NEVIS FINANCIAL SERVICES DEPARTMENT

Discussion Paper on Proposed Prudential Framework under the Nevis International Banking Ordinance, 2014

Introduction

In 2014, the Nevis International Banking Ordinance came into being empowering the Minister of Finance, Nevis Island Administration to licence international banks in Nevis. Currently one such bank, part of a larger banking group in Nevis, is authorised. The Nevis Financial Services (Regulation and Supervision) Department (FSRC – Nevis Branch) is responsible for the supervision of international banks.

In order to function as a modern international financial services centre, the Branch now needs an appropriate set of policies and guidelines to govern the international banking sector. This paper sets out the high-level proposals for a regulatory framework and poses questions seeking stakeholder views thereon.

Basel II

A starting question is whether the Branch should adopt Basel II. The latter was originally published in 2004. Since then, most developed jurisdictions have adopted Basel II but a substantial number of other jurisdictions have not done so. The argument for adopting Basel II is that while many jurisdictions have not yet adopted Basel II, few do not aspire to. This is the case for example across most of the Caribbean. On the other hand it could be argued that Basel II is too complicated for a small jurisdiction like Nevis and something very simple such as a leverage ratio would be sufficient.

The Branch considers that adoption of Basel II is appropriate but only in so far as the simpler approaches are adopted. This means adoption of the Standardised Approach for credit, together with simple approaches for market risk and so on, and the Basic Indicator Approach for operational risk. The reason for this is that Basel II will benefit banks that choose high quality counterparty risk, use good collateral and engage in mortgage activity. Basel II also applies some pillar one charge for operational risk, which all banks carry. The alternative – Basel I – is also not itself without burden as the Branch would still need to produce reporting forms to cover the balance sheet.

Basel II also includes Pillar 2. To this end the Branch proposes to adopt a simple approach by requiring banks to assess their own capital requirement in Pillar 2. For the avoidance of doubt, whether the Branch allocates capital in Pillar 2 and at what level is another issue and is considered elsewhere in this paper.

There is the argument that Basel II is now outdated and that the Branch should advance straight to Basel III. There are problems with this argument. The first is that Basel III is as yet not entirely complete. The second is that Basel III is at least as complicated as Basel II. The third is that Basel III is as yet untried for less complex regimes. Basel III at this stage seems therefore inappropriate.

The Branch is also aware of the potential reputation benefit of Basel II adherence.

1. *Do you agree that Basel II as suggested should be followed? If not, what would you propose and why?*

Large Exposures/Liquidity

Basel II covers capital requirements in Pillars 1 and 2. However, it does not cover either large exposures or liquidity. The Branch considers that a regulatory regime must cover these two areas as well as capital. The reason for this is that the history of banking failure is littered with examples of banks that failed either because they lent too much to one counterparty or because they failed to repay liabilities on time. Policies and guidelines in these areas are also therefore required.

2. *Do you agree that the Branch should have policies on large exposures and liquidity?*

Qualitative Issues

So far, the above discussion has concentrated more on the quantitative than on qualitative side of regulation, though the distinction between the two is always grey. That is to say that policies and guidelines on Basel II, large exposures and liquidity are eventually boiled down to specific and tangible regulatory ratios that must be observed.

However there is also the equally important qualitative side of supervision where a bank needs to be seen to adhere to a set of general guidelines. Now, a bank will have its own policies along these lines; for example around netting, outsourcing, IT, trading limits and so on. The Basel Committee has also produced best practice guidelines along these lines and many regulators have in turn produced their own versions of these policies.

Whilst this may work for heavily-resourced jurisdictions, it poses significant problems in a small international finance centre. One option is to place Basel documentation on the Branch website. This however creates a problem as to the status of such material and how the Branch is to assure compliance. Another option is to tailor Basel documentation for the Branch. This however re-creates the same problem of assurance, begs the question as to why the Branch needs a differentiated approach and creates a major amount of work in originating such policies.

For these reasons, the Branch proposes to require that the bank's qualitative management of risks is linked to the bank's Pillar 2 ICAAP. For example a bank will need to explain in the ICAAP how it assesses the risks related to outsourcing, in so far as that is a material activity for that bank.

Both the bank and the regulator will still be able to refer to best practice as set down in Basel documentation. This approach is thereby dynamic. For example if Basel produced a paper on cyber risk, it can immediately be referred to without the branch having to formally adopt it as a policy – a process that is likely to take several years.

The exception to this approach is that some qualitative standards will be set out by the Branch namely credit, large exposures and liquidity risks. The reason for this is that these are considered essential to all banks and because here the qualitative approach can easily be linked to the quantitative approaches.

3. *Do you agree with this approach?*

Regional Perspective

Policies and guidelines have also been designed in the context of the region; not least the Eastern Caribbean Central Bank (ECCB). This is because it will be the group supervisor in the case of Nevis international banks with a group domestic bank. However, in so far as the ECCD follows approaches divergent to these broader priorities listed above, then the latter will take precedence. For example as the ECCB has not yet implemented Basel II, risk weightings in the international bank will differ from a bank regulated by the ECCB.

4. *Do you agree with this prioritisation? If not, what priority would you suggest?*

Minimum Regulatory Capital Level

This section considers the above subject and offers various options for adoption by the Branch.

Option I

Basel II sets out a minimum level of regulatory capital at 8% Risk Asset Ratio (RAR) in Pillar 1. Whether additional capital is added in Pillar 2, is a matter for national discretion. Option 1 envisages that Pillar 2 capital is not required other than on exceptional occasions. Instead Pillar 2 concentrates more on systems and controls rather than capital. Nevertheless, under this option, a bank is still expected to produce its own internal analysis of how much capital it needs. Generally this level exceeds the 8% minimum.

Option II

This option is the same as option I but includes a requirement for additional capital in Pillar 2. There is no specific level for this, although some a two percentage point is not unusual.

Option III

As a result of the financial crisis starting in 2007, the Basel Committee concluded that the minimum level of regulatory capital should increase. In broad terms under Basel III the required level is now 10.5% under Basel III (with higher levels for systemic banks). Many regulators, irrespective of Basel III, have already raised their standards. Option III therefore sets a minimum level of regulatory capital of 10.5% I Pillar 1; with zero in Pillar 2

Option IV

This option is the same as Option III but with additional capital in Pillar 2. This might for example be a minimum of ½%; aggregate capital to 11%. This is the current approach in Guernsey.

5. *Which option do you support and why?*

6. *Are there any other general comments or suggestions you wish to make?*

Draft framework

The following is a list of the draft proposed policy documents, guidance material and reporting forms. Each document is provided as an attached Appendix.

Appendix 1 - Guidelines for External Auditing

Appendix 2 - Guidelines for Credit Risk Management

Appendix 3 - Large Exposure Policy

Appendix 4 - Guidance on Liquidity Risk Management

Appendix 5 - BSL2 General Guidance

Appendix 6 - Module 1 - Guidance to completing the Standardised Approach to Credit Risk module of BSL/2

Appendix 7 - Module 3 - Guidance to completing the Operational Risk module of BSL/2

Appendix 8 - Module 4 - Guidance to completing the Market Risk module of BSL/2

Appendix 9 - Module 5 - Guidance to completing the Settlement Risk module of BSL/2

Appendix 10 - Module 6 - Guidance to completing the Balance Sheet module of BSL/2

Appendix 11 - Module 7 - Guidance to completing the Individual Capital Guidance module of BSL/2

Appendix 12 - Module 8 - Guidance to completing the Prudential Information module of BSL/2

Appendix 13 - Module 9 - Guidance to completing the Maturity Analysis module of BSL/2

Appendix 14 - BSL/2 Reporting Form for Subsidiaries

Appendix 15 - BSL/2 Reporting Form for Branches

Appendix 16 - Guidance on the Internal Capital Adequacy Assessment Process