# BASEL II & the Caribbean Bank: One Year to Prepare for Massive Mandatory Change

Melinda Haseth & Felix van Rooy

"Ostriches may have the luxury of sticking their heads in the sand" notes the author, "unfortunately for banks in the Caribbean this is not an option when it comes to adopting the provisions of Basel II". By the end of 2011, banks across the Caribbean must put in place the new requirements of the Basel II Accords. For the average bank it is estimated that this will require more than a year of intensive overhaul and scrutiny of current operational and financial procedures. "Non-compliance is not an option, and time is running out," the author says.

Basel II is the follow up to Basel I (BI). The BI framework was set up in the 80's and 90's, however many countries failed to adopt its "one-size-fits-all" recommendations. Furthermore, as the financial market developed, the legislation lagged behind and did not fit actual economic conditions.

The Basel II Accords (BII) will become mandatory worldwide as they are enacted into each countries' legislation by the end of 2011 (see figure 1). The consequences for Central, private and commercial banks will be a fundamental restructuring of risk assessment and financial and operational procedures.

**What is Basel II For?** Basel II is a rigorous regulatory framework, requiring that banks have a sound internal ratings classification system subject to stringent supervisory standards and internal controls from each country's Central Bank. The objective of the framework and controls is to foresee and mitigate any exposure from probability of default, loss given default, and exposure at default. The main objectives of Basel II are to:

1. Develop a more meaningful link between banks on- and off-balance sheet risk exposures and the capital supporting them.
2. Strengthen the links between sound regulatory capital and risk-based supervision as a way to create incentives for strong risk management practices at banks.
3. Try to enhance market discipline through better information about banks' risk profiles, risk measurement techniques and capital.

**Figure 1 Worldwide Timelines for Adoption of Basel II**

| Basel II Timetable | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|
| Canada | | | | | | | |
| EU & UK | | | | | | | |
| Hong Kong | | | | | | | |
| Australia | | | | | | | |
| USA | | | | | | | |
| Japan | | | | | | | |
| China | | | | | | | |
| Bahamas | | | | | | | |
| Jamaica** | | | | | | | |
| Netherlands Antillies*** | | | | | | | |
| United Arab Emirates | | | | | | | |
| Barbados* | | | | | | | |
| Malaysia | | | | | | | |

**Legend:** * Pillar I 2009; ** Pillar I by 2010; *** Parallel run by 2010

**The Bank of International Settlement (BIS) has formulated Basel II to reduce risk in the financial system.**

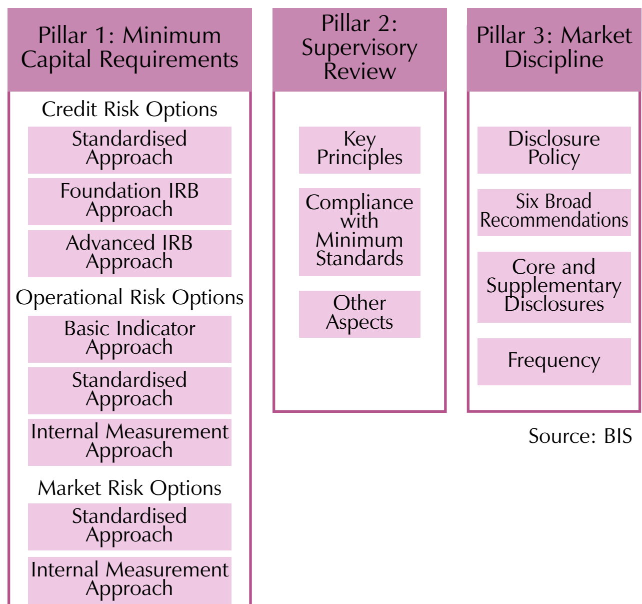
- The BIS was established in 1930. Headquartered in Basel, Switzerland, it is the world's oldest international financial organisation.
- The BIS is the bank for Central Banks. It fulfils this mandate by acting as:
  - A forum to promote discussion and policy analysis among Central Banks and within the international financial community
  - A centre for economic and monetary research
  - A prime counterparty for Central Banks in their financial transactions
  - An agent or trustee in connection with international financial operations

In addition Basel II has in place a variety of safeguards, which also have the benefit of reinforcing the Central Bank's authority to strengthen risk management and market discipline.

The Three Pillars of Basel II: Basel II is structured on three pillars (see Figure 2):

1. Pillar 1 - Minimum Capital Requirements: Pillar I of the new capital framework revises the 1988 Accord's guidelines by aligning the minimum capital requirements more closely to each bank's actual risk of economic loss.
2. Pillar 2 – Supervisory Review: Pillar 2 of the new capital framework recognises the necessity of exercising effective supervisory review of banks' internal assessments of their overall risks to ensure that the bank's management is exercising sound judgment and has set aside adequate capital for these risks.

**Figure 2: Basel II Pillars**




Source: BIS

3. Pillar 3 – Market Discipline: Pillar 3 leverages the ability of market discipline to motivate prudent management by enhancing the degree of transparency in banks' public reporting. It sets out the public disclosures that banks must make that lend greater insight into the adequacy of their capitalisation. (Source: BIS)

## Banks must Choose & Implement Complex Risk Controls

Market Discipline: The market discipline pillar of Basel II is designed to allow banks to share their risk ratings with the outside world. This will have consequences for all capital. Rating agencies will use this data to adjust their ratings, which will likely give them more power. Banks will also have improved data to rate other banks, thus being able to move more towards credit risk pricing.

Internal Rating-Based Approach: The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: credit risk, operational risk and market risk. The credit risk component can be calculated in three different ways of varying degree of sophistication. Your

## A New Approach to Risk

**In the new legislation there are more exposure classes for the bank to take into account:**

1. Claims or contingent claims on central Governments or Central Banks
2. Claims or contingent claims on regional Governments or local authorities
3. Claims or contingent claims on administrative bodies and non-commercial undertakings
4. Claims or contingent claims on multilateral development banks
5. Claims or contingent claims on international organisations
6. Claims or contingent claims on institutions
7. Claims or contingent claims on corporates
8. Retail claims or contingent retail claims
9. Claims or contingent claims secured on real estate property
10. Past due items
11. Items belonging to regulatory high-risk categories
12. Claims in the form of covered bonds
13. Securitization positions
14. Short-term claims on institutions and corporates
15. Claims in the form of collective investment undertakings ('CIU')
16. Other items

bank will have to choose one of three Approaches: Standardised, Foundation IRB, or Advanced IRB (IRB stands for Internal Rating-Based Approach). Currently the Liquidity Risk is under investigation and it is most likely that by the end of this year the new legislation will come into force regarding this category.

**Standardised vs. IRB Risk Reporting:** The Standardised Approach is the relatively easy way of calculating risk. It is based on the rules and conditions set by the regulator and is actually the most transparent method because all banks calculate their risk weight in the same manner. Ratings by an acknowledged External Credit Assessment Institution (ECAI), such as Standard and Poor's are allowed. The IRB approaches are actually based on models developed internally by the bank. This means that your bank will in fact be rating your customers and based on these ratings you will calculate the Risk Exposure. A bank is explicitly approved to use the IRB Approach by the bank's supervisor (e.g. Central Bank). For the IRB Approach there are stringent rules, for instance, at least five years of essential data to calculate PD, LGD is necessary. It is most likely that banks will opt for the Standardised Approach to start off with, then move to the IRB Approach at a later stage, thus building up their data, their models, and their expertise, while also adjusting their organisation, procedures, etc.

**What Will Your Bank Have to Do?** Banks will have to continuously improve the quality of their internal loss data. Basel II requires that banks have at least five years of data, including data collected during a downturn. This will include the need to estimate their recovery rates assuming a downturn in the credit cycle, and will reflect up front in capital that losses on liquidated collateral will be greater during stressful periods. In order to use Basel II advanced approaches, banks will have to demonstrate robust data management and firm-wide aggregation capabilities. These will take time to choose, implement and learn. Typically this will require investment in news systems and procedures. For instance banks will have to perform stress tests on their on- and off-balance sheet exposures. Based on these stress tests, banks will have to demonstrate to supervisors that they have adequate capital cushions to manage a down cycle. And finally, banks will have to provide much better transparency to the market about the range of exposures they hold, including securitisations and conduits. In Europe, which is the furthest along with looking at this issue, banks that have not sought outside expert assistance or proper training have become mired in four-year long projects involving 80-plus project members and highly expensive investments in new systems. This should not happen to you.

**Basel II & Central Banks – Barbados Leads the Way:** Central Banks in the region and worldwide will also face a difficult two years as they master the many intricacies of understanding and supervising the complex new risk measurements. Extensive training is being undertaken to ensure even a minimum level of preparedness. Dr. Marion Williams, Governor of the Central Bank of Barbados, is driving the most aggressive timetable in the Caribbean for compliance with Basel II. In her remarks in June 2008 to the Caribbean Group of Banking Supervisors Annual Conference she said that this "has placed considerable pressure on the Bank Supervision Department."

In order to be able to issue sensible guidelines that are applicable to banking in Barbados, the Central Bank of Barbados has taken a "multi-pronged approach" focused on the following:

- Seeking to enhance compliance with the Revised Basel Core Principle
- Enhancing Barbados' own internal processes and moving to a model of risk-based supervision
- Dialoguing with the various stakeholders including hosting a detailed technical seminar on Basel II
- Strengthening the Central Bank's internal data warehousing and data management systems
- Preparing the various reporting forms and instructions
- Assessing in-house skills and trying to develop human resources
- Conducting internal gap analysis and external impact assessments.

**For the Caribbean - Opportunity from Crisis:** The recent worldwide banking crisis and failures of blue-chip banks on Wall Street clearly demonstrate that no institution is immune to the dangers of risk in its internal systems or financial environment. However, as the Chinese symbol for crisis illustrates, turbulent times also offer opportunity.

**Figure 3: Opportunity from Crisis**

**Lower Capital Requirements in the Caribbean:** The new Risk Weight classifications may actually lower capital requirements for Caribbean banks (depending on the portfolio). The reduction of the capital requirements for residential mortgages (from 50% to 35%) is a good example of this opportunity. Given the fact that residential mortgages are a substantial part of the exposures of financial institutions in the Caribbean, one can say that the added Capital Requirements (Operational Risk) will in most cases be neutralised by the introduction of lowered risk weights.

**Proactive Risk Management = Greater Profitability:** With improved risk measurement in place, Caribbean banks will be able to shift from a passive to a more active risk management practice. Having an active risk management practice in place will enable financial institutions to manage capital allocation, budgeting and portfolio

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structuring. Using these parameters as risk drivers will allow financial institutions to deploy capital more effectively to increase profitability.

**Increased Competitiveness:** The new Capital Accord permits the use of internal and/or external ratings. To use internal ratings the new Accord dictates the availability of IRB models. However, to use external ratings, assessments from credit agencies are allowed. Using these ratings provides a greater differentiation in customer, asset and/or country risks. The higher differentiation will enable a more accurate risk rating which may be translated into a lower Risk Weight Assets. The OECD Country Risk rating vs. the current Accord's Zone A and B ratings is a clear example in this matter. Another benefit for applying external ratings is the option to use risk based pricing. Risk based pricing will allow financial institutions to interact better with the market as they will be able to provide products which have a direct correlation with the specific risk. Although this works both ways, we can say that the introduction of ratings will increase the competitiveness of financial institutions that opt to implement the Basel II Accord. Note, that rated customers will also prefer to look for credit where their rating will be considered as this will provide better pricing.

**Take the First Steps Now:** It will take most banks at least a year to be ready for Basel II. Implementing Basel II will affect the whole organisation, not just the reporting department. Management, Risk Management, the Commercial departments, Treasury, Accounting, IT will have to be trained and made aware what Basel II stands for and how it will influence their daily activities. Measures to be taken will include:

- Intensive training of upper management and staff
- Analysis of data quality available in the bank; revision of reporting standards
- Improved systems for measuring and aggregating performance and risk data
- Gap analysis of banking systems to evaluate whether replacement will be necessary
- Close, pro-active consultation and collaboration with the Central Bank

In Europe the consequences of not being compliant have been severe and have included fines by the Supervisor, strict supervision, and ultimately the suspension of a non-compliant bank's banking license. In the Eastern Caribbean, the ECCB has not yet issued a mandatory timetable for adoption and compliance, therefore there is still commercial opportunity and time to take a proactive and well-planned approach. This will avoid a costly, and rushed falling in line with regulations at the last minute. What is most likely is that the most commercially visionary banks – those that wish to operate at first world standards of excellence - will begin the process of Basel II compliance ahead of Central Bank regulation.

***Melinda Haseth*** *is Vice President, Marketing & Business Development, IBIS Management. + 5999 737 2065; Melinda.haseth@ibis-management.com; www.ibis-management.com* • ***Felix van Rooy*** *is Partner First Element. + 31 655 128 119; fvrooy@first-element.nl; www.first-element.nl*