CENTRAL BANK OF TRINIDAD & TOBAGO

Policy Paper

Proposed Amendments to the draft Financial Institutions (Capital Adequacy) Regulations

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I. Introduction

The draft Financial Institutions (Capital Adequacy) Regulations ("Regulations") which was issued by the Central Bank on August 3, 2018 was developed to give legal effect to the revised capital rules set out in the Central Bank's Basel II/III-Phase 1 policy proposal document. The draft Regulations treat primarily with Pillar 1 of the Basel II framework and covers, among other things,

i. the calculation of the minimum capital adequacy ratio;
ii. definitions of capital elements including common equity Tier 1 capital;
iii. the methodology for the calculation of risk weighted assets for credit, market and operational risk; and
iv. techniques to mitigate credit risk capital charges.

Two Basel III elements i.e. the increase in the tier 1 ratio and the minimum common equity ratio are also included in the Regulations to enhance the quality and quantity of capital held by licensees and financial holding companies.

Simultaneous with efforts to have the draft Regulations promulgated, the Central Bank has commenced Phase II of its Basel II/III project implementation plan which includes proposals for the implementation of Pillars 2 and 3 of Basel II together with the Basel III Leverage Ratio, Capital Conservation Buffer and Liquidity Coverage Ratio. As with Phase 1, the Phase 2 elements also need to be included in regulations to have legal effect.

The Central Bank is currently working with the Office of the Chief Parliamentary Counsel in the Ministry of the Attorney General and Legal Affairs to finalize the draft Regulations and therefore intends to include provisions to give effect to the Phase 2 rules. However, the proposed inclusions to treat with Pillars 2 and 3 and the additional elements of Basel III will only have legal effect after a notice has been placed in the Gazette by the Minister of Finance. This Notice will be placed only after consultation with the banking sector is concluded.

Notably, the country is currently subject to a Financial Assessment Sector Program (FSAP) review by the International Monetary Fund (IMF). As part of this review, the IMF has evaluated our bank capital rules under both Basel I and Basel II/III and has made recommendations with the aim of ensuring local bank capital standards are sufficiently prudent and robust. As a result of this assessment and to comply with international rules the Central Bank is also proposing additional amendments to the Regulations to treat with the IMF recommendations. These amendments will be effective once the Regulations are enacted.

II. Purpose

This policy paper outlines proposed amendments to the draft Financial Institutions (Capital Adequacy) Regulations in light of the implementation of Phase 2 of Basel II/III and to take account of the recommendations of the IMF. In particular, Part III outlines amendments to treat with the Phase 2 policy proposals. Part IV sets out amendments to existing provisions of the draft Regulations on account of the recommendations of the IMF.

III. Required Amendments to the draft Regulations for Phase 2-Basel II/III Implementation

a) Pillar 2 of the Basel II Framework

As detailed in the Central Bank's Phase 2 policy proposal document which was issued on November 7, 2019, Pillar 2 imposes a requirement for institutions to comprehensively assess their risks, risk management strategies and capital needs. Specifically, institutions are required to implement an Internal Capital Adequacy Assessment Process (ICAAP) which is supported by effective board and senior management oversight, stress testing and sound monitoring, reporting and internal control review. Pillar 2 takes into account the individual risk profiles of financial institutions, provides incentives for robust risk management to be put in place and encourages capital provisioning that considers all key risks (including the sufficiency of capital coverage for Pillar 1 risks[1]) and exceeds the minimum requirements established under Pillar 1.

Pillar 2 also provides for a supervisory review and evaluation process (SREP) whereby an institution's ICAAP is reviewed by the Central Bank. Importantly, the SREP facilitates the Bank's assessment of the internal capital target set by an institution relative to its risk profile and the strength of its risk management systems and controls.

Both the ICAAP and SREP are to be proportionate to the institutions' nature, size, complexity and scale of operations.

The Phase 2 proposal document provided detailed guidance on the Central Bank's expectations of the ICAAP. The ICAAP guideline, which would assist institutions in developing their internal processes, will be issued to the industry post-consultation.

[1] Credit risk, market risk and operational risk

The Phase 2 policy document also advised of the Central Bank's intention to include a provision in the Regulations to explicitly require the implementation and documentation of the ICAAP. The provision also allows for the application of a target capital requirement based on the ICAAP and SREP.

Accordingly, the following provision is being proposed for inclusion in the Regulations:

Regulation 6

6.(1) Every financial organization shall have in place an internal capital adequacy assessment process as set out in a guideline issued by the Central Bank that is proportional to their nature, scale, complexity and business strategy.

(2) Every financial organization shall- (a) document the internal capital adequacy assessment process which shall be approved by the board of directors and updated at least annually or at such other frequency as may be required by the Inspector to take account of changes in the business, strategy, nature, scale or complexity of activities or operational environment; and (b) submit the documented internal capital adequacy assessment process to the Central Bank in such time and with such frequency as the Central Bank may specify in a guideline.

(3) After review of the financial organization's internal capital adequacy assessment process, the Inspector may impose a target capital adequacy ratio on the financial organization that is higher than the minimum capital ratios set out in regulation 5.

(4) Notwithstanding regulation 6(3) based on its ongoing risk assessment of the financial organization the Inspector may impose a target capital adequacy ratio on a financial organization that is higher than the capital ratios set out in regulation 5.

b) Pillar 3 of the Basel II Framework

Pillar 3 is the final complementary pillar of the Basel II framework and requires market disclosure of information by financial institutions as a means of promoting market discipline. Pillar 3 requires both qualitative and quantitative disclosures including information on an institution's capital, risk, risk management and risk mitigation strategies. As outlined in the Phase 2 policy proposal document, the Pillar 3 disclosure requirement is intended "*to improve transparency, reduce information asymmetry and enhance market discipline by providing incentives for financial institutions to implement sound risk management frameworks*".

To establish expectations with respect to market disclosure by financial institutions, the Central Bank will issue a draft Pillar 3 Guideline in January 2020. Given developments by the Basel Committee for Banking Supervision (BCBS) after the financial crisis of 2007-2009, the Pillar 3 Guideline will include disclosure requirements under the updated Pillar 3 frameworks[2]. These include enhanced disclosure requirements for credit risk, operational risk, leverage and new disclosure requirements on asset encumbrance. Among other things, the draft Pillar 3 guideline will outline the requirement for a disclosure policy to be established by the institution, set out the areas to be disclosed and the level of detail required and establish the frequency of the respective disclosures.

To provide for the Pillar 3 disclosure requirement to have legal effect the following is proposed for inclusion in the Regulations:

Regulation 7

Financial organizations shall disclose such information pertaining to their capital, risk exposures, risk assessment processes, credit risk mitigation and capital adequacy in such time, form, manner and frequency as the Central Bank may specify in a guideline.

c) Capital Conservation Buffer

The capital conservation buffer (CCB) was introduced by the BCBS post financial crisis as a mechanism to enhance the high loss absorbency capacity of the banking sector and prevent institutions from making large distributions from capital notwithstanding their adverse financial condition. In this regard, under the CCB regime, institutions would be required to hold additional a minimum of 2.5% of common equity tier 1 capital in excess of the regulatory minimum capital requirements. Where an institution is unable to meet the minimum CCB, constraints are imposed on the discretionary distribution of earnings.

The CCB will help to ensure that financial institutions build-up and retain capital buffers outside of periods of stress which can be drawn down in exceptional circumstances if severe losses are incurred.

The following provision together with Schedule 5 (Appendix A) is proposed for inclusion in the Regulations to give effect to the CCB:

[2] Issued in both 2015 and 2018

Regulation 18

18. (1) A financial organization shall be required to maintain a minimum capital conservation buffer of two point five per cent common equity Tier 1 capital above the minimum common equity Tier 1 capital ratio of four point five per cent contained in Schedule 1.

(2) Where a financial organization fails to comply with the requirement in subregulation (1), it shall be subject to such constraints on the distribution of capital as contained in Schedule 5.

d) Leverage Ratio

The BCBS introduced the leverage ratio as a non-risk based "back-stop" to complement the risk based minimum capital requirements and help safeguard against unsustainable levels of leverage in the banking sector. In particular the BCBS noted that during the crisis, notwithstanding maintaining healthy risk based capital ratios, many financial institutions were adversely impacted by excessive on and off balance sheet leverage.

As a result the Basel III leverage ratio was introduced and is to be calculated as follows:

$$\frac{\text{Tier 1 Capital}}{\text{Exposure Measure}} \geq \textit{Leverage ratio}\ (3\%)$$

The Central Bank has introduced the leverage ratio as a complement to the minimum risk based capital requirements in its Phase 2 Basel II/ III Policy document and therefore the following provision is proposed for inclusion in the Regulations:

Regulation 19

19. (1) A financial organization shall be required to maintain a minimum leverage ratio of three per cent calculated as the ratio of Tier 1 capital to adjusted on-balance sheet and off-balance sheet assets.

(2) For the purposes of subregulation (1), a financial organization shall determine its adjusted on-balance sheet and off-balance sheet assets in the manner specified by the Central Bank in a guideline.

The Central Bank has provided guidance on the components of the leverage ratio and post consultation a guideline on the leverage ratio will be issued to the industry.

e) Domestic Systemically Important Banks (D-SIBS)

In the Phase 1 policy proposal document issued in 2014, the Central Bank proposed the introduction of a capital surcharge for domestic systemically important banks (D-SIBS). The proposal emanated from the BCBS who, subsequent to the global financial crisis, sought to treat with the "negative externalities" created by systemically important institutions.

As a consequence, the Central Bank signalled its intention to implement a higher minimum capital adequacy ratio of 12% for D-SIBS. In addition, the Bank's Basel II/III reporting framework was designed to accommodate the charge.

The Central Bank plans to include the requirement for the D-SIB charge in the draft Regulations. Simultaneously, the Bank is finalizing the criteria for the categorizing and oversight of systemically important financial institutions and will be issuing guidance in 2020 for consultation with the sector.

Specifically, the D-SIB charge will align with the recommendations of the BCBS which require the add-on to be met with common equity Tier 1 capital given its high loss absorbing capacity. Further, the charge for a D-SIB may range from 0% to 2.5% common equity tier 1 capital based on the evaluation of the financial institution against criteria including size, importance, complexity, cross-border activity and interconnectedness.

In accordance with international requirements, the D-SIB charge is to apply only at the level of the licensee and will therefore not apply at the holding company level.

Accordingly, the following is proposed for inclusion in the Regulations:

Regulation 20

20. (1) A licensee that is deemed to be systemically important in accordance with such criteria specified by Notice published in the Gazette by the Central Bank shall be required to maintain an additional capital charge.

(2) The additional capital charge referred to in sub regulation (1) shall range between zero per cent to two point five per cent common equity Tier 1 capital as determined by the Inspector.

IV. Additional Amendments

As discussed above, the IMF is currently conducting its FSAP review of Trinidad and Tobago which includes an assessment of the regulatory framework (both existing and prospective) for the banking sector. Accordingly, the revised capital rules set out in the Regulations were reviewed and recommendations were put forward by the IMF to ensure that the capital framework for banks is sufficiently robust.

The following paragraphs propose additional amendments to the Regulations to treat with key recommendations of the IMF.

a) Asset Revaluation Reserves

In line with capital rules set out in the Financial Institutions (Prudential Criteria) Regulations, 1994 institutions are allowed to recognize asset revaluation reserves in Tier 2 capital up to the limit of 20% of core (tier 1) capital. This treatment accords with the Basel I framework and was maintained under Basel II, but is not in keeping with Basel III.

As a consequence, asset revaluation reserves must be excluded from Tier 2 capital as a means of enhancing the quality of capital held by the banking sector.

It is therefore proposed that regulations 11 (f) and 13 (e) of the draft Regulations be deleted.

b) Residential Real Estate

Clause 12 of Schedule 2 in the Regulations addresses the treatment of residential mortgage loans. Specifically, clause 12 (3) allows for the application of a 50% risk weight to the entire portfolio of residential mortgage loans where loan to value ratios are not maintained for all facilities in the portfolio. However, it has been recommended that this treatment be removed and facilities for which there is no loan to value information be risk weighted at 100%. Consequently, **it is proposed that clause 12 (3) be deleted and clause 12 (2) be amended to include a part (c) as follows**:

Clause 12 (2) –Schedule 2

(2) Where a residential mortgage loan secured by the residential property satisfies subclauses (1)(a) and (1)(b) but-

(a) the loan to value ratio exceeds eighty per cent but is less than ninety per cent, a seventy-five per cent risk weight shall be applied; (b) the loan to value ratio exceeds ninety per cent, a one hundred per cent risk weight will be applied; and

c) the financial organization has no loan-to-value information for the residential mortgage loan, a hundred per cent risk weight shall be applied.

c) Public Sector Entities

Clause 6 (2) of the Regulations provides for the application of a blanket 20% risk weight to exposures to local public sector entities (PSEs) which are denominated and funded in Trinidad and Tobago. This treatment was applied when the country was assigned a sovereign rating of "A" by Standards & Poor's (S&P). However, as was indicated in the Phase 1 Policy document (footnote 10), the preferential risk weight applied to sovereign and PSE exposures will be kept under constant review (and are subject to change). Given the downgrading of Trinidad and Tobago by both S&P and Moody's, this preferential treatment for a local PSE is not considered prudent. In this regard, **it is proposed that Clause 6 (2) of Schedule 2 of the Regulations be deleted**.

Appendix A

Capital Conservation Buffer

Capital Constraints under the Capital Conservation Buffer (Regulation 18)

1.

"earnings" means the distributable profits calculated prior to the deduction of the elements that are subject to the restriction on distributions of capital contained in this Schedule.

"scrip dividend" means a dividend offered in the form of additional shares in a company instead of an automatic offer of a cash dividend".

Minimum capital conservation standards

2. (1) A financial organization shall maintain the following minimum capital conservation standards:

Minimum capital conservation standards	
Column 1	**Column 2**
Buffer Ranges (Common Equity Tier 1 Ratio of 4.5%+ Capital Conservation Buffer)	**Capital Constraints (Expressed as a percentage of earnings)**
4.5% - 5.125%	100%
>5.125% - 5.75%	80%
>5.75% - 6.375%	60%
>6.375% - 7%	40%

(2) Where a financial organization falls within the buffer ranges in column 1 of the table in subclause 1, it shall withhold the distribution of capital in accordance with the corresponding capital constraints in column 2.

Restrictions on distributions

3.

(1) Elements that shall be subject to the restriction on the distribution of capital shall include –

(a) dividends and share buy-backs;

(b) discretionary payments on other Tier 1 capital instruments; and

(c) discretionary bonus payments to staff of the financial organization.

(2) Distributions of capital shall not include payments that do not result in a depletion of common equity Tier 1 capital including scrip dividends.

(3) Distribution restrictions shall not apply to dividends which meet the following criteria:

(a) the dividends cannot be legally cancelled by the financial organization;

(b) the dividends have already been removed from common equity Tier 1; and

(c) at the time the financial organization declared dividends the financial organization had complied with the capital conservation standards specified by the Central Bank.

Calculation of earnings

4. (1) Earnings shall be calculated after the tax which would have been reported if none of the distributable elements referred to in clause 3 had been paid.

(2) A financial organization shall be restricted from making positive net distributions as described in clause 3(1) where-

(a) the financial organization does not have positive earnings and has a common equity Tier 1 ratio of less than seven per cent; or

(b) the financial organization's common equity Tier 1 ratio is higher than seven per cent because its capital conservation buffer has been expanded by other buffers specified by the Central Bank.

Individual and consolidated application

5. The capital conservation buffer and restrictions referred to in this Schedule shall apply to a financial organization on an individual and consolidated basis.

Imposition of Time Limits

6. Where a financial organization falls within the common equity Tier 1 capital buffer ranges in clause 2 and the Inspector is of the opinion that it is unreasonable for the financial organization to operate within this buffer range he may require the financial organization to increase its

common equity Tier 1 capital to meet the minimum requirements in Regulation 18 within such timeframe as he may specify.