

Credit Risk and Basel II Implementation in the Caribbean

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Presentation Outline

- Background
- Links between Banking Crisis and Credit Risk
- Risk Sensitive Capital
- Basel Core Principles
- Basel Capital Accord - Implementation of Basel II in the Caribbean Region
- Policy Priorities

Importance of Sound Supervision and Regulation

““If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere... If a country opts for lax accounting and reporting standards, capital will flow elsewhere.” - **Arthur Levitt (Former Chairperson: US SEC)**



Traditional Economic

Theory of Regulation Suggests...

1. Constrain the use of monopoly power and prevent distortion to competition
 2. Protect essential needs of ordinary people
 3. Reduce burden of market failure
- *Reference: “The Fundamental Principles of Financial Regulation” (2009) - International Centre for Monetary and Banking Studies.*

Poor Asset Quality Driving Banking Crises in the ECCU: Forcing Changes in Regulation

- Stanford International Bank Ltd
- ABI Bank Ltd (2009)
- Bank of Antigua Ltd

Antigua and
Barbuda

Anguilla

- Caribbean Commercial Bank (Anguilla) (2013)
- National Bank of Anguilla (NBA) (2013)

- St. Vincent Building and Loan Association (Near-bank, 2013)

St. Vincent and
the Grenadines

Poor Asset Quality Driving Banking Crises/Near Crises in other CARTAC Member Countries:

- Blaze Trust (1995)
- Century National Bank (1997)
- Eagle Commercial Bank (1997)
- Workers Savings and Loan Bank (1997)
- Island Victoria Bank (1997)
- Jamaica Citizens Bank (1997)

Jamaica

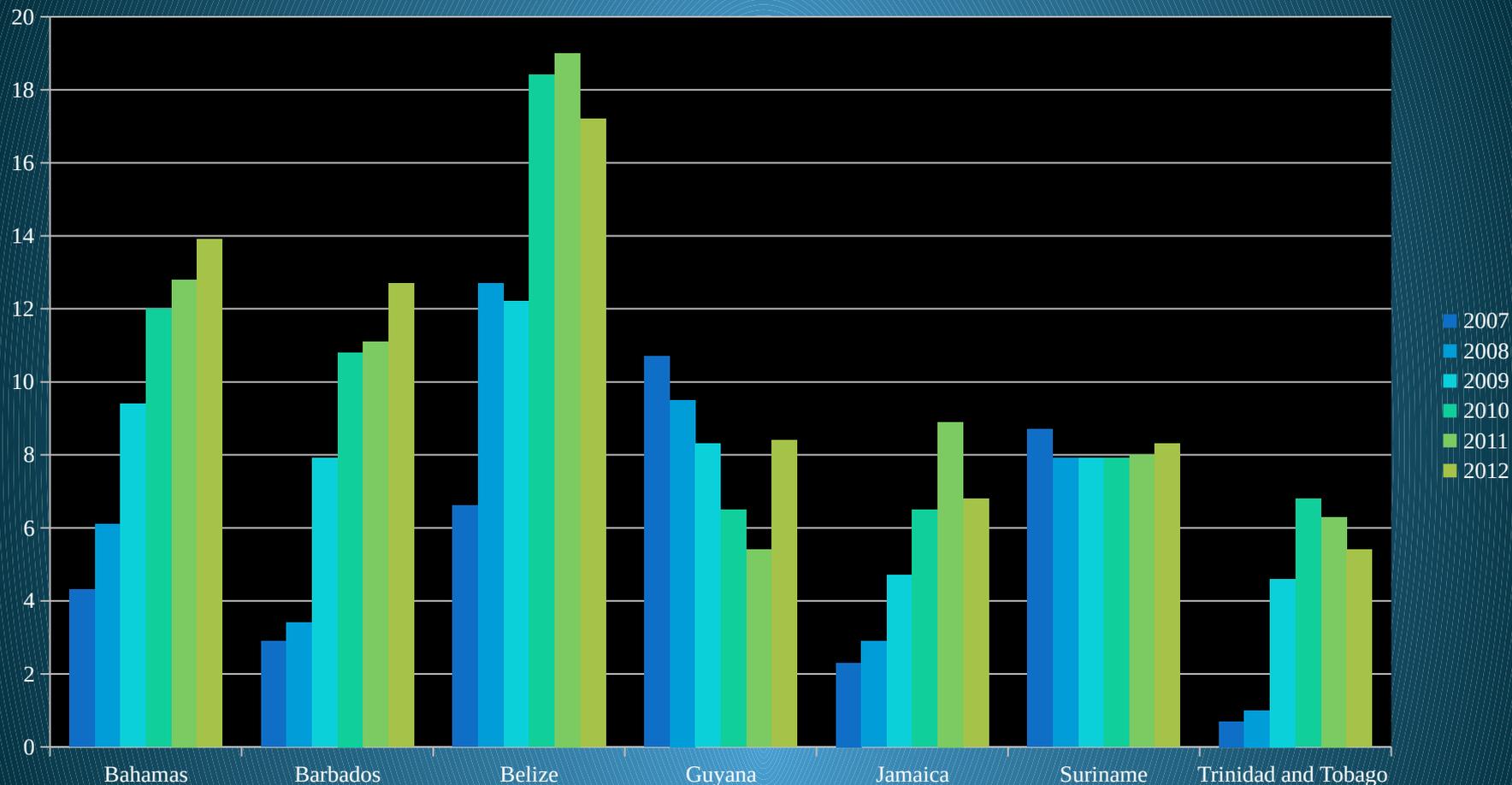
Trinidad and Tobago

- CLICO (2009)
- Hindu Credit Union Coop (HCU) (2009)

- Butterfield Bank ,Bermuda (2009)
- TCI Bank (2009)
- British Atlantic Financial Services (2009)

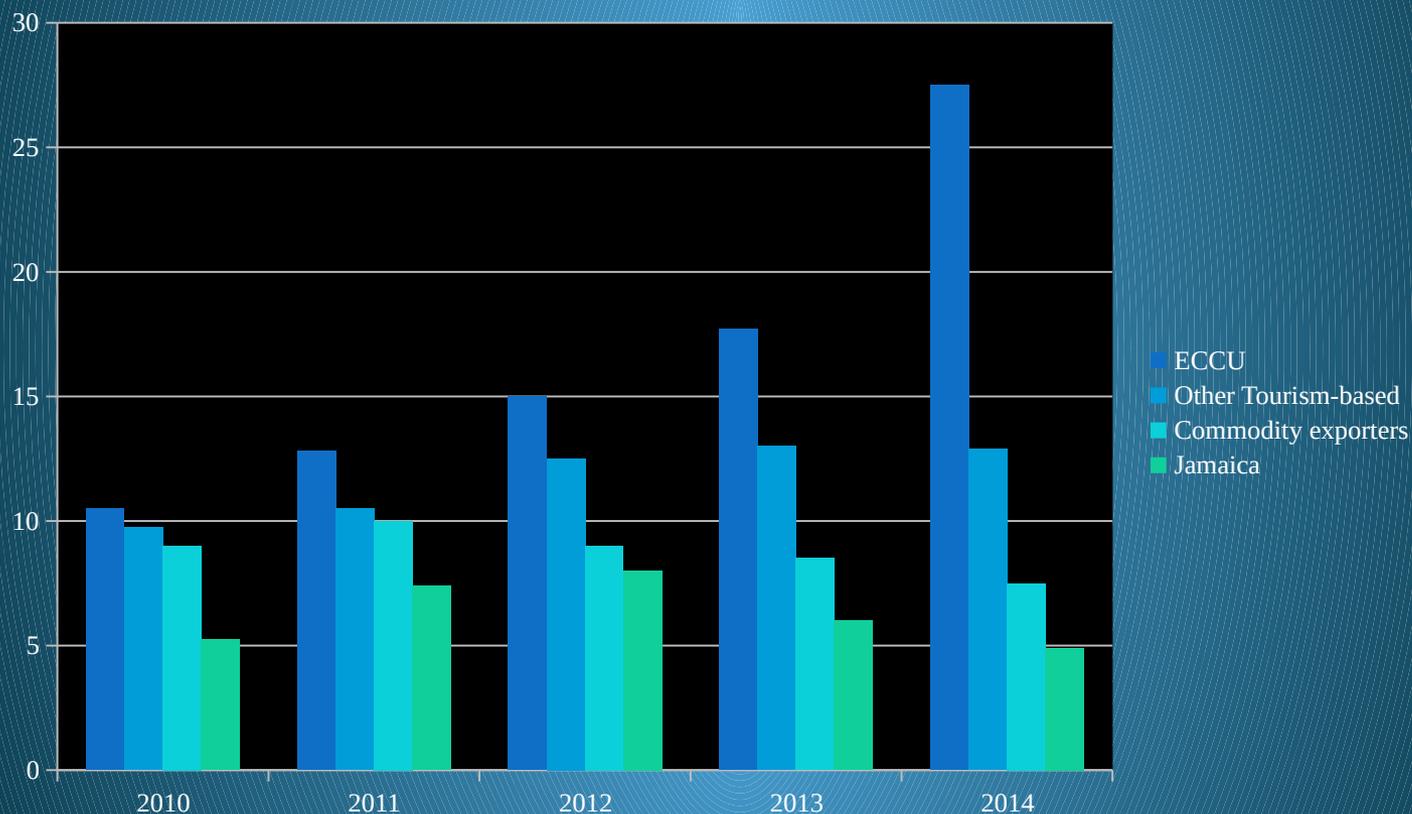
Bermuda / Turks and Caicos

Nonperforming Loans in Select Countries in the Region



Sources: Country Authorities and IMF

Nonperforming Loans in Countries in the Region

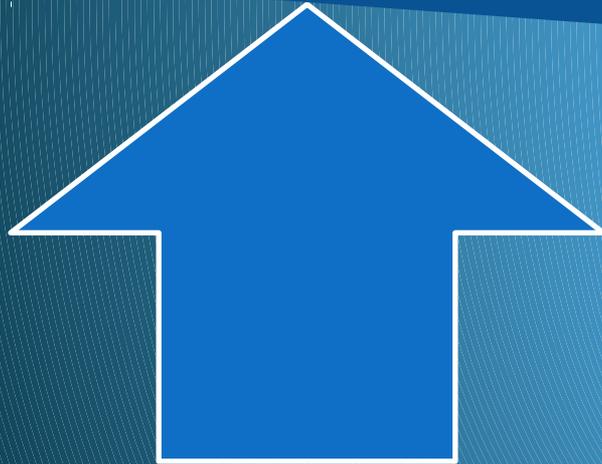


Sources: Country Authorities and IMF

The Risk / Capital

Challenge

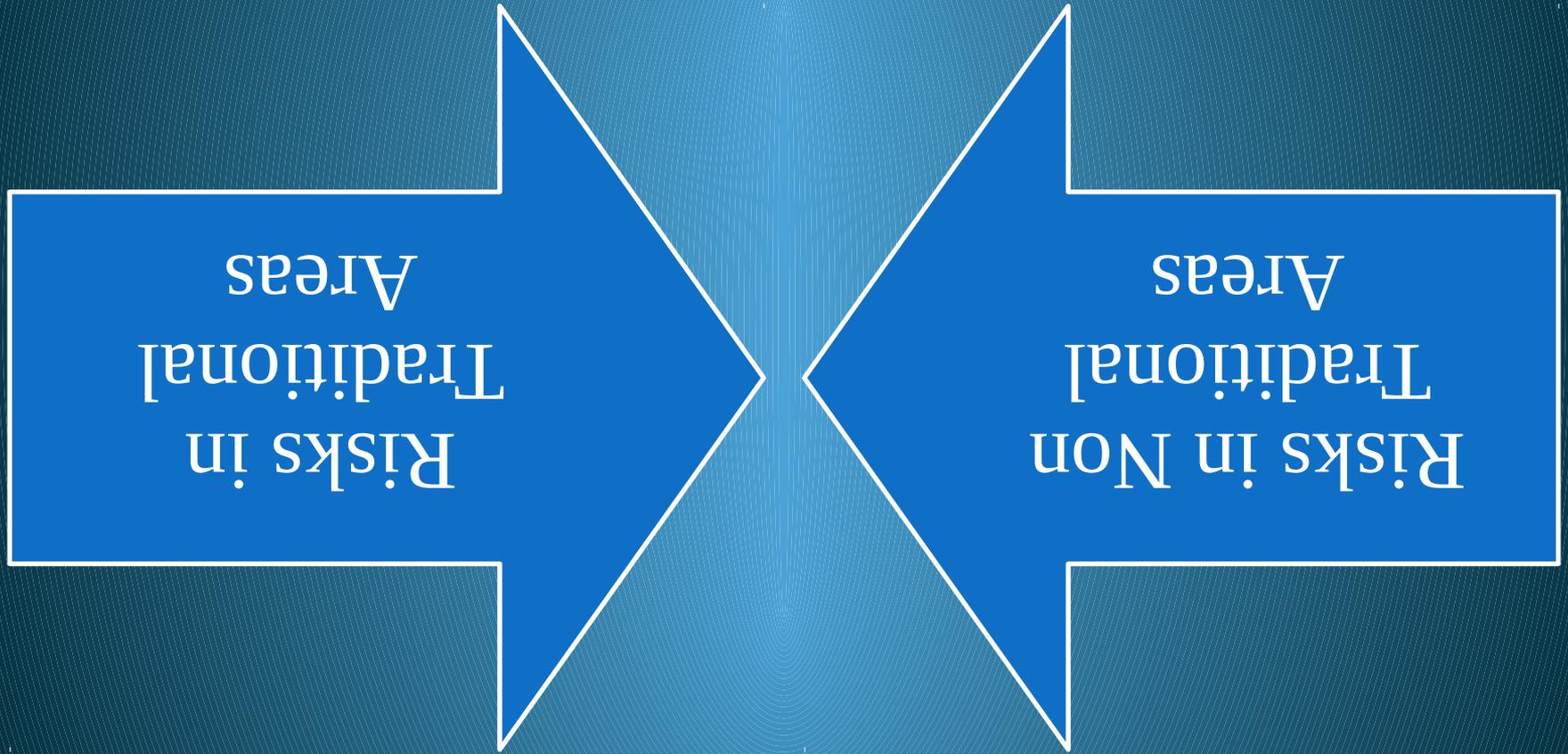
Capital



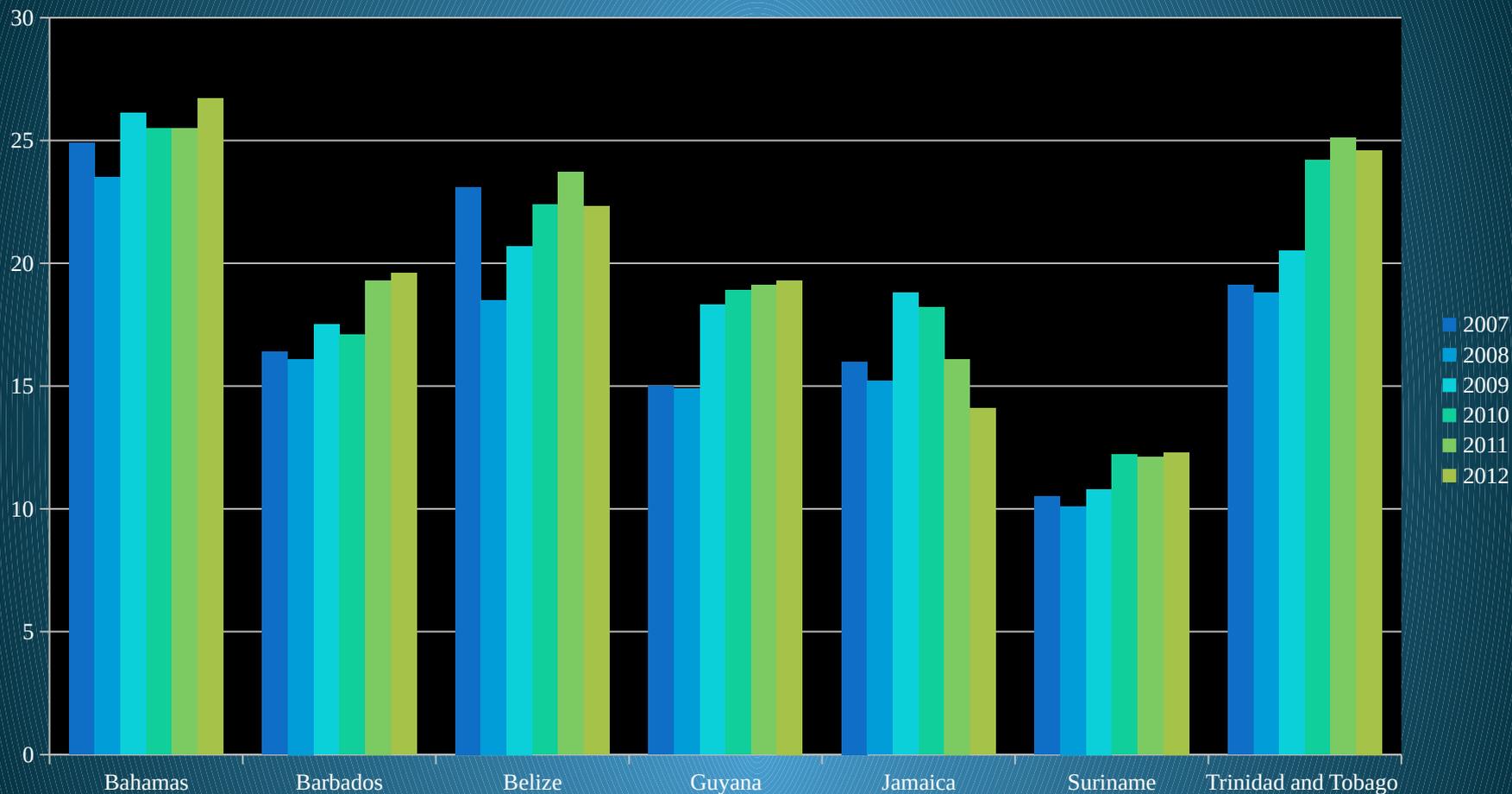
Risk



Capital Adequacy Considerations



Risk Weighted Capital Adequacy Ratios (Under Basel I) for Select Countries



Sources: Country Authorities and the IMF

BCBS International Standards for Banks

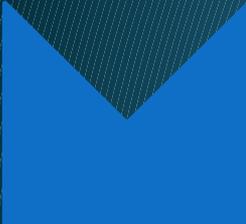
BCPs

- Basel Core Principles for Effective Supervision – Sept 2012 / (Oct 2006)

Basel Capital Accord

- International Standard on Capital Adequacy 2012/(2006)/(1988)
- Basel I, Basel II; Basel III

Changes in the BCPs (2012) With Focus On ...



- Greater supervisory intensity



- System-wide macro perspective



- Effective crisis management

New Capital Accord:

Basel III (2010) Focus:



- Capital Adequacy

- Liquidity

- Counter Cyclical Buffers
- Macro Prudential Supervision

International Standards for Banks
The Basel Core Principles (BCPs)

BCP 17

- Credit Risk

BCP 18

- Problem Assets,
Provisions and Reserves

BCP 19

- Concentration Risks and
Large Exposures

The Basel Capital Framework Whither the Caribbean?

• 1988

Basel I

• 2006

Basel II

• 2010

Basel III

The Basel Capital Framework



Initially focused predominantly on three risk types (credit, Market and operational risks)
One size fits all approach
Operational risks were not covered
Limited monitoring



Expanded to focus on additional risks
Introduced a new process (ICAAP)
Enhanced transparency and disclosure requirements
Strengthened management oversight, internal controls, risk management
• Became more challenging during the 2007/2008 global financial crisis



Designed to absorb shocks
Enhanced governance and risk management
Increased transparency and disclosure

Objectives of Basel II

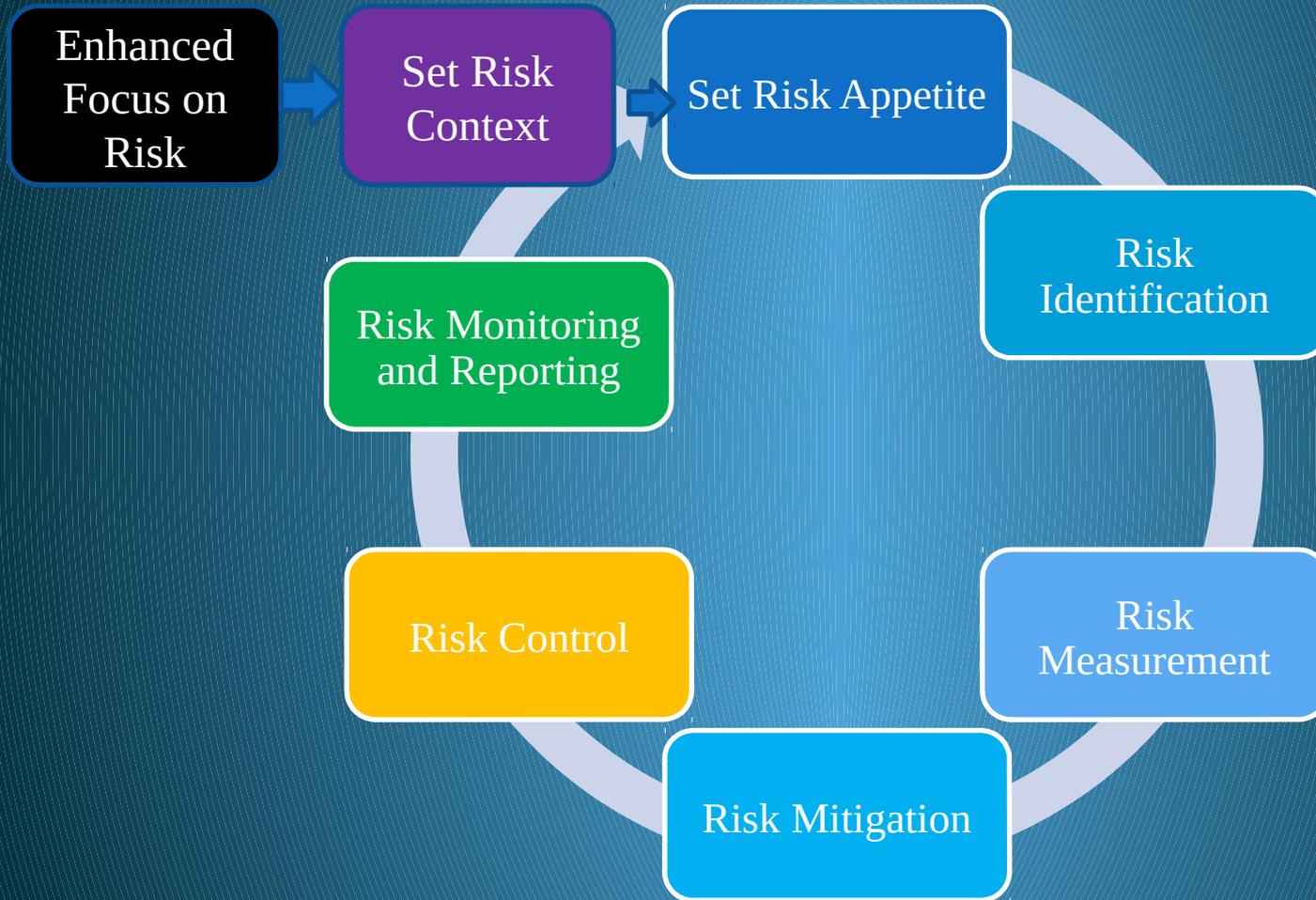
Implementation in the Caribbean



Objectives of Basel II Implementation in the Caribbean ..What's in it for the Banks?

- International Best Practice Standards will make banks operating in the region more attractive
- Enhance competitiveness of banks/jurisdiction
- Enhance risk management practices in banks / closer align banks capital to risks; safer and sounder institutions
- Enhance governance and board oversight
- Enhance internal controls
- Enhance market discipline
- Facilitate regional harmonization of capital standards

What's Expected from the Banks?



Source: Prepared by Courtney Christie-Veitch

Risk-based Supervision: A Supervisory Approach



Source: Courtney Christie-Veitch

Credit Risk Assessment: An External Rating Agency's Approach

Credit Rating Methodology for Corporate Entities



Source

Countries Implementing Basel II in the Caribbean

ECCU
(Operational Risk)

T & T
(Credit Risk, CRM, Securitization)

Barbados
(Market Risks)

The Bahamas
(IRRBB)

Jamaica
(Pillar II)

Countries Implementing Basel II in the Caribbean Cont'd

BVI
(Pillar III)

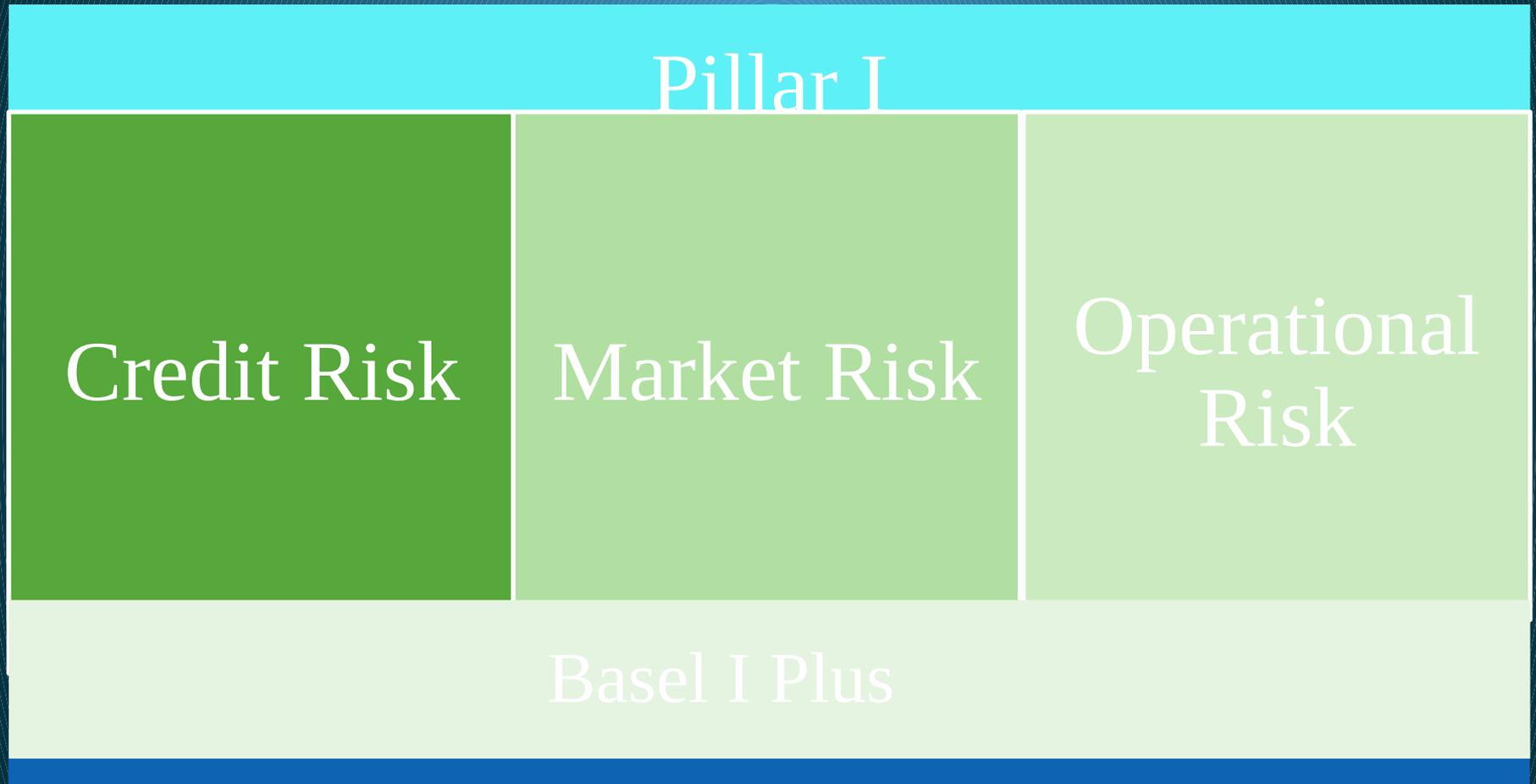
Cayman
Islands
(National
Discretions)

TCI
(Prudential
Information
Forms)

Guyana

Belize

The Basel II Capital Framework – Standardized Approach for the Region



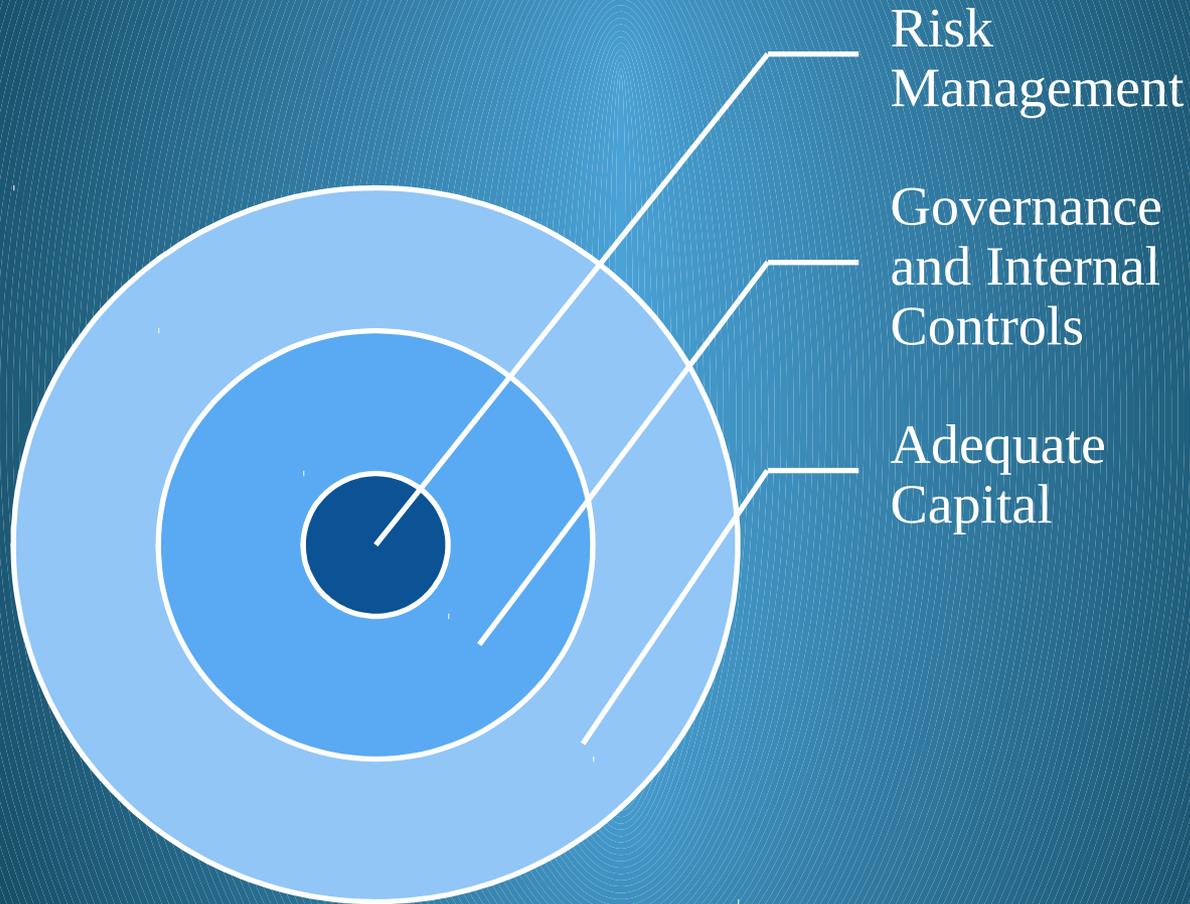
- Credit Risks – Three Approaches:
 - Standardized Approach
 - Foundation Internal Rating Based Approach
 - Advanced Internal Rating Based Approach
- Operational Risk Measurement - Three Approaches:
 - Basic Indicator Approach
 - Standardized Approach
 - Advanced Measurement Approach
- Market Risk Measurement
 - Standardized
 - Internal Models

Credit Risk Under Pillar I



- Group Internal Capital Adequacy Assessment Process (ICAAP) would focus on qualitative controls in managing credit and concentration risks
- Some of the qualitative measures will include:
 - Effective risk management systems and processes, including risk mitigation strategies
 - Adequate compliance and internal control framework
 - Adequate governance arrangements
 - Regular monitoring and reporting

Internal Capital Adequacy Process (ICAAP)



Risk assessment under the ICAAP

- All commercial banks are in scope
- Banks submit a formal document to the Authority annually referred to as an ICAAP
- Identification and measurement of the following risk types:
 - Pillar II risks (Systemic, liquidity, IRRBB, business/strategic risk, reputational risks and credit concentration risks)
 - External factors such as changes in economic environment, regulation and accounting rules.
- Material risks should be reviewed frequently and incorporated into the ICAAP report.
- Board and Internal Audit involvement / “use test”

Pillar II - Supervisory Review Process

- Risk Assessment under the ICAAP
 - ICAAP should include bank's review and comments on historical financial performance (three years); risk management; internal controls and governance arrangements
 - ICAAP should identify key and significant risks, provide analysis on risk measurement approaches and results for these risks, include estimates of capital required to cover all identified key risks and rationale for no capital requirement as appropriate
 - Summary table of required capital to cover individual pillar I and pillar II risks
 - Supervisors to review ICAAP submission and provide feedback
 - Supervisors to issue individual capital guidance to each bank

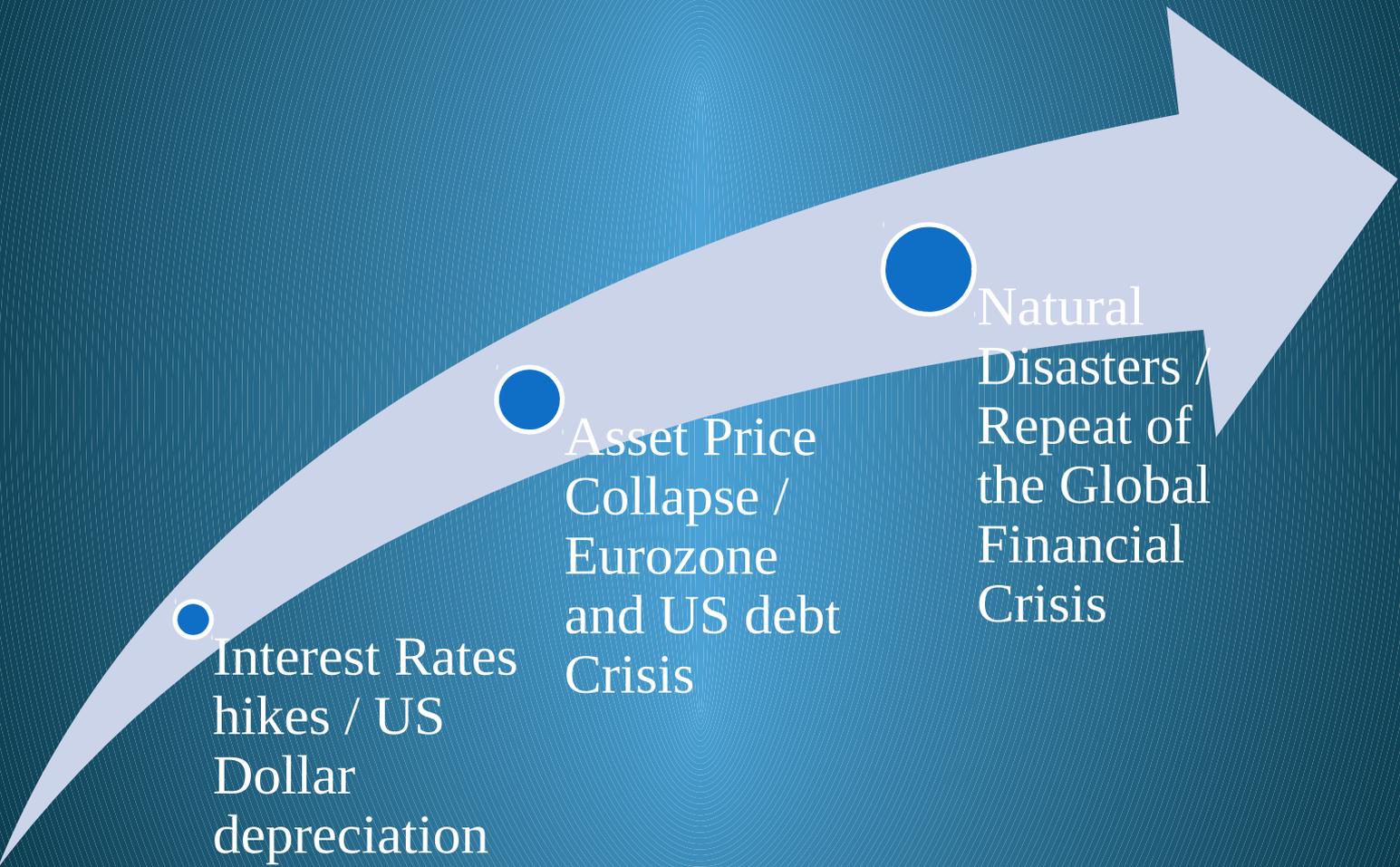
Need for Regular Stress Testing

- Stress Testing Programme for Supervisors should be embedded in the Supervisory Review Process (Pillar II)
- Overview of stress testing framework should be incorporated in banks ICAAP reporting
- Bank's stress testing programme should be embedded in the risk and capital management process of the bank/group

Need for Regular Stress Testing

- Stress testing should be seen as key function of capital planning and business planning processes
- Stress testing should be seen as a forward looking capital management and risk management tool of all banks – how banks perform under extreme but plausible conditions (economic, political or environmental).
- Stress testing framework should be approved by the banks' board of directors

Possible Stress Testing Scenarios



Interest Rates
hikes / US
Dollar
depreciation

Asset Price
Collapse /
Eurozone
and US debt
Crisis

Natural
Disasters /
Repeat of
the Global
Financial
Crisis

Pillar III Market Discipline – Disclosure and Transparency

- 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)
- Ensure that bank's capital is maintained at adequate levels
- Allows market participants to assess bank's capital adequacy and can provide strong incentive for banks to conduct business in a safe and sound manner
- Provides market participants with information about bank's ability to absorb losses
- Market participants are provided with information about a bank's risk profile and risk appetite (these provide info on the stability of the bank and sensitivity of earnings potential to changes in market conditions)

Regional Priorities

- Priority areas of focus should include:
 - Fast Track implementation of risk-based supervision
 - Accelerate implementation of the Basel Revised International Standard – Enhance Supervisory Review and Market Discipline
 - Develop and accelerate implementation of credit classification and provisioning requirements
 - Accelerate implementation of effective Supervisory Intervention (Corrective Action) Guidelines
 - Continue the building of supervisory capacity through training of Supervisors/Regulators in the assessment of credit risk
 - Maintenance of Independent Credit Ratings by all banks
 - Facilitate regional harmonization of capital standards and effective information sharing arrangements

Selected References

- Basel III: A global regulatory framework for more resilient banks and banking systems, *Basel Committee of Banking Supervisors (BCBS)*, (2010)
- Basel III: International framework for liquidity risk management, standards and monitoring, *BCBS* (2010)
- Basel II: International convergence of capital measurement and capital standards: A revised framework, *BCBS*, (2006).
- Basel Core Principles for Effective Banking Supervision, Bank for International Settlements, 2012.
- The Fundamental Principles of Financial Regulation, *Markus Brunnermeir, Andrew Crockett, Charles Goodhart, Avinash D. Persaud and Hyun song Shin*, *International Center for Monetary and Banking Studies*, (2009)

Thank you!
Any questions?