will be required to prepare and maintain on an on-going basis.
The Central Bank also plans to commence its parallel run for Pillar 1 and Basel III reporting in the second phase.

The third phase of the implementation program commences Q3 2014 and it would involve the release of the actual reporting forms and Guidelines.

As a part of phase 3, the Central Bank will introduce the framework for the key liquidity ratios under the Basel III framework.

And finally, during this phase the Central Bank will continue with the parallel run, spanning several quarters of reporting, which would culminate into the final QIS before the live implementation by Q1 2016.
High-Level Summary of Deliverables

**PHASE 1**
(Q3 2013-Q4 2014)
- Industry Briefing
- Publish Road Map
- Basel Readiness Survey
- Consultative Papers under Pillar 1 - Credit Risk
- Consultative Papers under Pillar 1 - Operational Risk
- Consultative Papers under Pillar 3 - Minimum Disclosures
- Consultative Paper for Basel III - Capital Structure
- Conduct QIS for Pillar 1 Requirements
- Orientation and Awareness Training for Pillar 1 Requirements

**PHASE 2**
(Q1 2014-Q4 2015)
- Consultative Paper - ICAAP
- Amend Corporate Governance Guidelines (to include Basel II and Basel III Expectations)
- Amend Ladder of Supervisory Intervention Framework
- Issue Draft Guidelines on Consolidated Supervision
- Publish Consultative Papers under Basel III - Capital Buffers, LCR, NSFR and Leverage Ratios
- Parallel Run on Pillar 1 and Basel III
- Conduct onsite Benchmarking Meetings with Licensees
- Industry Briefing for ICAAP and Reporting Forms

**PHASE 3**
(Q3 2014-Q4 2016)
- Consultative Paper for D-SIBs
- Implement the LCR, NSFR and Leverage Ratio
- Issue Final Reporting Forms and Guidelines
- Conduct Full QIS Exercise
- Live Implementation
Immediate Next Steps

- Publish the Basel II and III Implementation Road Map
- Request Licensees to identify Basel II and III Implementation Coordinator
- Conduct Basel Readiness Survey
- Publish Quarterly updates through a dedicated Basel Implementation Program Newsletter, commencing Q1 2014
- Conduct internal and industry sessions after certain key milestones of phase 1 are met
BASEL II: Pillar 1 - Minimum Capital Requirements

Credit Risk – Standardized Approach
Basel II offers four (4) approaches / methodologies for the assessment of Credit Risk
- Simple Standardized Approach (Basel I)
- Standardized Approach (SA)
- Foundation: Internal Ratings Based (IRB) Approach
- Advanced: Internal Ratings Based (IRB) Approach

CBOB has determined the SA approach appropriate for banks in this jurisdiction
Important Improvements from the Basel I Accord

- Risk weights more sensitive to inherent riskiness
  - Wider spectrum of risk buckets
  - Recognition of external credit assessment institutions
  - Greater recognition of collateral (credit risk mitigation techniques)

- Introduction of additional risk weights (e.g. 75%, 150%)

- Removal of current OECD/non-OECD rule for risk weighting of sovereign exposures

- Refinement to treatment of Securitization

- Refinement of off-balance sheet risk weights
Basel II comprises a number of explicit “national discretion items” to allow local application and flexibility to regulators.

The selection of these items depends on the supervisor’s own judgement and assessment of its appropriateness in the local context.

Approximately 24 National Discretion (ND) areas under Credit Risk – Standardized Approach
- Consideration – Standardized approach for securitization exposures
- Conduct a Securitization Survey to better understand scope of application
Table 1: Risk-weights for credit risk in Basel II (standardized approach) and in Basel I

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Basel II (standardized approach)</th>
<th>Basel I</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>AAA</td>
<td>A+</td>
</tr>
<tr>
<td>Corporate</td>
<td>20%</td>
<td>50%</td>
</tr>
<tr>
<td>Bank&lt;sup&gt;a&lt;/sup&gt;</td>
<td>Option 1</td>
<td>LT</td>
</tr>
<tr>
<td></td>
<td>Option 2</td>
<td>ST</td>
</tr>
<tr>
<td>Sovereign</td>
<td>0%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Note:  
<sup>a</sup>The distinction between Option 1 (risk-weight one category below that of the sovereign) and Option 2 (risk-weight based on the rating of the bank) applies only in Basel II

## Comparative Risk Weights under Basel I and II Frameworks

<table>
<thead>
<tr>
<th>Exposure / Asset</th>
<th>Basel I Bahamas</th>
<th>Basel II</th>
<th>Basel II Bahamas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash or Deposits at Central Bank</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Claims on sovereigns (governments or on central banks, denominated / funded in the national currency)</td>
<td>0%</td>
<td>0% - 150%</td>
<td>0% - 150%</td>
</tr>
<tr>
<td>Claims on Public Sector entities (PSEs)</td>
<td>20%</td>
<td>ND</td>
<td>ND</td>
</tr>
<tr>
<td>Claims on Multi-lateral Development Banks (MDBs)</td>
<td>20%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Claims on banks and securities firms</td>
<td>20% - 100%</td>
<td>20% - 150%</td>
<td>20% - 150%</td>
</tr>
<tr>
<td>Claims on corporate</td>
<td>20% - 100%</td>
<td>20% - 150%</td>
<td>ND</td>
</tr>
<tr>
<td>Claims on retail portfolio (credit cards, overdraft facilities etc.)</td>
<td>100%</td>
<td>75%</td>
<td>ND</td>
</tr>
<tr>
<td>Claims secured by residential mortgages</td>
<td>50%</td>
<td>35%</td>
<td>ND</td>
</tr>
<tr>
<td>Claims on commercial real estate</td>
<td>100%</td>
<td>100%</td>
<td>100% / ND</td>
</tr>
<tr>
<td>Past due loans (over 90 days)</td>
<td>100%</td>
<td>100% - 150%</td>
<td>100% - 150%</td>
</tr>
<tr>
<td>Higher-risk categories</td>
<td>100%</td>
<td>≥ 150%</td>
<td>150%</td>
</tr>
<tr>
<td>Other assets</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

*ND - National Discretion*
### Comparative Risk Weights under Basel I and II (cont’d)

<table>
<thead>
<tr>
<th>Off Balance Sheet Exposures / Assets</th>
<th>Basel I Bahamas</th>
<th>Basel II</th>
<th>Basel II Bahamas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term Commitments (e.g. Standby facilities, credit lines)</td>
<td>0%</td>
<td>0% - 20%</td>
<td>20%</td>
</tr>
<tr>
<td>Long-term Commitments</td>
<td>50%</td>
<td>0% - 50%</td>
<td>50%</td>
</tr>
<tr>
<td>Short-term, self-liquidating, trade related contingencies</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Transaction-related contingent items (e.g. warranties, standby letters of credit)</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Direct credit substitutes (e.g. General guarantees, endorsements, repurchase agreements)</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>
## Credit Risk Mitigation Techniques

### Basel I Accord
- Limited recognition of collateral and guarantees
- Substitution with risk weights of the collateral issuer or guarantor

### Basel II Accord
- Collateral
  - Cash
  - OECD government and PSE securities
  - Securities issued by certain MDBs
- Guarantees
  - OECD government and PSEs
  - Multi-lateral development banks
  - Banks and Securities Firms
• Issue a Securitization Survey to better understand scope of application re Securitization framework in this jurisdiction

• Develop criteria and guidance for recognition of ECAIs

• Issue 1st Draft Guidelines for Credit Risk Framework – Standardized Approach
BASEL II - Pillar 1: Minimum Capital Requirements

Operational Risk – Basic Indicator Approach (BIA) and Standardized Approach (SA)
There are three methods for calculating the capital charge for operational risk, each progressing in sophistication and risk sensitivity:

- Basic Indicator Approach (BIA)
- Standardized Approach (SA)
- Advanced Measurement Approach (AMA)
<table>
<thead>
<tr>
<th>Approach</th>
<th>Allowed by The Central Bank?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic Indicator Approach</td>
<td>✓</td>
</tr>
<tr>
<td>Standardized Approach</td>
<td>✓</td>
</tr>
<tr>
<td>Alternative Standardized Approach</td>
<td>✓</td>
</tr>
<tr>
<td>Advanced Measurement Approach</td>
<td>✗</td>
</tr>
</tbody>
</table>
• The BIA is the default approach

• Licensees must seek the Central Bank’s approval to use the SA and the ASA

• Licensees will not be allowed to revert to the BIA, without the Central Bank’s approval, once it has been approved for the SA or ASA
Basic Indicator Approach

• Simplest of the approaches in calculating the operational risk capital charge

• Licensees must hold capital equal to 15% of positive gross income averaged over the previous 3 years.
  – Gross income is equal to net interest income + net non-interest income

• No specific criteria for use of the BIA, but licensees are encouraged to comply with the Basel Committee’s guidance on Principles for the Sound Management of Operational Risk (June 2011)
Basic Indicator Approach

Capital charge under BIA:

\[ K_{\text{BIA}} = \frac{\sum (G_{1...n} \times a)}{n} \]

where:
- \( K_{\text{BIA}} \) = the capital charge under the Basic Indicator Approach
- \( G \) = annual gross income, where positive, over the previous three years
- \( N \) = number of the previous three years for which gross income is positive
- \( a = 15\% \), which is set by the Committee, relating the industry wide level of required capital to the industry wide level of the indicator.
Standardized Approach

- Licensees’ activities are divided into eight (8) business lines.
- The capital charge for each business line is calculated by multiplying gross income by a factor assigned to that business line:

<table>
<thead>
<tr>
<th>Business Line</th>
<th>Factor (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Finance</td>
<td>18%</td>
</tr>
<tr>
<td>Trading &amp; Sales</td>
<td></td>
</tr>
<tr>
<td>Payment and Settlement</td>
<td></td>
</tr>
<tr>
<td>Commercial Banking</td>
<td>15%</td>
</tr>
<tr>
<td>Agency Services</td>
<td></td>
</tr>
<tr>
<td>Retail Banking</td>
<td>12%</td>
</tr>
<tr>
<td>Asset Management</td>
<td></td>
</tr>
<tr>
<td>Retail Brokerage</td>
<td></td>
</tr>
</tbody>
</table>
Standardized Approach

• The total capital charge is calculated as the 3 year average of the simple summation of the capital charges across each business line each year.

• In any given year, negative capital charges (resulting from negative gross income) in any business line may offset positive capital charges in other business lines without limit.
Capital charge under SA:

\[ K_{SA} = \frac{\sum_{\text{years 1-3}} \max (\sum GI_{1-8} \times \beta_{1-8}), 0}}{3} \]

where:
- \( K_{SA} \) = the capital charge under the Standardized Approach
- \( GI_{1-8} \) = annual gross income in a given year, for each of the eight business lines
- \( \beta_{1-8} \) = a fixed percentage, set by the Committee, relating the level of required capital to the level of the gross income for each of the eight business lines.
Standardized Approach

• Qualifying criteria include:

  – Board and Senior Management as appropriate are actively involved in the oversight of the licensee’s operational risk management framework;
  – The licensee has an operational risk management system that is conceptually sound and implemented with integrity;
  – The licensee has sufficient resources to adequately implement its framework across its major business line as well as in its control and audit areas.
Alternative Standardized Approach

• The calculation is the same as for the SA, except for two business lines – retail banking and commercial banking – which are based on the loan portfolio.

• Instead of using Gross Income, loans and advances for these business lines are multiplied by a fixed factor of 3.5%.

• The capital charge under the ASA for retail banking (with the same basic formula for commercial banking) can therefore be expressed as:

\[
K_{RB} = \beta_{RB} \times m \times L_{ARB}
\]

where:
- \(K_{RB}\) = the capital charge for the retail banking business line
- \(\beta_{RB}\) = the beta for the retail banking business line
- \(L_{ARB}\) = total outstanding retail loans and advances (non-risk weighted and gross of provisions), averaged over the past three years
- \(m = 0.035\)
• Issue surveys to:
  
  – Assess licensees’ level of compliance with the *Principles for the Sound Management of Operational risk*
  – Determine the approaches licensees intend to use

• Issue 1st draft of Methodology for the Computation of the Capital Charge for Operational Risk
BASEL II - Pillar 1: Minimum Capital Requirements

MARKET RISK
CBOB has completed its implementation of the **1996 Market Risk Amendment** to Basel I

Guidelines for the Management of Market Risk released in December 2012

No changes are envisaged to the current framework for market risk, given:
- limited trading book activity and
- number of licensees subject to a market risk capital charge
Pillar 1 – Capital Charge Computation

Credit Risk + Operational Risk + Market Risk = 8%
BASEL II: PILLAR II – SUPERVISORY REVIEW
Overview of Pillar II

• Encourages banks to enhance risk management techniques. Starting point and emphasis is on bank’s internal capital adequacy assessment ("ICAAP")

• Ensure banks have sufficient capital to support all risks

• Focus on internal, not regulatory capital

• Accommodate differences between banks

• Promote effective, risk-based supervisory practice
Summary of Four Key Principles

• Four Key Principles

  • Banks' own assessment of capital (ICAAP)
  • Supervisory review of the adequacy of capital
  • Ensure Capital is above regulatory minimum
  • Supervisory intervention as appropriate
“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.”

- Internal Capital Adequacy Assessment Process (ICAAP)
- No set model
- Banks must have a formal process to build a comprehensive risk profile and assessment of economic capital
- Can be complex economic capital model or more basically derived from Pillar I plus add-ons
Key ICAAP Features

• Identification/assessment of risk appetite and risk profile
• Identification and quantification of material risks
• Evaluation of capital and capital planning
• Scenario and stress testing
• Internal audit review
Pillar II Capital Risks

- Pillar I Risks +
  - Concentration Risks
  - IRRB (interest rate risk in the banking book)
  - Reputation Risks
  - Pension Risks
  - Liquidity Risks
  - Legal Risks
  - Securitization Risks
  - Business/Strategic Risks
2. Supervisors should review and evaluate bank’s internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

- Does the bank have a credible framework?
- Is risk management appropriate to risk profile and business plan?
- Is Board/Senior Management fully engaged?
- Is the risk assessment comprehensive?
- Is the analysis forward-looking?
- How does the bank’s internal capital differ from regulatory capital?
Further considerations:

- How has the ICAAP been derived and compiled?
- Does the bank have a good track record of effective risk monitoring and control?
- Review assumptions and methodologies
- Consider sensitivity of results to adverse circumstances
The Internal Capital Adequacy Assessment Process (ICAAP)

What We Expect to See in the Annual Submission of the ICAAP

• Executive summary
• Risk Identification
• Risk Appetite
• Discussions of Pillar I and Pillar II Risks
  – Key risks, how were they measured, how were they assessed/what were the exposures, what is the proposed capital add-on (by the bank) if necessary.
• Stress testing
  – Framework, Assumptions
    • Loan Book, Investment Book
• Evidence of Use Test
3. Supervisors should expect banks to **operate above the minimum regulatory capital ratios** and should have the ability to require banks to hold capital in excess of the minimum.

4. Supervisors should seek to **intervene at an early stage** to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.
1. Consultative Paper on ICAAP
2. Amend Corporate Governance Guidelines
3. Amend Ladder of Supervisory Intervention Framework
4. Issue Draft Guidelines on Consolidated Supervision
PILLAR 3 – MARKET DISCIPLINE
• Pillar 3 is a fundamental component of the Basel II Framework, which seeks to achieve greater transparency through disclosures by banks in order to allow market participants to better assess the organization’s capital and capital adequacy, risk exposures and the risk assessment practices.

• The purpose of market discipline is to complement the minimum capital requirements and the supervisory review process.

• Bank’s disclosures should be consistent with how senior management and the board of directors assess and manage the risks of the bank.
• Promote safety and soundness in banks and financial systems

• Support and enhance bank’s capital assessment and internal assessment (Pillar 1)

• Support and enhance the Supervisory Review Process (Pillar 2)
• Allow market participants to assess a bank’s capital adequacy

• Provide market participants with information about bank’s ability to absorb losses

• Provide market participants with information about a bank’s risk profile and risk appetite (giving insight on the stability of the bank and the sensitivity of its earnings potential to changes in market conditions)
DISCLOSURE REQUIREMENTS

Inclusive of Qualitative and Quantitative Disclosures
Scope of Application

Qualitative
• Name of the top corporate entity
• For accounting and regulatory purposes, outline differences in the basis of consolidation
• All restrictions or major impediments on transfer of funds or regulatory capital

Quantitative
• Aggregate amount surplus capital of insurance subsidiaries
• Aggregate amount of capital deficiencies in all subsidiaries
• Aggregate amount of the firm’s total interests in insurance entities, which are risk weighed
• Amount of Tier 1 capital; separate disclosures of:-
  • Paid-up share capital / common stock
  • Reserves
  • Minority interests in the equity of subsidiaries
  • Innovative instruments
  • Other capital instruments
  • Surplus capital from insurance companies
  • Regulatory calculation differences deducted from Tier 1 capital
  • Other amounts deducted from Tier 1 capital, including goodwill and investments
• Summary of the terms and conditions of main features of capital instruments

• Total amount of Tier 2 capital

• Other deductions from capital

• Total Eligible capital
Capital Adequacy

• Summary discussion of the bank’s approach to assessing capital adequacy to support current and future activities

• Capital requirements for:
  • Credit Risk
  • Market Risk
  • Operational Risk

• Total and Tier 1 Capital Ratio
• Risks to which banks are exposed and the techniques that banks use to identify, measure, monitor and control those risks

• Several key banking risks are considered:-
  • Credit Risk
  • Market Risk
  • Interest Rate Risk and Equity Risk in the Banking Book
  • Operational Risk
1. Disclosure Policy

2. Frequency of Disclosures

3. Related Guidance Notes

4. Compliance Statement

5. Medium of Disclosure

6. Verification and Validation of Disclosures
• External Auditors and the Bank’s licensees participated in two surveys conducted by Central Bank on Market Discipline during 2012 and 2013, respectively.

• The Draft Minimum Disclosure Guidelines will be issued for Consultation in 2014.

• Proprietary and Confidential Information

• Basel III – Composition of capital disclosure requirements
BASEL III: AN OVERVIEW
• A bank’s capital should have the following characteristics:
  – Provide a permanent and unrestricted commitment of funds;
  – Be freely available to absorb losses;
  – Not impose any unavoidable servicing charges against earnings; and
  – Rank behind the claims of depositors and other creditors in the event the bank is wound up.
In line with the Basel Capital Accord, 1988, the Central Bank focuses on the following elements for capital adequacy purposes:

- credit risk associated with a bank’s on and off-balance sheet exposures; and
- form and quality of capital held by the bank to support these exposures.
A bank’s eligible capital base is currently assessed in three tiers: -

- Tier 1: Permanent Capital
- Tier 2: Supplementary Capital
- Tier 3: Trading Book Capital

Total Capital = Tier 1 + Tier 2 + Tier 3
Basel III is a comprehensive set of measures to strengthen the regulation, supervision and risk management of the banking sector.

These measures aim to:
- Improve the banking sector's ability to absorb shocks arising from financial and economic stress – whatever the source
- Improve risk management and governance
- Strengthen banks' transparency and disclosures

The reforms target:
- bank-level, or micro-prudential supervision
- system-wide, or macro-prudential, risks
Basel III does **not** replace Basel I or Basel II – but rather it supplements these two standards.

As with Basel II, Basel III remains a ‘risk-based’ capital regime.

The CBOB seeks to build a framework to fully implement Basel II – bearing in mind the requirements for Basel III.
The New Elements

<table>
<thead>
<tr>
<th>AREAS</th>
<th>MAIN BASEL III COMPONENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Capital reform (including quality and quantity of capital, risk coverage, leverage ratio, capital buffers)</td>
<td>- Capital Definition</td>
</tr>
<tr>
<td>- Liquidity reform (short-term and long-term ratios)</td>
<td>- Capital Conservation Buffer</td>
</tr>
<tr>
<td>- Other elements relating to general improvements to the stability of financial system</td>
<td>- Countercyclical Capital Buffer</td>
</tr>
<tr>
<td></td>
<td>- Leverage Ratio</td>
</tr>
<tr>
<td></td>
<td>- Liquidity Coverage Ratio</td>
</tr>
<tr>
<td></td>
<td>- Minimum Capital Standards</td>
</tr>
</tbody>
</table>
Focus on Common Equity – Core Tier 1 ratio as the key ratio

Harmonized regulatory adjustments (deductions) to be made from CET1

Greater detail of public disclosures
Comparison of Capital Rules
Minimum Capital Adequacy Requirement

Current Capital Requirements

T1 (4%) + T2 (4%) + T3

Total Capital (8%)

Proposed (New) Capital Requirements

CET1 (4.5%) + T1 (6%) + T2 (2%) + Add T1 (1.5%)

Total Capital (8%)
## Measurement of Eligible Capital Base

<table>
<thead>
<tr>
<th>CBOB Current Guidelines</th>
<th>Basel III Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tier 1 (Core Capital)</strong></td>
<td><strong>New Tier 1 (Going – concern Capital)</strong></td>
</tr>
<tr>
<td>i. Permanent Capital</td>
<td>1. Common Tier 1 Equity</td>
</tr>
<tr>
<td>• Ordinary share capital issued and fully paid.</td>
<td>• Common shares meeting the criteria for classification as common shares for regulatory purposes.</td>
</tr>
<tr>
<td>• Perpetual non-cumulative preference shares</td>
<td>• Stock surplus (share premium) resulting from the issue of instruments included in CET1</td>
</tr>
<tr>
<td>ii. Reserves</td>
<td>2. Additional Tier 1</td>
</tr>
<tr>
<td>iii. Current year’s retained profits; and</td>
<td>• Retained earnings</td>
</tr>
</tbody>
</table>

**i. Permanent Capital**
- Ordinary share capital issued and fully paid.
- Perpetual non-cumulative preference shares.

**ii. Reserves**

**iii. Current year’s retained profits; and**
- Retained earnings.
- Instruments that meet the criteria for inclusion in Additional Tier 1 capital (and are not included in CET1).
- Stock surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital.
### Measurement of Eligible Capital Base

<table>
<thead>
<tr>
<th>CBOB Current Guidelines</th>
<th>Basel III Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tier 1 (Core Capital)</strong></td>
<td><strong>New Tier 1 (Going - concern Capital)</strong></td>
</tr>
<tr>
<td>iv. Minority interests</td>
<td>1. Common Equity Tier</td>
</tr>
<tr>
<td><strong>Adjustments:</strong></td>
<td>• Accumulated other comprehensive income and other disclosed reserves.</td>
</tr>
<tr>
<td>• Goodwill and other intangible assets;</td>
<td>• Common shares issued by consolidated subsidiaries and held by third parties (i.e. minority interest) that meet the criteria for inclusion in CET1</td>
</tr>
<tr>
<td>• Current year’s losses; and</td>
<td>• Regulatory adjustments applied in calculation of CET1</td>
</tr>
<tr>
<td>Any holdings of own shares (treasury shares)</td>
<td></td>
</tr>
</tbody>
</table>
### CBOB Current Guidelines

**Tier 2 (Supplementary Capital)**

- Fixed Asset Revaluation Reserves;
- Other Asset Revaluation Reserves;
- General Provisions;
- Hybrid (debt/equity) instruments;
- Subordinated Term Debt;
- Minority interests

**Adjustments:**

- Eligible general provisions limited to 1.25% of RWAs
- Subordinated debt limited to 50% of Tier 1 capital
- Amortization on tier 2 subordinated debt
- Excess Tier 2 limited to 100% of Tier 1 capital

### Basel III Framework

**Tier 2 Capital (Gone-concern Capital)**

- Instruments that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital)
- Stock surplus (share premium) resulting from the issue of instruments included in Tier 2 capital
- Instruments issued by consolidated subsidiaries and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital
- Certain loan loss provisions
- Regulatory adjustments applied in the calculation of Tier 2 capital.
OTHER KEY PARTS OF BASEL III
In addition to the minimum capital requirements for CET1, T1 and Total Capital, two types of buffers are introduced:

- Capital Conservation Buffer; and
- Countercyclical Buffer.
• Designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred.

• This buffer is to be set at 2.5%, comprised of CET1, is to be established above the regulatory minimum capital requirement.

• The buffer will be phased in between 1 January, 2016 and year end 2018 becoming effective on 1 January, 2019 at incremental levels of 0.625% of RWA.
### Minimum Capital Conservation Standards

<table>
<thead>
<tr>
<th>Common Equity Tier 1 Ratio</th>
<th>Minimum Capital Conservation Ratios (expressed as % of earnings*)</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.5% - 5.125%</td>
<td>100%</td>
</tr>
<tr>
<td>&gt;5.125% - 5.75%</td>
<td>80%</td>
</tr>
<tr>
<td>&gt;5.75% - 6.375%</td>
<td>60%</td>
</tr>
<tr>
<td>&gt;6.375% - 7.0%</td>
<td>40%</td>
</tr>
<tr>
<td>&gt;7.0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

* Earnings is defined as distributable profits calculated prior to the deduction of elements subject to restriction on distributions.

Source: p. 56 – Basel III: A global regulatory framework for more resilient banks and banking systems
• To help protect against losses incurred in the banking sector which can be potentially large when a downtown is preceded by a period of excess credit growth, which can destabilize the banking sector and contribute to a downturn in the economy.

• This buffer aims to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate.

• This buffer can range between 0% to 2.5%, at the discretion of national supervisors.
The Leverage Ratio is designed to constrain leverage build up in the banking sector.

- Ratio calculated as a minimum of 3% of Total Tier 1 Capital to Total Exposure/Assets
  - Calculation is based on definition of Tier 1 Capital and total exposures (on- and off-balance sheet)
  - Leverage ratio is being tested from 2013 to 2017 (it is envisaged this ratio will be formalized as a Pillar 1 requirement in 2018 to assess how it will interact over the economic cycle)
The Liquidity Coverage Ratio (LCR) requires banks to maintain sufficient high quality liquid assets to cover net outflows over a 30-day stress situation.
- Stock of high-quality liquid assets / Total net cash outflows over the next 30 calendar days

LCR will be complemented by the Net Stable Fund Ratio (NSFR) which requires banks to fund certain proportion of assets that mature after one year with liabilities that mature after one year
- Available amount of stable funding / Required amount of stable funding

Implementation for LCR and NSFR not envisaged until 2015 and 2018 respectively
### Basel III: The Phase-in Process

<table>
<thead>
<tr>
<th>Year</th>
<th>Phase-in of minimum CET1 ratio</th>
<th>Phase-in of deduction from CET1</th>
<th>Phase-in of minimum Tier 1 capital ratio</th>
<th>Total Capital ratio</th>
<th>Phase-in of capital conservation buffer</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>3.5%</td>
<td>20%</td>
<td>4.5%</td>
<td>8.0%</td>
<td>Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital (phased over a 10-year period beginning 2013)</td>
</tr>
<tr>
<td>2014</td>
<td>4.0%</td>
<td>40%</td>
<td>5.5%</td>
<td>8.0%</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>4.5%</td>
<td>60%</td>
<td>6.0%</td>
<td>8.0%</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td></td>
<td>80%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2018</td>
<td></td>
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</tr>
<tr>
<td>2019</td>
<td></td>
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</tr>
</tbody>
</table>
Expectations for Banks

• Consultative Papers - under Basel III requirements

• Full Quantitative Impact Study (QIS) to test capital impact of proposed rules
  – Transparency
  – Data Quality

• Enhanced ERS Reporting Forms
  – Parallel Run on Pillar I and Basel III areas: Best efforts Basis for 2 consecutive quarters. The parallel run will include 5 quarters of reporting. All banks would have to report at least two quarters of clean data.

• Live Implementation
Further Considerations

- Development of a framework for domestic systemically important banks (i.e. D-SIBs) is under review. This will be a key part of the Basel III rules, to help address systemic risks due to:
  - Inter-linkages; and
  - Common exposures across institutions

- To strengthen the enforceability of our enhanced capital rule for Basel III, the CBOB is considering issuing Capital Regulations, supplemental to its Guidelines.

- The Commercial Banks have already begun the phasing out of capital instruments that no longer qualify as CET1, Additional T1 or Tier 2 capital. A similar phase-in exercise of CET1 will be imposed on the international licensees.
CBOB presently considering implementation of the Capital Conservation Buffer (CCB) and the Countercyclical Capital Buffer (CCCB). While the CCB is required under Basel III, the CCCB may be imposed at national discretion.

The Bank is also considering the application of a Leverage Ratio (formerly our Gearing Ratio which was set at ≥ 5% Capital /Total Assets).

It is contemplated that the Liquidity Coverage Ratio and the Net Stable Fund Ratio will be phased-in at a later stage (i.e. 2015/2016).
QUESTIONS & ANSWERS

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