

**Central Bank of The Bahamas
Consultation Paper
PU52-0310**



**Proposed Amendments to the Guidelines for the
Management of Large Exposures**

**Policy Unit
Bank Supervision Department**

November 22nd, 2010

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1. Background

Credit risk concentrations of one kind or another have consistently been the source of a number of major bank failures over the years and the financial turmoil of recent years has placed this issue at the forefront of the international regulatory agenda. In this regard, in its September 2009 quarterly communication to licensees, the Central Bank (the Bank) foreshadowed a review of its **Guidelines for the Management of Large Exposures** (the Guidelines), which sets out the Bank's minimum standards and requirements that licensees are expected to follow in relation to controls on large exposures and credit risk concentrations.

2. Statement of Purpose

The purpose of the review was to strengthen and clarify the guidance, where necessary, and to ensure that The Bahamas' rules remain consistent with international best practices in this area. The revisions to the Guidelines primarily seek to provide additional guidance on the criteria for granting exemptions for related party exposures to parent and group entities for treasury management purposes. The review has been completed and accordingly, the Bank proposes to issue revised Guidelines. Following is a summary of the substantive revisions that are contemplated. The revised Guidelines are annexed to this Consultation Paper.

3. Key Proposed Revisions to the Large Exposures Guidelines

i. Applicability

The Bank proposes that the Guidelines apply to all licensees, with the exception of branches of foreign banks and restricted trust companies whose operations are limited to conducting business on behalf of one client or clients who are members of the same family. However, the Bank will expect that a branch of a foreign bank will comply at all times with the large exposure policies and limits established by its head office, including any limits established by its home regulator. Branches of foreign banks will also be required to discuss these arrangements with the Bank and if, in the opinion of the Bank, the head office of a branch of a foreign bank does not have a comparable relevant policy, the Bank may require the branch to comply with the large exposure limits set out in Guidelines.

ii. Board of Directors' Responsibilities

The Board of Directors ("the Board") of licensees have ultimate responsibility for establishing and monitoring compliance with policies governing large exposures and risk concentrations of licensees. This section proposes that the Board include a statement in its Annual Corporate Governance Certification confirming that the

Board has reviewed the large exposures policy statement and that it considers it appropriate to the licensee's operating circumstances.

iii. Exempt Exposures

The Bank proposes to include an exemption from the related party limits to allow licensees to facilitate group treasury functions. This proposed exemption would be appropriate for exposures which are short-term in nature and that are placements with the licensee's parent or another member of the licensee's banking group. It is proposed that the placements be surplus to the needs of the firm and that the amount of the placement fluctuates regularly.

Where exempted exposures require support, letters of comfort have been the standard form of support. The Bank recognises that a number of licensees already have exemptions for exposures supported by letters of comfort in place. These exemptions are grandfathered, where this is the case. However, going forward the Bank will reserve the right to request a parental guarantee where cases warrant legal support, due to the particulars of the group being reviewed.

Along with proposed amendments, a standard form has been created for banks to request new exemptions from the large exposure requirements (see **Large Exposures Reporting Form**). This form will capture all of the relevant information, which would assist relationship managers in determining whether an exemption should be granted and would standardize the approval process and achieve consistency in the information requested from firms in support of an application for exemptions. Firms will be also required to submit an application for an exemption at least one month prior to entering into an exposure.

4. Consultation Period

Licensees are invited to submit comments or questions seeking clarification on the proposals contained in this Consultation Paper to the Policy Unit, Bank Supervision Department by **December 3, 2010**.

Comments may be submitted in writing via email, post mail or fax to the following address:-

The Policy Unit
Bank Supervision Department
The Central Bank of The Bahamas
Market Street
P.O. Box N-4868
Nassau, Bahamas
Fax: (242) 356-3909
Email: Policy@centralbankbahamas.com

ANNEX

DRAFT FOR INDUSTRY CONSULTATION



SUPERVISORY AND REGULATORY GUIDELINES: PU52-0310

Large Exposures Guidelines

Issued: 25th March, 2005

Amended: 22nd November, 2010

LARGE EXPOSURES GUIDELINES

I. INTRODUCTION

The Central Bank of The Bahamas (“the Central Bank”) is responsible for the licensing, regulation and supervision of banks and trust companies operating in and from within The Bahamas pursuant to the Banks and Trust Companies Regulation Act, 2000 (Chapter 316), and the Central Bank of The Bahamas Act, 2000 (Chapter 351). Additionally, the Central Bank has the duty, in collaboration with financial institutions, to promote and maintain high standards of conduct and management in the provision of banking and trust services.

All licensees are expected to adhere to the Central Bank’s licensing and prudential requirements and ongoing supervisory programmes, including periodic on-site examinations, and required regulatory reporting. Licensees are also expected to conduct their affairs in conformity with all other Bahamian legal requirements.

II. PURPOSE

Credit risk concentration may arise from excessive exposures to individual counterparties, related counterparties, and a group(s) of connected counterparties with similar characteristics (e.g. counterparties in specific geographical locations, economic or industry sectors). While credit concentration risks are inherent in banking and cannot be eliminated, they can be limited and reduced by adopting robust risk control and diversification strategies. The Central Bank is concerned about credit risk concentration because if these exposures cannot be recovered, the financial condition of the licensee could be adversely affected.

These Guidelines outline the minimum standards and requirements that licensees are expected to follow in relation to controls on large credit exposures, as defined in these Guidelines (see **Section IX**). Additionally, the Central Bank endorses the Basel Committee’s document, “*Measuring and Controlling Large Credit Exposures*” (January 1991).

III. APPLICABILITY

These Guidelines are applicable to all licensees with the exception of branches of foreign banks and restricted trust companies whose operations are limited to conducting business on behalf of one client or clients who are members of the same family. However, the Central Bank expects that a branch of a foreign bank will comply at all times with the large exposure policies and limits established by its head office, including any limits established by its home regulator. Branches of foreign banks should discuss these arrangements with the Central Bank. If in the Central Bank's opinion the head office of a branch of a foreign bank does not have a comparable relevant policy the Central Bank may require the branch to comply with the limits set out in Section VI of these Guidelines.

IV. LARGE EXPOSURE POLICY STATEMENTS

Safeguarding against credit risk concentrations should form an important component of a bank's risk management system. Therefore, licensees are required to adopt and set out in writing their internal policies and internal limits¹, which will ensure the licensee's compliance with the exposure limits set out in these Guidelines (**see Section VI**). For some licensees, the Central Bank may determine it prudent to set lower exposure limits by way of prudential norms. The Central Bank will not apply common maximum percentages for licensees' sectoral or country exposures but will monitor such exposures on an individual and general basis.

Licensees must set out their policies on large exposures in their policy statements and include definitions and limits for differing types of exposures to individual counterparties, groups of connected counterparties, countries and economic sectors. Licensees' policy statements must be approved by its Board of Directors. Additionally, the policy statement should identify the licensee's "related parties" and its policies towards lending to and investing in these parties. Licensees are required to submit their Large Exposures Policy Statements to the Central Bank. Significant changes to the policy statement must be reported to the Central Bank. Licensees are expected to pre-notify and discuss with the Inspector any proposed transaction that will result in an exposure representing a significant departure from a licensee's Large Exposure Policy Statement submitted to the Central Bank.

Elements of a licensee's policy statements on large exposures should cover, but are not limited to, the following:

- (a) A general statement of the Board of Directors' adoption of the Central Bank's Large Exposure Regulations and Guidelines including the definition of an "exposure" contained therein.

¹ It may be appropriate for a licensee to set lower internal limits, which are reasonable in relation to its capital base and balance sheet size.

- (b) The maximum individual exposure considered acceptable to counterparties categorized as follows:
 - (i) Banks (Zone A and other)
 - (ii) Non-bank counterparties (individual and corporate)
 - (iii) Sovereigns and their central banks (Zone A and other) and Multilateral Development Banks (MDBs)
 - (iv) Economic Sectors
 - (v) Country/Geographical limits
- (c) The maximum level of large exposures considered acceptable to the Board of Directors.
- (d) The internal procedures/policies by which counterparty limits are determined and reviewed (including various levels or authority).
- (e) Details of the procedures by which exposures are measured, monitored and controlled (in relation to limits).
- (f) The circumstances under which limits may be exceeded and the process for authorising exceptions to these limits.
- (g) The policy on related party exposures and intra-group lending. The Board of Directors should identify the licensee's related parties and its procedures and limits for exposures to related parties, including the limits for exposures entered into for treasury management purposes, as a part of this exercise.
- (h) Any differentiation in policies between secured and unsecured exposures, together with descriptions of permissible forms of security.
- (i) The allocation of responsibility for large exposures reporting and pre-notification to the Central Bank.

The Central Bank is aware that some licensees operate within policies and limits set by their parent banks. Therefore, a licensee's policy statement should clearly indicate where this is the case and describe the policy of its parent bank.

V. BOARD OF DIRECTORS' RESPONSIBILITIES

The Board of Directors ("the Board") of a licensee is responsible for establishing and monitoring compliance with policies governing large exposures and risk

concentrations of the licensee. In undertaking this responsibility, the Board should, inter alia:

- (a) Approve the licensee's large exposure policy statement;
- (b) Review the policy statement periodically, but at least annually;
- (c) Regularly review compliance with the large exposures policy;
- (d) Review sectoral exposures and limits at least quarterly;
- (e) Approve all exceptions to established internal limits; and
- (f) Include a statement in the Annual Corporate Governance Certificate confirming that the Board has reviewed the large exposure policy statement and that it considers it appropriate to the licensee's operating circumstances.

VI. EXPOSURE LIMITS

Licensees shall comply at all times with the exposure limits established in paragraphs 1-3 below, unless the Central Bank has granted an exemption, as set out in Section VII of these Guidelines. Notwithstanding the established exemptions, the exposures set out in **Section VII (2)** must be preapproved by the Inspector before a licensee may avail itself of an exemption to these limits.

A licensee must notify the Inspector of Banks and Trust Companies (the Inspector) no later than 2 working days after breaching any of these limits and take immediate action to bring the exposure within the established limits as soon as practicable, but no later than 10 working days after breaching the limits. The notification must include the nature of the breach, the reason for the breach and a plan of action for correcting the breach. Depending on the circumstances, the Central Bank may direct a licensee to take measures to reduce its level of risk concentration or increase its capital.

1. Single Exposure Limit

A licensee may not incur exposures, on an aggregate basis, to an individual counterparty or group of connected counterparties, which exceeds 25 percent of its capital base.

In addition, a licensee may not hold non-capital investments in securities of a single issuer, which exceed 10 percent of the licensee's capital base.

2. Related Party Limit

A licensee may not incur exposures to its related parties which, in aggregate, exceed 15 percent of its capital base. All exposures to related parties must be:

- (a) negotiated on an arm's length basis for the clear commercial advantage of the licensee at market rates and without concessive terms; and

(b) specifically approved by the licensee's Board of Directors.

The Central Bank will closely monitor all exposures to related parties and may deduct them from the capital base of the licensee if they are, in the opinion of the Central Bank, of the nature of a capital investment or made on concessive terms.

3. Aggregate Limit on Large Exposures

A licensee may not incur large exposures, which in aggregate, exceeds 800 percent of its capital base.

VII. EXEMPT EXPOSURES

The following exposures are exempt from limits outlined above in Section VI:

1. Exempt exposures where no prior approval of the Inspector is required

- (a) Exposures to the Government of The Bahamas and non-commercial Bahamian governmental institutions or secured by securities/guarantees of the Government of The Bahamas;
- (b) Exposures to Zone A central banks;
- (c) Exposures to Zone A central governments rated high grade or higher by two of the major credit rating agencies²for foreign currency debt;
- (d) Exposures secured by securities/guarantees from Zone A central governments rated high grade or higher by two of the major credit rating agencies for foreign currency debt;
- (e) Short-term interbank deposits of not more than six (6) months maturity, booked with Zone A banks which are located in Zone A countries; and
- (f) Exposures which are fully collateralized throughout their tenure by cash deposits (including certificates of deposit and equivalent instruments issued by the lending bank) held by the lender with the specific right of offset, where the release of the deposit is conditional on the repayment of the related extension(s) of credit.

2. Exempt exposures where the prior approval of the Inspector is required

Licenses seeking the prior approval of the Inspector for an exemption from the limits set out at **Section VI** above must apply via the Large Exposures Reporting Form (in rear of these Guidelines), at least one month prior to entering into the exposure. In assessing possible exemptions, the Central Bank will have regard to,

²For the purposes of these Guidelines, the reference credit rating agencies and ratings are Fitch (AA- and higher), Moody's Investors Service (Aa3 and higher) and Standard & Poor's (AA- and higher).

inter alia, whether the exposure(s) would significantly increase the risk to depositors of the licensee, periodic reviews of the financial soundness of the licensee and its parent and/or group and whether the exposure(s) is/are consistent with the licensee's large exposures policy statement. Licensees should refer to the *Minimum Standards for Letters of Comfort and Parental Guarantees* for the minimum applicable requirements, where such support is required to be submitted with respect to any of the following.

- (a) Exposures to Zone B central governments and central banks which are denominated in the country's local currency and funded by liabilities in the same currency rated high grade or higher by two of the major credit rating agencies for foreign currency debt;
- (b) Exposures which are collateralized by marketable securities throughout their tenure having a market value equal to at least one hundred percent of the extension of credit or such higher percentage as the Inspector shall require;
- (c) Exposures that are supported by a parental guarantee acceptable to the Inspector. [Exemptions for which the prior-approval of the Inspector have already been obtained, which are covered by letters of comfort, are not required to be supported by a parental guarantee];
- (d) Underwriting exposures, which do not exceed 90 days duration. Any residual holdings of securities, which are held for more than 90 days, are not treated as exempt and are subject to the exposure limits outlined in **Section VI** above;
- (e) Off-balance sheet exposures (such as derivative contracts) to banks, which are acceptable to the Inspector; and
- (f) Exposures to related parties where the licensee or the related counterparty is fulfilling a treasury role on behalf of the group or managing liquidity across the group, provided the exposures meet the following conditions:
 - i. The banking group is subject to adequate consolidated supervision by the home supervisor in accordance with Basel Core Principles for Effective Banking Supervision;
 - ii. The licensee must satisfy the Central Bank that the appropriate management and other group control systems are in place to ensure that risk-taking among related counterparties is properly monitored and controlled;
 - iii. The exposures have an original maturity of one year or less and are placements with the licensee's parent or to another member of the banking group. The placement should be surplus to the needs of the licensee and the amount of the surplus should fluctuate regularly;

- iv. A ‘No Objection’ letter should be secured from the home supervisor and a copy attached to the application. The letter should include confirmation that the group is subject to consolidated supervision; and
- v. The licensee is required to provide an estimated level of activity of these exposures in the application and pre-notify the Central Bank if the level of activity is expected to increase.

VIII. REPORTING REQUIREMENTS

Licensees must report to the Inspector all large exposures, whether exempt or not, on a quarterly basis via the Quarterly Reporting System (QRS).

The Measure of “Exposure”

For large exposures reporting purposes, the measure of exposure should reflect the maximum loss that will arise should a counterparty fail. The measure of “exposure” should include the amount at risk arising from:

- (a) A licensee’s claims on a counterparty including actual claims and potential claims that would arise from the drawing down in full of undrawn advised facilities (whether revocable, irrevocable, conditional or unconditional), which the licensee has committed itself to provide and claims which the licensee has committed itself to purchase or underwrite. In the case of undrawn advised overdraft facilities, the advised limit must be reported after deduction of any provisions. In the case of loans, the net outstanding balance as shown in the books of the licensee should be reported after deduction of any provisions.
- (b) A licensee’s contingent liabilities arising in the normal course of business and liabilities that would arise from the drawing down of undrawn advised facilities. In the case of undrawn trade finance or similar facilities, the advised limit should be reported.
- (c) A licensee’s holdings of equity capital, bonds, bills or other financial instruments. In the case of financial instruments, the current fair value (as shown in the books of the licensee) should be reported.
- (d) Any other assets that constitute a claim on a counterparty by the licensee and which are not included in (a), (b) or (c), above.

As a rule, exposures should be reported on a gross basis (i.e. no offsets). However, debit balances on accounts for a counterparty may be offset against credit balances on other accounts with the licensee if:

- (a) a legally enforceable right of set off exists in all cases (as confirmed by a legal opinion addressed to the licensee);
- (b) the debit and credit balances relate to the same counterparty or group of connected counterparties;
- (c) the licensee intends to settle on a net basis or to realize the debit balances and settle the credit balances simultaneously. For a group facility a full cross guarantee structure must also exist before debit balances on accounts may be offset.

Calculations of Large Exposures

Large exposures are calculated using the sum of nominal amounts before the application of any risk weightings for on-balance sheet items and credit conversion factors and risk weightings for off-balance sheet items. For derivative contracts only, the amount at risk is taken to be the credit equivalent amount (as defined in the Guidance Notes for the Completion of the BSD Quarterly Reporting Forms).

A licensee's exposure arising from its securities trading operations is calculated as its "net long position" in a particular security. A licensee's "net long position" in a security refers to its commitment(s) to buy the security plus its current holdings of the security less any commitments to sell the same security. A short position in one security issue may not be offset against a long position in another issue made by the same party.

Identity of Counterparty

For the purposes of measuring exposures, a counterparty is generally the borrower (customer), the person guaranteed, the issuer of a security in the case of an investment in a security, or the party with whom the contract is made in the case of a derivative contract. Where a third party has guaranteed an exposure (the guarantee must be explicit, unconditional, irrevocable and direct) and subject to the licensee's large exposures policy statement not stating otherwise, the guaranteed licensee may elect to report the exposure as being to the guarantor rather than the counterparty.

IX. DEFINITIONS

"Large exposure" means any exposure that is equal to or exceeds 10 percent of the licensee's capital base.

"Capital base" means the eligible capital base of a licensee used for calculating its risk-weighted capital adequacy ratio, as defined by the *Guidelines for the Management of Capital and the Calculation of the Calculation of Capital Adequacy*.

“Risk concentration” means any exposure with the potential to produce losses that are substantial enough to threaten a licensee’s capital strength or earnings or otherwise undermine public confidence in the licensee.

A **“group of connected parties”** exists where two or more individual counterparties constitute a single risk and includes:

- (a) any party that, either directly or indirectly, controls (**see definition below**) the counterparty;
- (b) any party that is controlled, either directly or indirectly, by any party that controls, either directly or indirectly, the counterparty;
- (c) a subsidiary or associate company of the counterparty;
- (d) directors, executive officers, senior staff, and controlling shareholders of the counterparty; or
- (e) directors, executive officers, senior staff, and controlling shareholders of any person identified in (a), (b) and/or (c), above.

A **“related party”** is a counterparty that is linked to the licensee and includes:

- (a) a person that controls, whether directly or indirectly, a licensee;
- (b) a person that is controlled, whether directly or indirectly, by the person that controls the licensee;
- (c) the subsidiaries or associate companies of a licensee;
- (d) the directors, executive officers, senior staff of—
 - (i) a licensee;
 - (ii) any person identified in paragraphs (a), (b), or (c) above;
- (e) any person who, either alone or together with any associate, is entitled to exercise control over ten percent or more of the share capital of –
 - (i) a licensee;
 - (ii) any person identified in at (a), (b) or (c) above;
- (f) the immediate family members of persons identified in paragraphs (a), (d) or (e) above;
- (g) partnerships, companies, trusts or other entities in which an immediate family member referred to in paragraph (f) above, has a controlling interest; and
- (h) any person that manages or is managed by the licensee under a management contract.

“Control” (in the above context) means the ability of a legal or natural person to ensure the affairs of a legal entity are conducted in accordance with the wishes of that person by means of either:

- (a) the holding of shares, voting rights, or the position of voting power; or
- (b) by virtue of any agreement or any other powers conferred by the articles of association or any other document.

“Zone A” consists of The Bahamas and all countries that are full members of the Organization for Economic Co-operations and Development (OECD), together with those countries that have concluded lending arrangements with the International Monetary Fund associated with the General Agreement to Borrow, excluding those countries that have rescheduled their external debts during the preceding five years, as well as those countries whose rating for long-term liabilities in foreign currencies is lower than “investment grade” or that have no rating and whose yield to maturity and remaining duration are not comparable with those of long-term liabilities with an “investment grade” rating.

“Zone B” consists of those countries which are not included in Zone A.

“Fully collateralized” means secured by marketable securities acceptable to the Inspector and cash deposits, including certificates of deposit and equivalent instruments, held with the specific right of offset by and under the exclusive administration of the licensee, where repayment of the deposit is conditional on the repayment of the related extension(s) of credit. Such collateral must have a market value equal to at least one hundred percent of the extension of credit. The licensee would have to show it has the ability and that it will regularly mark these securities to market during the loan and take immediate action if this valuation shows a shortfall of collateral.

The End



Large Exposures Reporting Form

Name of Licensee: _____

Date Completed: _____

Large Exposure Details

Name of Counterparty: _____

Group Name: _____

Related? (Y/N) _____

Amount of Exposure: _____

Currency: _____

US\$ Equivalent (in 000s): _____

Start Date: _____

Maturity: _____

Interest Rate (where applicable): _____

Purpose of the Exposure: _____

Security/Support and Amount: _____

Other Exposures to the Same Borrower: _____

If necessary
Securitization
Liquidity
Investment
Other

Type of Exemption Being Sought:
Place an "X" in the appropriate box.

Section VII(2) of the Guidelines for the Management of Large Exposures

- a) Exposures to Zone B central governments and central banks
- b) Exposures fully collateralized by marketable securities throughout their tenure
- c) Exposures supported by a parental guarantee
- d) Underwriting exposure which do not exceed 90 days duration
- e) Off-balance sheet exposures to banks
- f) Exposures to related parties where the licensee or a counterparty is fulfilling a treasury role or managing liquidity

Activity Level (US\$000s): _____

Details of Security

Type: _____

Notional Amount: _____

Market Value: _____

Maturity: _____

Type: _____

Notional Amount: _____

Market Value: _____

Maturity: _____

Additional Information:

Signature _____

Signature _____

Name _____

Name _____

Date _____

Date _____