Revised Capital Standards for Institutions Licensed under the Financial Institutions Act, 2008

CENTRAL BANK OF TRINIDAD & TOBAGO

November 2014

Agenda

A. Purpose

B. Basel II and Basel III Overview

i. Rationale for the adoption of Basel II standards

ii. Applicability

iii. Overview of Basel II

iv. Overview of Basel III

v. Basel III Implementation Considerations for Trinidad and Tobago

C. Basel II/III Implementation Plan

Purpose of the Presentation

- Sensitize the industry to the requirements under Basel II and Basel III
- Provide the rationale for aligning our local capital regime with the Basel II framework
- Outline the aspects of Basel II that will be applied to the local banking sector
- Provide a roadmap for implementation of Basel II
- Highlight the approach of the Central Bank with respect to Basel III implementation

Basel II Framework- *Rationale for Basel II Implementation*

- Need to modify local capital standards given the implementation of a revised Financial Institutions Act in 2008.

- Compliance with international standards (including Basel Core Principles, Basel II framework).

- The need to expand the local capital adequacy regime to address other key risks such as operational and credit concentration risks.

- To treat with recommendations from the International Monetary Fund (IMF).

- Regional initiatives to Implement Basel II.

Basel II Framework-*Applicability*

- Basel II capital standards will apply (on an individual and consolidated basis) to all institutions licensed under the Financial Institutions Act, 2008

- The simpler versus advanced approaches will apply although parent companies of some local financial institutions may be subject to advanced approaches by their home regulator

- The Central Bank is considering additional capital requirements for Domestic Systemically Important Financial Institutions (D-SIFIs)

Overview of Basel II Framework

Provides for more risk sensitive capital requirements and expands the capital regime by including capital charges for operational risk (in addition to credit and market risk)

Offers simple and complex methodologies for the calculation of capital requirements and allows for national regulators to select the approaches deemed most suitable for them (areas of national discretion)

Encourages banks to establish a strong and comprehensive risk management framework commensurate with the complexity and diversification of their business

Promotes detailed disclosure to enhance transparency and market discipline

Overview of Basel II Framework

Basel II
Three Pillars

- **Pillar 1:** Minimum Capital Requirements
  - Credit Risk
  - Market Risk
  - Operational Risk
- **Pillar 2:** Supervisory Review
  - Supervisor reviews the bank's documented assessment of its risks. Supervisor also reviews capital ratio set by the bank.
- **Pillar 3:** Market Discipline
  - Increased Disclosure

Pillar 1-
Minimum Capital Adequacy Requirement

Credit Risk -

Standardized Approach

Overview of Basel II Framework-Credit Risk

Basel II
Three Pillars

Pillar 1:
Minimum Capital Requirements

Pillar 2:
Supervisory Review

Pillar 3:
Market Discipline

Credit Risk
Market Risk
Operational Risk

Supervisor reviews the bank's documented assessment of its own risks. Supervisor also reviews capital ratio set by the bank.

Increased Disclosure

Overview of Basel II Framework-Credit Risk

- Basel II offers four methodologies for the assessment of credit risk:
  - *Simple Standardized Approach (SSA)*
  - *Standardized Approach (SA)*
  - *Foundation: Internal Ratings Based (IRB) Approach*
  - *Advanced :Internal Ratings Based (IRB) Approach*

- **The Central Bank intends to implement the Standardized Approach in Trinidad and Tobago.**

Overview of Basel II Framework-Credit Risk

- Among other things, the **Standardized Approach** for credit risk introduces:
  - *Risk weights that are more aligned with the risk of an exposure.*
  - *A wider spectrum of risk buckets and risk weights.*
  - *The use of assessments of external credit rating agencies.*
  - *Greater recognition of credit risk mitigation techniques (e.g. collateral)*
  - *A comprehensive framework for the treatment of securitization exposures*

Overview of Basel II Framework-Credit -Risk

Use of External Credit Ratings to Determine Risk Weights

		AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	Below B-	Unrated
Sovereign		0%	20%	50%	100%	100%	150%	100%
Bank	**Option 1**	20%	50%	100%	100%	100%	150%	100%
	Option 2 LT	20%	50%	50%	100%	100%	150%	50%
	ST	20%	20%	20%	50%	50%	150%	20%
Corporate		20%	50%	100%	100%	150%	150%	100%

LT: Long Term ST: Short Term

Overview of Basel II Framework-Credit Risk

Credit Risk Mitigation

Basel I	Basel II
Limited recognition of **Collateral** and G**uarantees** (only OECD central Governments and specified multilateral development banks)	**Collateral** More extensive list of eligible collateral instruments Different methods for calculation for example the simple and comprehensive approaches are applied for the treatment of collateral
Substitution with risk weight of the collateral issuer or guarantor	**Guarantees** More extensive list of eligible guarantors
	Introduction of **On-Balance Sheet Netting and Credit Derivatives**

Overview of Basel II Framework-Credit Risk

Securitization Framework

- Under Basel II banks are required to hold capital against all securitization exposures including those arising from the provision of credit risk mitigants

- Higher risk weights are assigned to securitized assets and deductions from capital are required for unrated securitization exposures

- Enhanced operational requirements for the use of credit rating agencies for securitization exposures

Example of Risk Weights for Long Term Securitization

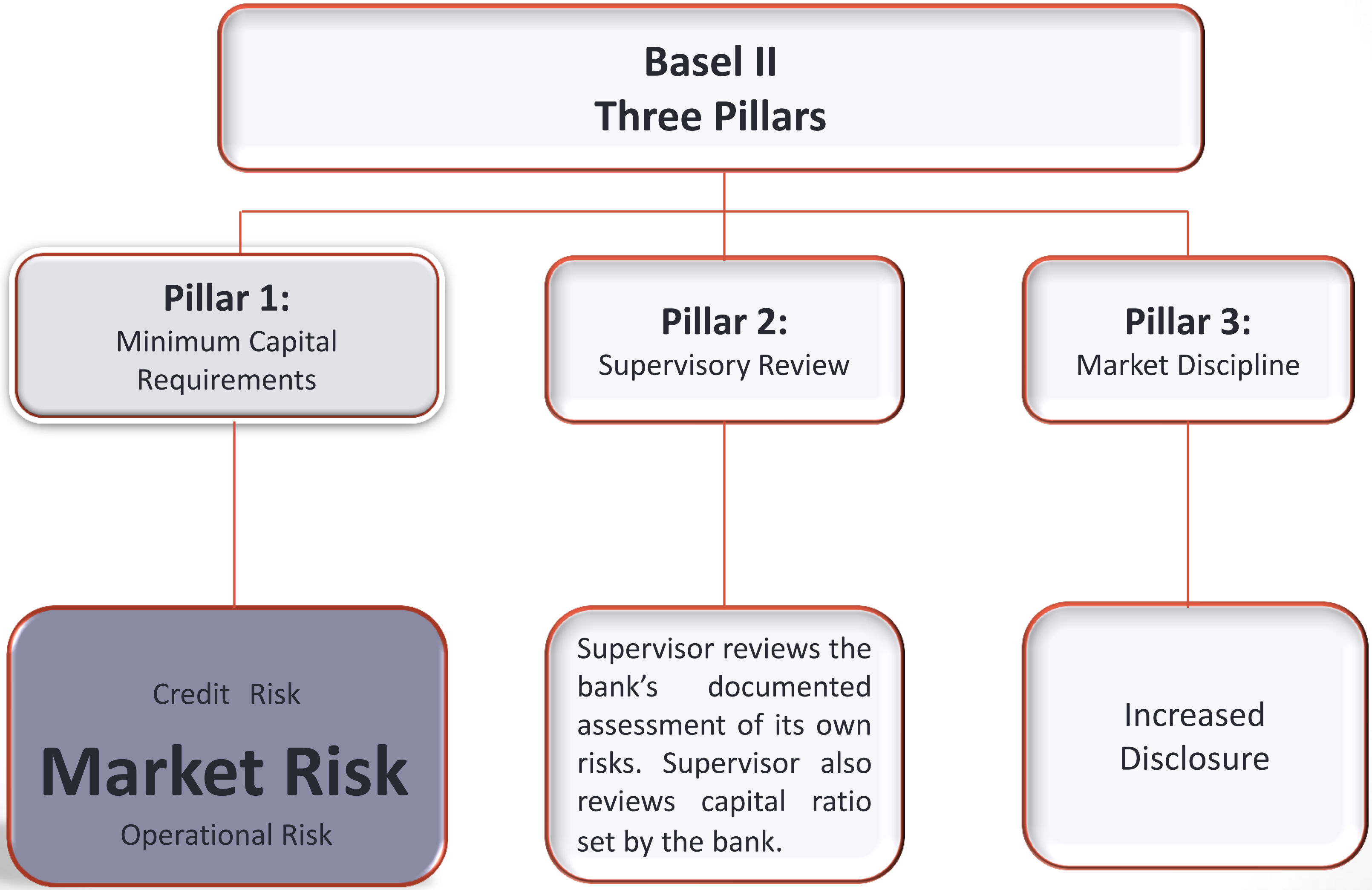
AAA to AA-	A+ to A-	BBBB+ to BBB-	BB+ to BB-	B+ and below or unrated
20%	50%	100%	350%	Deduction

Pillar 1- Minimum Capital Adequacy Requirement

Market Risk-

1996 Market Risk Amendment

Overview of Basel II Framework-Market Risk



Overview of Basel II Framework-Market Risk

- As with the 1996 market risk amendment, Basel II provides two approaches for the calculation of the market risk capital charge:
  - The Standardized Measurement Approach
  - The Internal Models Approach

- The Capital charge for market risk is the sum of charges for interest rate risk, foreign exchange risk, equities risk and commodities risk

Overview of Basel II Framework-Market Risk

- The Central Bank incorporated market risk into the capital framework by fully implementing the 1996 market risk amendment to the Basel I accord

- The Market risk amendment was implemented via the "Market Risk Instruction Manual" issued by the Central Bank in 2008

- Given its recent introduction and in light of the relatively conservative local market, **the current market risk methodology is to be maintained**

Pillar 1- Minimum Capital Adequacy Requirement

Operational Risk-

The Standardized Approach(TSA)

Overview of Basel II Framework-Operational Risk

Basel II
Three Pillars

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Overview of Basel II Framework-Operational Risk

There are four (4) methods for calculating capital charges for operational risk:

Approach	**Options for Trinidad and Tobago**
Basic Indicator Approach (BIA)	**X**
Standardized Approach (TSA)	√
Alternative Standardized Approach (ASA)	**X**
Advanced Measurement Approach (AMA)	**X**

Overview of Basel II Framework-Operational Risk

The Standardized Approach (TSA)

- Under this approach, the institution’s activities are divided into eight (8) business lines

- The capital charges for each business line is calculated by multiplying gross income by a factor assigned to that business line:

	Business Line	Factor (%)
1	Corporate Finance	18%
2	Trading & Sales	
3	Payment & Settlement	
4	Commercial Banking	15%
5	Agency Services	
6	Retail Banking	12%
7	Asset Management	
8	Retail Brokerage	

Overview of Basel II Framework-Operational Risk

The Standardized Approach (TSA)

- 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

- Any year for which the aggregate capital charge across all business lines is negative should be excluded from the overall calculation of the capital charge for operational risk

Overview of Basel II Framework-Operational Risk

The Standardized Approach (TSA)

Capital Charges under the TSA are calculated as follows:

$$K_{TSA} = \{\Sigma \text{ years}_{1\text{-}3} \max [\Sigma(GI_{1\text{-}8} \times \beta_{1\text{-}8}), 0]\}/3$$

where:

K_{TSA} *= the capital charge under the Standardized Approach*

$GI_{1\text{-}8}$ *= annual gross income in a given year, for each of the eight business lines*

$\beta_{1\text{-}8}$ *= a fixed percentage related to each of the eight business lines*

Overview of Basel II Framework-Operational Risk

The Standardized Approach (TSA)

- Institutions will also be required to demonstrate on an ongoing basis that:
  - *There is effective Board and Senior Management oversight of the operational risk management framework*
  - *An operational risk management system is implemented that is conceptually sound and implemented with integrity*
  - *There are sufficient resources to adequately implement the framework across its major business lines as well as the audit and control areas*

Pillar 1- Minimum Capital Adequacy Requirement

Minimum Capital Adequacy Ratio (CAR)

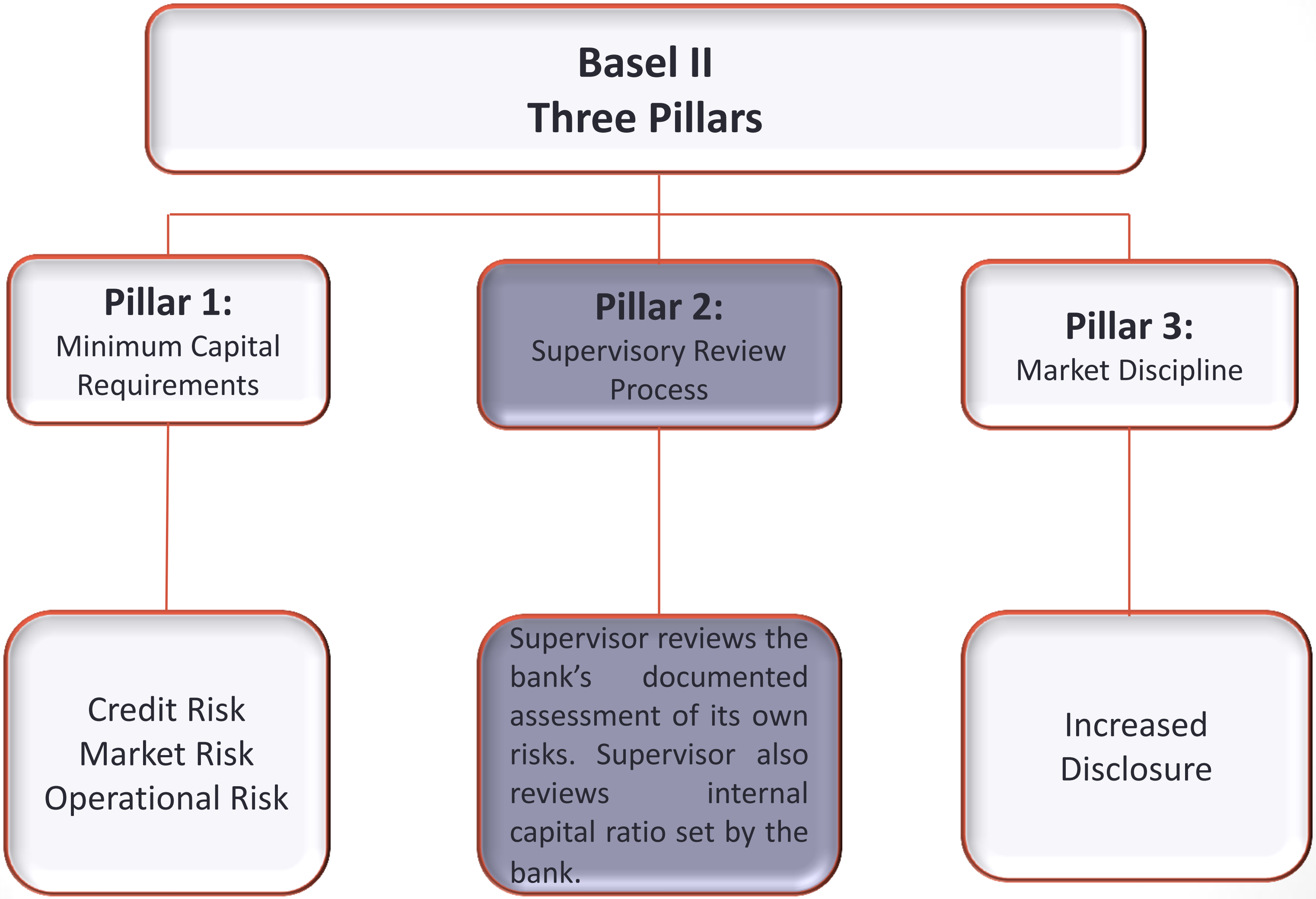
Overview of Basel II Framework-Minimum CAR

Proposed Minimum Capital Requirement

Credit Risk + Market Risk + Operational Risk = 10%

Pillar 2
Supervisory Review Process (SRP)

Overview of Basel II Framework- SRP



Overview of Basel II Framework- SRP

Key Principles of the SRP

Principle 1: 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.

Principle 2: Supervisors should review and evaluate banks' 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.

Overview of Basel II Framework- SRP

Principle 3: Supervisors should expect banks to operate above the minimum capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 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.

Overview of Basel II Framework- SRP

- Encourages banks to enhance risk management techniques with an emphasis on bank's internal capital adequacy assessment.
- Ensures banks have sufficient capital to support all risks including risks for which there is no capital charge under Pillar 1 such as:
  - *interest rate risk in banking book*
  - *concentration risk*
  - *residual risks (e.g. legal, reputational, business strategy).*
- Accommodates differences between banks.
- Aligns capital requirements to the risk profile of individual banks.
- Promotes effective risk based supervisory practices.

Overview of Basel II Framework- SRP

- A critical component of Pillar 2 is the **Internal Capital Adequacy Assessment Programme (ICAAP)** that must be established by banks.

- Pillar II requires supervisory review of this internal capital assessment as well as a review of the robustness of risk management processes, systems and controls.

Overview of Basel II Framework- SRP

Key Features of the ICAAP

- Identification/assessment of each bank's risk appetite and risk profile.
- Identification and quantification of material risks.
- Evaluation of capital and capital planning.
- Scenario and stress testing.
- Internal Audit Review.

Overview of Basel II Framework- SRP

Features of the Review to be done by the Supervisor

- Evaluate the credibility of the internal review process:
  - *How was the ICAAP derived and compiled?*
  - *What were the assumptions and methodologies employed?*
  - *Are the assumptions reasonable?*
  - *Does analysis consider both present and future conditions?*
  - *Is the risk assessment comprehensive?*

- Assess the risk management to ensure it is appropriate to the risk profile and business plan of the institution.

- Determine the extent to which the results are sensitive to adverse circumstances.

Overview of Basel II Framework- SRP

- Determine the extent to which the Board and Senior Management are engaged in the process.

- Interrogate differences between the capital requirement determined by the institution and the regulatory capital requirement.

Pillar 3-
Market Discipline

Overview of Basel II Framework- Market Discipline

Basel II
Three Pillars

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Increased Disclosure

Overview of Basel II Framework- Market Discipline

- Pillar 3 seeks to achieve greater transparency through qualitative and quantitative disclosure by banks.

- The market discipline component complements the minimum capital requirements and the supervisory review process.

- Banks' disclosures should be consistent with how the Board and senior management assess and manage the risks of the institution.

- Pillar 3 disclosures should not conflict with International Accounting Standards.

Overview of Basel II Framework- Market Discipline

- **Examples of Qualitative Capital Disclosure**
  - *Summary of the approach of the institution to assessing the adequacy of its capital to support current and future activities.*
  - *Definitions of past due and impaired.*
  - *Discussion of risk management policies.*

- **Examples of Quantitative Capital Disclosure**
  - *Total amount of Tier 1 and Tier 2 capital.*
  - *Deductions from capital.*
  - *Total eligible capital.*
  - *Total and Tier 1 capital ratio.*
  - *Total gross risk exposure (in respect of different risk categories).*
  - *Amount of impaired loans.*

BASEL III OVERVIEW

Basel III Framework

- The Basel III framework was introduced to improve the banking sector's ability to absorb shocks arising from financial and economic stress.

- To achieve this, the Basel III reforms seek to strengthen the capital framework and also introduces quantitative standards for liquidity .

- Basel III targets:
  - *Bank-level/micro-prudential supervision*
  - *System-wide/ macro-prudential risks.*

- Basel III does not replace Basel II, but rather should be considered as supplemental to the Basel II standards.

Basel III Framework- *Key Components*

Enhanced Capital Framework

- *Redefining of Capital (Tier One and Two and associated deductions).*
- *Increase of the Tier 1 Ratio.*
- *Minimum Common Equity Tier One Ratio.*
- *Leverage Ratio.*
- *Capital Conservation Buffer.*
- *Enhanced Pillar 1 and Pillar 2 standards.*

Basel III Framework- *Key Components*

Global Liquidity Standard

- *Liquidity Coverage Ratio*
- *Net Stable Funding Ratio*

Other Standards to Improve Financial Stability

- *Counter Cyclical Capital Buffer*

Basel III Framework–*Considerations for Trinidad and Tobago*

- In the FSAP report in 2011, the IMF recommended that Trinidad and Tobago "*consider taking steps to adopt Basel III*".

- However, given that banks are very well capitalized the Central Bank is to introduce the **Minimum Common Equity Tier 1 Ratio on a phased basis by December 2016** :

Year of Implementation	Common Equity Ratio
On passage of revised Regulations	3.5%
Within one year of the passage of the Regulations	4%
Within two years of the passage of the Regulations	4.5%

Basel III Framework– *Considerations for Trinidad and Tobago*

- In addition, the Central Bank proposes to **increase the minimum tier 1 ratio to 7%** to provide a more robust measure for solvency.

- The **revised definitions for capital** under the Basel III framework are also being considered.

- However, this is an area for which there may be harmonization across the region and timetables for implementation will therefore be considered in cognizance of the regional approach adopted.

- **The Central Bank will consult with the industry prior to the implementation of any aspects of Basel III.**

Basel II/ III Implementation Plan

Basel II/III Implementation Plan

- The Central Bank will adopt a phased approach to the implementation of Basel II/III with immediate focus on:-
  - Pillar 1- The Minimum Capital Requirement.
  - Minimum Common Equity Ratio.
  - Increase in the Tier 1 ratio.

- This first phase is scheduled for completion by **December 2015.**

- A consultation paper on immediate proposals for revisions to the capital framework will be released which will provide more granular information on the options proposed for adoption in Trinidad and Tobago.

Basel II/III Implementation Plan

November 2014	Industry Briefing Publishing of Roadmap Issue of Consultation Paper (Elements to be implemented by December 2015)
February 2015	Convening of Industry Technical Working Group
April 2015	Orientation and Awareness Session (in preparation for the Quantitative Impact Study)
April – May 2015	Quantitative Impact Study 1
July-August 2015	Quantitative Impact Study 2

Basel II/III Implementation Plan

October 2015	Initiate Period of Parallel Reporting
December 2015	Enactment of Revised Prudential Criteria Regulations (Implementation of Pillar 1)
December 2016	Implementation of Pillar 2-Supervisory Review Process
January 2017	Assessment of Industry Readiness for other Basel III elements
December 2017	Implementation of Pillar 3-Market Discipline

Thank you
for your attention

Any Questions