BASEL II PRELIMINARY SURVEY

BVI Financial Services Commission

Banking and Fiduciary Services Division

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SUMMARY

The Basel Capital Framework, called the International Divergence of Capital Measurement and Capital Standards, was first developed in 1988 by the Basel Committee on Banking Supervision and was subsequently revised in 2003.

The main objective of the framework has been to establish standards for ensuring appropriate risk management and capital adequacy in internationally active banks.

The Revised Capital Framework, or Basel II, has three pillars.
Pillar I: Minimum Capital Requirements
Pillar II: Supervisory Review
Pillar III: Market Discipline

The original framework focused on credit risk in developing minimum capital requirements. The revised capital framework enhances the approach to credit risk and adds market and operational risk as factors used in calculating capital adequacy. The addition of two pillars broadens the framework's approach to banks' risk management. Appendix I contains a summary of the changes made in and implications of the revised framework.

The objective of this questionnaire is to identify banks' knowledge of and strategies to be used in the implementation of the Revised Capital Framework in the BVI.

Institutions are requested to complete the following survey and submit to the attention of:

Kenneth Baker
Director Banking and Fiduciary Services Division
BVI Financial Services Commission
PO Box 418
Pasea Estate
Tortola, VG 1110
British Virgin Islands

The due date for the receipt of completed survey is March 30th, 2007.

THANK YOU FOR PARTICIPATING IN THIS SURVEY.

BANK INFORMATION

1. **Name of Bank:**

2. **Contact Details:** ***(Please indicate the details of the contact person for this questionnaire)***

   Name:

   Position:

   Telephone:

   Email Address:

3. **To which of the following types of bank categories does your bank belong?**
   Choose only one option
   - ☐ Locally owned bank ***(GO TO QUESTION 5)***
   - ☐ Subsidiary of foreign bank
   - ☐ Branch of a foreign bank
   - ☐ Offshore or international bank

4. **Where is your parent bank/head office located?**

5. **How is your bank's capital distributed in terms of Tier 1 and Tier 2 capital at the end of 2006?** *Please complete Appendix II.*

BASEL II

6. Is your bank familiar with the New Basel Capital Accord (Basel II)?

☐ Yes ***(GO TO QUESTION 8)***
☐ No

7. What is the reason that your bank is not familiar with the New Basel Capital Accord? *Use a separate sheet.*

8. What is your bank's primary perception of Basel II?
Choose only one option.

☐ Opportunity to enhance risk management processes
☐ Opportunity to enhance corporate governance
☐ It will cause us more problems than it will help resolve
☐ Little to no added value
☐ Other, namely: ____
☐ Don't know

9. Is your bank aware of the fact that certain aspects of Basel II might be implemented in the BVI in the future?

☐ Yes
☐ No

10. Has your bank taken any steps for the possible implementation of Basel II?

☐ Yes ***(GO TO QUESTION 12)***
☐ No

11. Please state why your bank has not taken any steps yet: *Use a separate sheet.*

12. Please describe (as detailed as possible) the steps taken by your bank for the implementation of Basel II? *Use a separate sheet.*

13. Is your bank adopting:

☐ its own aspects of Basel II?
☐ the same aspects of Basel II as its parent bank/head office?

14. Which approach to credit risk would your bank/parent bank/head office choose to implement? *Choose only one option.*

☐ Simplified Standardised Approach ***(GO TO QUESTION 15)***

☐ Standardised Approach ***(GO TO QUESTION 15)***

☐ Internal Ratings Based ***(GO TO QUESTION 29)***

STANDARDISED APPROACH

Within Basel II, there are two broad methodologies for calculating the minimum required capital to be held for credit risk. These are the Standardised and the Internal Ratings Based (IRB) approaches. ***The Standardised Approach, to be adopted by the BVI Financial Services Commission, measures credit risk in a standardised manner, supported by external credit assessments.***
The Simplified-standardised approach extracts the simplest aspects of the standardised approach by using established sovereign risk weights.

15. How familiar is your bank/parent bank/head office with the Standardised Approach? *Choose only one option.*

- ☐ We have personnel with great knowledge of the Standardised approach
- ☐ We have read the necessary documents on the Standardised approach and have basic knowledge.
- ☐ We have very little knowledge of the Standardised approach.
- ☐ We have no knowledge whatsoever of the Standardised approach.
- ☐ Other, namely:____

16. Has your bank/parent bank/head office done an impact study to calculate the impact that the Standardised Approach will have on your capital requirements, as compared to your current situation?

- ☐ Yes
- ☐ No ***(GO TO QUESTION 18)***

17. What were your conclusions? *Use a separate sheet.*

18. Does your bank have staff that is prepared (trained) to use the Standardised Approach?

- ☐ Yes ***(GO TO QUESTION 20)***
- ☐ No

19. How does the bank intend to gain the necessary knowledge/expertise to use the Standardised Approach? *Use a separate sheet*

20. What do you consider the biggest <u>advantage(s)</u> of the Standardised Approach for your bank? *Use a separate sheet.*

21. What do you consider the biggest <u>disadvantage(s)</u> of the Standardised Approach for your bank? *Use a separate sheet.*

22. Considering all the research and effort already done by your bank/parent bank/head office and the advantages and disadvantages that might affect your bank, does your bank/parent bank/head office consider it realistic to implement the Standardised Approach? *Use a separate sheet.*

23. Does your bank/parent bank/head office have a roadmap for this implementation?

- ☐ Yes
- ☐ No ***(GO TO QUESTION 38)***

24. Please provide a summary of this roadmap: *Use a separate sheet.*
(After answering please proceed to QUESTION 38)

IRB APPROACHES

Within Basel II, there are two broad methodologies for calculating the minimum required capital to be held for credit risk. These are the Standardised and the Internal Ratings Based (IRB) approaches.

The IRB approach has two options: the Foundation-IRB and the Advanced-IRB. This approach relies on a bank's internal ratings system, approved by the Supervisory Authority, to calculate capital requirements for credit risk. The bank's internal ratings system must quantify risk in a consistent, reliable and valid fashion.

25. How familiar is your bank/parent bank/head office with the IRB approaches?
Choose only one option.
- ☐ We have personnel with great knowledge of the IRB approaches
- ☐ We have read the necessary documents on IRB approaches and have basic knowledge.
- ☐ We have very little knowledge of the IRB approaches.
- ☐ We have no knowledge whatsoever of the IRB approaches.
- ☐ Other, namely: ______________________________________

26. Which of the approaches did your bank/parent bank/head office consider?
Choose only one option.
- ☐ Foundation IRB
- ☐ Advanced IRB
- ☐ We haven't made a choice yet

27. Which aspects were taken into account in this consideration? *Use a separate sheet.*

28. Has your bank/parent bank/head office done an impact study to calculate the impact that the IRB approaches will have on your capital requirements, as compared to your current situation?
- ☐ Yes
- ☐ No ***(GO TO QUESTION 30)***

29. What were your conclusions? *Use a separate sheet.*

30. Does your bank have staff that is prepared (trained) to use the IRB Approach?
- ☐ Yes ***(GO TO QUESTION 32)***
- ☐ No

31. How does the bank intend to gain the necessary knowledge/expertise to use the IRB Approach? *Use a separate sheet.*

32. **What do you consider the biggest <u>advantage(s)</u> of the IRB approach for your bank?** *Use a separate sheet.*

33. **What do you consider the biggest <u>disadvantage(s)</u> of the IRB approach for your bank?** *Use a separate sheet.*

34. **Considering all the research and effort already done by your bank/parent bank/head office and the advantages and disadvantages that might affect your bank, does your bank/parent bank/head office consider it realistic to implement the IRB approach?** *Use a separate sheet.*

35. **How does your bank/parent bank/head office feel the implementation of the IRB approaches in other countries /islands in the Caribbean region might affect its competitive position in the region?** *Use a separate sheet.*

36. **Does your bank/parent bank/head office have a roadmap for this implementation?** *Use a separate sheet.*
    - ☐ Yes
    - ☐ No ***(GO TO QUESTION 38)***

37. **Please provide a summary of this roadmap:** *Use a separate sheet.*
    (After answering please proceed to QUESTION 38)

<u>GENERAL</u> (to be completed by all banks as applicable)

38. What are the key challenges that Basel II will generate for your bank? *Use a separate sheet.*

39. Does your bank expect to see a material change in its capital levels as a result of Basel II?

☐ Yes
☐ No ***(GO TO QUESTION 41)***

40. If so in what areas (dealing with credit and operational risk)? *Use a separate sheet.*

41. Are there any specific issues related to Basel II that you would like the Commission to address? *Use a separate sheet.*

42. Do you have any additional comments/remarks? *Use a separate sheet.*

Name of Authorised Signatory ____________________

Position Held ____________________

Signature ____________________

Date ____________________

APPENDIX I:

Elements of the Revised International Divergence of Capital Measurement and Capital Standards (Basel II Capital Framework)

Pillar I: Minimum Capital Requirements		
Element	**Changes**	**Implications**
Regulatory Capital	No changes made to the definition and components of regulatory capital. The risk-asset-ratio, calculated as total capital base divided by risk weighted assets must be equal to 8% or more.	Regulatory capital as indicated on Prudential Returns to determine capital adequacy remains the same. The categories are: Tier 1: **Permanent shareholders' equity** (issued and fully paid ordinary shares/common stock and perpetual non-cumulative preference shares) and **disclosed reserves** (share premiums, retained profit, general reserves and legal reserves). Tier 2: **Undisclosed reserves**, **Revaluation reserves**, **general provisions**, **hybrid capital instruments** and **subordinated term debt**. Deductions from Tier 1: **Goodwill** and **increase in equity resulting from securitisation exposure**. Deductions (50% from Tier 1, 50% from Tier 2): **investments in unconsolidated banking and financial subsidiary companies**, **investments in other banks and financial institutions**, **significant minority investments in other financial entities**.
Risk Weighted Assets	Credit Risk: (1) the standardised approach	Credit risk is measured in a standardised manner, supported by external credit assessments. 100% risk weighting is assigned to assets for which there is no external risk weighting. Past-due loans carry 150% risk weighting when specific provisions are less than 20% of the outstanding loan.

	(2) the internal ratings-based (IRB) approaches: foundation and advanced.	Internal ratings system approved by supervisor is used. Based on measures of unexpected losses (UL) and expected losses (EL). Banking book exposures classified as (a) corporate, (b) sovereign, (c) bank, (d) retail and (e) equity. Minimum requirements for IRB approaches focus on a bank's ability to rank order and quantify risk in a consistent, reliable and valid fashion.
	Operational Risk: (1) the basic indicator approach (2) the standardised approach (3) the advanced measurement approaches	Banks must hold capital equal to the average over the previous three years of a fixed percentage of positive annual gross income. Banks' activities are divided into eight business lines. The capital charge for each business line is calculated by multiplying gross income by a factor assigned to that business line. Subject to supervisory approval, internal operational risk measurement system is used to assign risk weightings.
	Market Risk: (1) Interest Rate Risk (2) Foreign Exchange Risk	There are two separately calculated charges: specific risk of each security and charge to the interest rate risk in the portfolio. The risk measurement system should incorporate factors corresponding to the individual foreign currencies in which the bank's positions are denominated.

Pillar II: Supervisory Review
Pillar II is based on four key principles: (1) Bank's own assessment of capital adequacy (2) Supervisory review process (3) Capital above regulatory minimum (4) Supervisory intervention

Pillar III: Market Discipline

Provides a strong incentive for banks to conduct business in a safe, sound and efficient manner and to maintain a strong capital base. Reliable and timely information allows banks to perform well founded counterparty risk assessments.

APPENDIX II:

Capital Base Calculations

Capital Base Calculations

1. Tier 1 Capital

1.1 Shareholders Equity (15.0)

1.2 Minority Interests (18.0)

1.3 Other (on a case by case basis)

2. Deductions

2.1 Goodwill and Other Intangible Assets (6.4)

2.2 Other (on a case by case basis)

3. Tier 2 Capital (<= 100% of Tier 1) 100%

3.1 Unsecured Subordinated Debt (<= 50% of Tier 1 capital)(10.1) 50%

3.2 Hybrid Debt/Equity Instruments (10.2)

3.3 General Loan Loss Reserves (<= 1.25% RWA*)(13.1) 1.25%

3.4 Other (on a case by case basis)

4. Total Tier 1 and 2 Capital

5. Deductions

5.1 Affiliated Bank and Other Financial Institutions (5.2.1)

5.2 Locked-in Connected Loans (on a case by case basis)

5.3 Other (on a case by case basis)

6. Adjusted Total Capital Base