# BERMUDA MONETARY AUTHORITY

## BASEL III FOR BERMUDA BANKS – FINAL RULE

JANUARY 2015

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## I. ABBREVIATIONS

For the purposes of this paper the following abbreviations will be used:

| | |
|---|---|
| "AT1" | Additional Tier 1 Capital |
| "Basel Committee" | Basel Committee on Banking Supervision |
| "CAR" | Capital Adequacy Ratio |
| "CARP" | Capital Assessment and Risk Profile |
| "CCB" | Capital Conservation Buffer |
| "CET1" | Common Equity Tier 1 Capital |
| "D-SIB" | Domestic-Systemically Important Bank |
| "HQLA" | High Quality Liquid Assets |
| "IOSCO" | International Organisation of Securities Commissions |
| "LCR" | Liquidity Coverage Ratio |
| "NSFR" | Net Stable Funding Ratio |
| "OCI" | Other Comprehensive Income |
| "PIR" | Prudential Information Return |
| "QIS" | Quantitative Impact Study |
| "RWA" | Risk-Weighted Assets |
| "T1" | Tier One Capital |

## II. PREAMBLE

1. The financial crisis of 2007-2008 was a crisis of both liquidity and capital. Many banks engaged in a funding regime that was excessively weighted in short-term and volatile wholesale liabilities that were invested in illiquid assets, which became a prime causal factor in the crisis and an enduring and valuable lesson that has been carried forward into the creation of Basel III. The crisis also raised significant concerns over the quantity and quality (loss absorbency as a going concern) of bank capital. Accordingly, Basel III addresses the challenges of improving the quantity and quality of bank capital (including by emphasising the going concern importance of common equity), while also addressing the need for a potent liquidity buffer to counteract periods of financial market stress.

2. To introduce Basel III to the Bermuda banking sector, the Bermuda Monetary Authority (the Authority) produced a Discussion Paper (DP) in 2011 and a Consultation Paper (CP) in 2013. An extensive formal public consultation process followed to ensure familiarity with and acceptance of the Basel III measures, as adapted for the Bermuda market. The measures focus on three main areas: the quantity, quality, consistency and transparency of capital; the imposition of a prudent leverage ratio and capital buffers; and the adoption of prudential liquidity standards centered on a bank's ability to fund itself during a short-term stress period.

3. In the DP and CP, the Authority provided an overview of the Basel III standards and sought the views of Bermuda's banks and other stakeholders on their implementation in Bermuda. The consultation process that followed the CP included a series of meetings with the banking sector, represented by their Chief Financial Officers. Discussions covered the feedback received on the CP as well as issues relating to a planned leverage ratio, the appropriate level of various capital buffers, the interaction of these new requirements with existing Pillar II guidance, and the specification of the Liquidity Coverage Ratio (LCR) framework to include the allowance of bank-specific and empirically supported deposit behavior assumptions. An additional round of LCR Quantitative Impact Study (QIS) was also conducted as at Q2-2014, to ensure that the banking sector would be able to adopt an LCR reporting template and start meeting the phased-in requirements commencing in 2015.

4. The Authority has consistently communicated its view that the adoption of these new standards, with minimal deviation from the core Basel framework, is important to protect the interests of a diverse base of depositors, preserve the stability of the Bermuda financial system, and enhance the reputation of the Bermuda banking market and its participants. The Authority was pleased to note that submissions in response to the DP and CP and the follow-on implementation meetings largely supported this position.

5. The Authority assessed respondents' feedback on the implementation of specific elements of Basel III in Bermuda and reflected these views in the capital and liquidity standards put forward in this final rule. In addition, the Authority has incorporated the findings of its QIS analysis of the banking sector's ability to meet these enhanced capital and liquidity requirements on a sustainable basis. The Authority has also analysed the detailed credit information gleaned from its enhanced monitoring efforts to assess the impact of a prolonged period of economic stagnation on the credit quality and capital adequacy of the sector. The Authority believes that the capital buffers, contained in the Basel III framework, will provide the capital base needed to successfully manage through the credit cycle.

6. The final rule appropriately balances prudent risk taken by banks while simultaneously preserving prudent capital buffers and liquidity resilience to protect depositors and preserve the stability of the banking sector within Bermuda.

7. Concerns that have been addressed in the final rule:

***a. Level playing field***

Respondents were concerned that the adoption of a revised framework, if inconsistently applied to individual institutions, would lead to artificial barriers to local competitiveness and the ability to compete with other jurisdictions. The Authority has weighed these concerns and is confident that this final rule adopts a framework which adheres tothe fundamental components of the Basel approach, such as the definitions of capital, conservation buffers and leverage ratio, balanced against limited jurisdictional adjustments consistently applied to all banks. However, not all banks will be subject to exactly the same capital requirements, which will need to reflect each bank's unique risk profile through the Capital and Risk Assessment Profile (CARP) Pillar 2 process and the setting of capital surcharges for Domestic-Systemically Important Banks (D-SIBs). The Authority is confident that its regime is consistent with international standards and will accomplish the primary goal of strengthening the resilience of the Bermuda banking sector, while enabling it to continue to be globally competitive.

***b. Timetable for implementation***

Given the multi-year implementation timetable built into the core Basel III framework and the significant consultation period – including several rounds of QIS and an extensive series of sector outreach meetings to work through identified concerns and facilitate implementation – the Authority is confident it has provided sufficient time for institutions to prepare for the adoption of the new rule, including system adjustments to comply with the new reporting requirements. Annex 1 of this paper sets out the Bermuda implementation timetable.

8. The banking sector and all interested parties are hereby advised that this final rule will become effective on 1st January 2015, with all provisions coming into effect at that time unless stated otherwise in the body of this document, including Annex 1. All banks will be expected to report in a Basel III consistent manner commencing with the Prudential Information Return (PIR) for the first quarter of 2015.

## III. BACKGROUND

9. Bermuda banks and deposit companies are required to meet, on an ongoing basis, the minimum licensing criteria set out in the Second Schedule to the Banks and Deposit Companies Act 1999 (the Act). This provides, among other requirements, that institutions must conduct their business in a prudent manner, including that they maintain capital and financial resources (liquidity) commensurate with the nature and scope of their operations. The setting and monitoring of requirements for capital adequacy and liquidity, including the effective assessment and management of risk within

institutions, represent key elements in the framework of prudential oversight and control applied by the Authority to help protect the interests of depositors. The approach developed and applied by the Authority in this regard has reflected applicable regulatory standards designed and promulgated by the Basel Committee, the international standard-setting body for banks. Since January 2009, banks licensed in Bermuda have been required to comply with the framework set out in the Authority's final rule and guidance.

10. At the end of 2010, the Basel Committee agreed to the key elements of a more comprehensive set of standards that not only strengthened the capital adequacy and risk management provisions of the Basel II framework, but also introduced international prudential liquidity standards.

11. The movement to Basel III adoption by Bermuda is consistent with past adoption of Basel I and Basel II and represents Bermuda's adherence to international standards aimed at the aforementioned strengthening of capital and liquidity in the banking sector.

12. In this final rule, the Authority adopts the capital and liquidity regulatory requirements consistent with Basel III for this jurisdiction, with implementation to begin 1 January 2015. These requirements should be viewed in the broader context of the Authority's efforts to maintain high standards of risk management and corporate governance within Bermuda's banks. While Pillar 1 of the Basel III standards focuses on quantitative regulatory capital and liquidity requirements, the Authority is of the view that observance of quantitative regulatory prudential minima is only one important element in a comprehensive framework.

13. Of equal importance is the adoption within an institution of a sound framework of governance and risk management under Pillar 2 and appropriate public disclosure under Pillar 3. Consistent with this view, the Authority will continue to promote strengthened internal risk management through the Capital Assessment and Risk Profile (CARP) process and its Pillar 2 authority to prescribe capital levels commensurate with a bank's assessed risk profile.

## IV. REVISED CAPITAL FRAMEWORK

***Definition of Capital***

14. The Authority adopts Common Equity Tier 1 Capital (CET1) as the primary and predominant form of regulatory capital, and this standard will be deemed the primary capital adequacy measure for Bermuda banks. CET1 is intended to absorb losses on a "going concern" basis with a bank continuing in operation. Additional Tier 1 capital (AT1) will also be allowed in the capital framework, subject to the inclusion criteria contained in section 55 of the June 2011 Basel III framework document[1] (Basel III rules). Tier 2 capital will provide an additional measure of regulatory capital, on a "gone concern" basis of impending insolvency and potential liquidation. A condition of AT1 or Tier 2 eligibility will be a clear and unequivocal provision (acceptable to the Authority) requiring the elimination of the capital instrument or its conversion to common equity at the point of non-viability of the bank as determined by the Authority. This loss absorbency feature is key to any component of capital being considered at any tier. Tier 3 capital will no longer qualify as regulatory capital.

***Minority Interests***

15. The Authority adopts the Basel III rules with respect to the recognition of qualifying minority interests, comprising Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries and meeting certain classification criteria, as regulatory capital.

***Regulatory Adjustments and Deductions***

16. The Authority adopts the Basel III rules with respect to the regulatory adjustments and deductions in the calculation of regulatory capital. These adjustments will be applied in the calculation of CET1.

17. The Authority retains national discretion to allow banks to exclude temporarily from the deduction requirement certain investments where these have been made in the

[1] Basel Committee on Banking Supervision, A global regulatory framework for more resilient banks and banking systems, December 2010 (revised June 2011).

context of resolving or providing financial assistance to restructure a distressed institution.

18. The Authority adopts the one-time and irrevocable election to exclude Other Comprehensive Income (OCI) from CET1 with each bank required to make a definitive election, no later than 31st March 2015.

19. The detailed provisions for all other regulatory adjustments and deductions from CET1, including but not limited to goodwill, all intangibles and certain deferred tax assets can be found in paragraphs 66 to 90 of the Basel III rules.

***Minimum Capital Ratios***

20. The Authority adopts the Basel III regulatory minimum capital levels as follows:

a. CET1 must be at least 4.5% of Risk-Weighted Assets (RWA) at all times;
b. Tier 1 (T1) capital must be at least 6.0% of RWA at all times; and
c. Total capital (T1 + T2 capital) must be at least 8.0% of RWA at all times.

**The regulatory limits above do not include Pillar 2 related add-ons that may be applied by the Authority in connection with its Prudential Supervision.**

***Capital Conservation Buffer***

21. The Authority adopts the Capital Conservation Buffer (CCB), set at the full 2.5% of RWA, composed of CET1 eligible capital. The CCB is designed to ensure that banks build up and retain capital buffers outside of periods of stress which can be drawn down in exceptional circumstances if severe losses are incurred. Appropriate capital distribution constraints will be imposed on any bank whose capital level falls below this buffer.

***Countercyclical Buffer***

22. The Authority adopts the inclusion of a Basel III countercyclical buffer to be introduced when macro-economic indicators provide an assessment of excessive credit or other pressures building in the banking sector. At this point, the Authority will assess the need for a capital buffer of up to 2.5% so that banks build up their capital ahead of having to meet possible losses should these pressures be reversed. The countercyclical buffer must comprise CET1 eligible capital.

*Domestic Systemically Important Banks (D-SIB)*

23. The Authority will assess the extent to which Bermuda's banks (collectively and individually) pose a degree of material systemic risk to the economy of Bermuda due to their roles in deposit-taking, corporate lending, payment systems and other core economic functions[2]. This assessment will be based on a range of metrics relating to the size, interconnectedness, substitutability and complexity of each bank. The Authority will apply a capital surcharge buffer, specified as a stated percentage of RWA and composed of CET1 eligible capital, for Bermuda banks designated to be a D-SIB on the basis of the assessment. The size of this buffer will vary between 0.5% and 3%, depending on the extent of systemic risk posed by each D-SIB. Each D-SIB will be advised of its specific buffer directly by the Authority.

*Counterparty Credit Risk*

24. The Authority adopts the Counterparty Credit Risk (CCR) requirements of Basel III, which include the addition of a Credit Valuation Adjustment (CVA) to the capital charge to address potential mark-to-market losses associated with the deteriorating credit-worthiness of any applicable counterparty.

*Central Counterparties*

25. The Authority adopts the Basel Committee rules relating to exposures to central counterparties[3].

*External Credit Assessment*

26. The Authority retains the external credit assessment institution eligibility criteria in line with Basel III, which includes the incorporation of key elements of the International Organization of Securities Commission's (IOSCO's) *Code of Conduct Fundamentals for*

[2] Basel Committee on Banking Supervision: A framework for dealing with domestic systemically important banks, June 2012.

[3] Basel Committee on Banking Supervision, Capital requirements for bank exposures to central counterparties, April 2014.

*Credit Rating Agencies* in the criteria. It is anticipated that existing approved external credit assessment institutions will continue to be eligible.

***Market Risk Framework***

27. The Authority retains the exemption from reporting under the market risk framework where market risk remains at *de minimis* levels, with reservation of authority to impose such reporting should material market risk be incurred.

***Leverage Ratio***

28. The Authority adopts the introduction of a 5% leverage ratio calculated as the ratio of T1 Capital (including AT1) to Total Exposure as calculated in the Basel III rule[4]. All Bermuda banks currently have T1 capital levels that exceed this limit. Total Exposure will include both on-balance sheet exposures (generally measured following the accounting measure of exposure) and off-balance sheet exposures, as defined under Basel III rules and subject to the credit conversion factors used in the Basel Standardised Approach for credit risk, with a floor of 10%. In computing any of the on-balance sheet or off-balance sheet exposures, collateral netting is not allowed. This leverage ratio has been chosen because it reflects an appropriate capital backstop for a jurisdiction that does not have a central bank or a fully funded deposit insurance scheme, thus ensuring that a robust capital framework is in place to support financial stability.

## V. PILLAR 2

29. The Authority will continue to utilise Pillar 2 to cover emerging identified risks that are not captured, or not fully captured, in existing Pillar 1 provisions and to address any departures from the Basel III standard. Potential areas where Pillar 2 may be deployed include but are not limited to the adjustment of Risk-Weighted Assets (RWA) percentages and the continued integration of stress testing results to reveal potential capital shortfalls and to address those shortfalls through a capital charge.

[4] Basel Committee on Banking Supervision, Revised Basel III leverage ratio framework and disclosure requirements, January 2014.

## VI. LIQUIDITY

***Liquidity Coverage Ratio***

30. In January 2013, the Basel Committee released a revision to the Liquidity Coverage Ratio (LCR) proposal presented in the original Basel III Liquidity Paper[5]. This revision reflected various refinements to the LCR to address issues identified by national authorities and the international banking community since the LCR was originally published. The major areas of change were: the expansion of the range of assets eligible for inclusion as High Quality Liquid Assets (HQLA) for LCR purposes, through the addition of a new category of Level 2B assets, which national supervisors may elect to recognise as HQLA in their local LCR regulations; a recalibration of the stress assumptions for some cash-flow items; an affirmation of the usability of the stock of HQLA by banks in times of stress; and the adoption of a phase-in timetable for implementing the LCR.

31. The Authority has conducted extensive outreach with the sector concerning the technical implementation issues largely centred on deposit outflow assumptions, and as a result of that effort has refined its final rules (reflected in Items #31-36 below) for the local implementation of the LCR.

32. The Authority adopts the LCR implementation timetable consistent with that published by the Basel Committee beginning on 1st January 2015, with a minimum requirement of 60% rising in equal annual steps to reach 100% on 1st January 2019.

33. The Authority adopts the haircuts for Level 2 assets set consistently with the January 2013 LCR revision, with a reservation by the Authority to employ national discretion in applying a higher haircut percentage or to restrict a class of assets from this group, should unacceptable risk concentrations develop.

34. The Authority will use limited national discretion to widen Level 1 asset eligibility by

[5] Basel Committee on Banking Supervision, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013.

allowing US dollar assets, qualifying under Basel III as Level 1 assets, to be fully eligible as Level 1 assets in Bermuda. The Authority will also allow a bank to include certain US dollar balances held in its qualifying correspondent bank to be included as a Level 1 asset to offset the fact that this jurisdiction does not have a central bank. This inclusion of qualifying correspondent bank balances will be subject to a 25% of HQLA Level 1 limit and a demonstration to the bank's Board that the credit quality of the correspondent bank is satisfactory. In addition, the Authority requests that all Bermuda banks continue to work with their existing correspondent banks to identify conduits for bank funds to be placed at the US Federal Reserve, in a pass-through account or into a secured funding vehicle such as a reverse repurchase facility, backed with HQLA Level 1 assets.

35. Corporate and trust deposits are normally considered unsecured wholesale funding provided by business customers. They may be subject to run-off rates applicable to more stable deposits, provided they meet all necessary eligibility criteria and ongoing validation, satisfactory to the Authority. Any departures from the Basel III standard for deposit outflows will only be considered upon the production of a *bona fide* deposit behavioral analysis, refreshed at least annually, with a conclusion drawn by the bank as to the appropriate outflow to be assigned to that segment. The Authority will make the appropriate determination after reviewing the analysis and will communicate its conclusion to the respective entity.

36. The Authority also adopts the position that unsecured funding provided by non-financial small business customers, managed as retail exposures and generally considered as having similar liquidity risk characteristics to retail accounts, will be treated as such, provided that the total aggregated funding raised from each single small business customer is less than $500,000. It is - further required that such deposits would only be eligible as stable deposits, subject to a 5% run-off, where among other criteria they are fully covered by deposit insurance. Small business deposits that do not meet the necessary eligibility criteria will be classified as less stable and subject to a 10% run-off assumption and those that exceed the $500,000 threshold will be treated as ordinary corporate deposits.

37. Institutions will be expected to begin formal reporting of the Liquidity Coverage Ratio (LCR) from the first quarter of 2015. The Authority may refine the assumptions in the

LCR calculation based on the results of monitoring local impact and assessing international developments.

***Net Stable Funding Ratio***

38. The Authority will delay implementation of the Basel III Net Stable Funding Ratio (NSFR) until the January 2018 effective date set by the Basel Committee[6] with respect to its final provisions.

***Scope***

39. The LCR and NSFR should be applied at both the consolidated and unconsolidated level.

## VII. PILLAR 3 AND PUBLIC DISCLOSURE

40. The Authority adopts the amendments to Pillar 3 under Basel 2.5 and Basel III.

[6] Basel Committee on Banking Supervision, Consultative Document, Basel III: The Net Stable Funding Ratio, January 2014.

## ANNEX 1. BASEL III IMPLEMENTATION TIMETABLE FOR BERMUDA[7]

| (All dates are as of 1st January) | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|
| **Minimum CET1 CAR** | 4.50% | 4.50% | 4.50% | 4.50% | 4.50% |
| **Capital Conservation Buffer** | 0.00% | 0.63% | 1.25% | 1.88% | 2.50% |
| **Minimum CET1 CAR plus Capital Conservation Buffer** | 4.50% | 5.13% | 5.75% | 6.38% | 7.00% |
| **Minimum Total CAR** | 8.00% | 8.00% | 8.00% | 8.00% | 8.00% |
| **Minimum Total CAR plus Capital Conservation Buffer** | 8.00% | 8.63% | 9.25% | 9.88% | 10.50% |
| **Leverage ratio** | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% |
| **LCR** | 60.00% | 70.00% | 80.00% | 90.00% | 100.00% |

[7] Does not include the D-SIB buffer