Global Financial Reform and the Caribbean

Kurt Focke
Division Chief
Capital Markets & Financial Institutions
Institutional Capacity & Finance

October 2010

The Bahamas | Barbados | Belize | Guyana | Haiti | Jamaica | OECS | Suriname | Trinidad and Tobago

Agenda

- Caribbean Financial Sector & Challenges
- Global Financial Reform & Implications
- Financial Reform in The Caribbean
- Concluding Remarks

Caribbean Financial Sector & Challenges

Overview Of The Caribbean Financial Sector

- Bank centered system primarily funded by local deposits and dominated by Canadian banks
  - Commercial banks highly regulated with robust CAR and strong liquidity
- NBFIs less regulated and conglomeration necessitating consolidated supervision
  - Insurance supervision and regulation strengthened with CL Financial failure and GFC
  - Securities markets concentrated in the Barbados, Jamaica, and Trinidad and Tobago
    - Low liquidity and turnover with limited product range
  - Credit unions largely unsupervised despite being significant investors in local financial markets and having significant presence in ECCU
- GFC and global slowdown have prompted new and existing regional financial reform initiatives to address systemic risk and to harmonize regional financial legislation and supervision
  - Impact on the financial sector almost exclusively felt via the deterioration of the real economy

Real Sector Impacted Strongly By GFC & Global Slowdown

- Slump in tourism revenues and remittance flows combined with collapse of commodity prices triggered a pronounced recession in most Caribbean countries, exposing the region's vulnerability to external demand

- Deterioration amongst the most severe of all developing economy regions

GDP Growth	2007A (%)	2008A (%)	2009A (%)	2010E (%)	2011E (%)
The Bahamas	0.7	(1.7)	(5.0)	(0.5)	2.0
Barbados	3.4	3.4	(5.3)	(0.5)	3.0
Belize	1.2	1.2	(1.1)	1.0	2.0
ECCU	5.6	1.9	(6.1)	(0.3)	1.5
Guyana	7.0	2.0	3.3	4.4	4.9
Haiti	3.3	0.8	2.9	(8.5)	7.0
Jamaica	1.5	(0.9)	(2.8)	(0.3)	1.5
Suriname	5.2	6.0	2.5	4.0	4.7
Trinidad and Tobago	4.6	2.3	(3.5)	2.1	2.3
Average (w/o Guyana & Suriname)	***2.9***	***1.0***	***(3.0)***	***(1.0)***	***2.8***
Guyana & Suriname	***6.1***	***4.0***	***2.9***	***4.2***	***4.8***
United States	2.1	0.4	(2.4)	3.1	2.6
Central America	6.7	4.3	(0.8)	2.6	3.5
South America (1)	6.5	6.0	(0.0)	3.8	3.8
ASEAN-5 (2)	6.3	4.7	1.7	5.4	5.6

Source: IMF April 2010 World Economic Outlook.

(1) South America does not include Guyana and Suriname.

(2) ASEAN-5 includes Indonesia, Malaysia, Philippines, Thailand, and Vietnam.

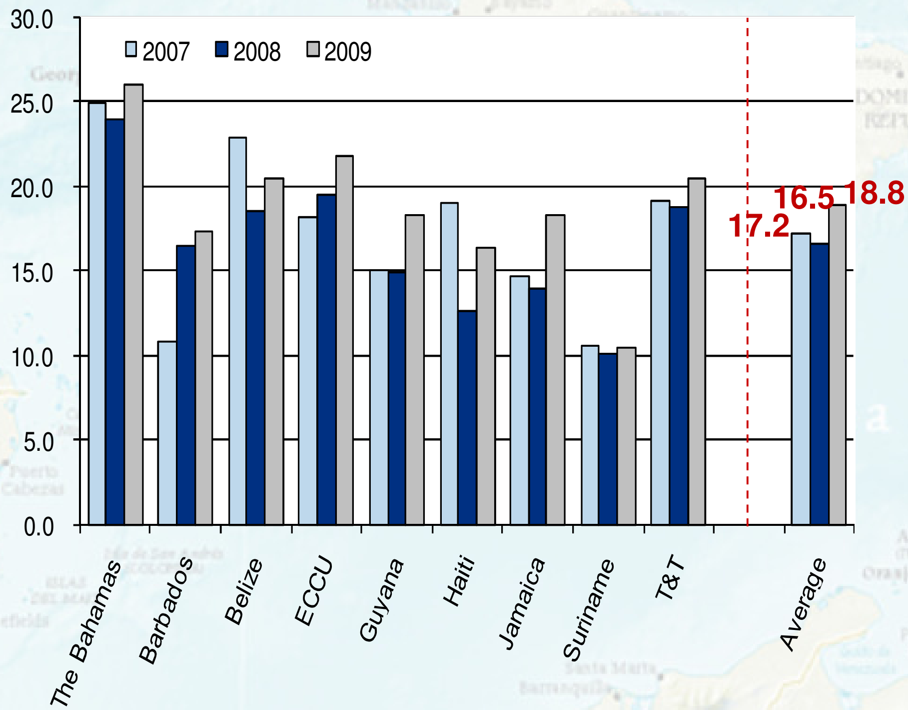
Impact Of GFC On The Caribbean Financial Sector

Banks — Highly Capitalized and Liquid

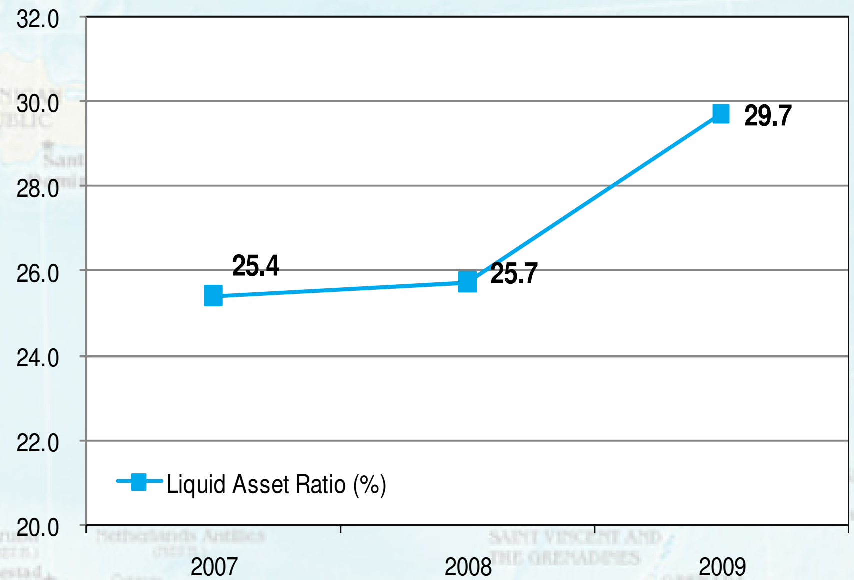
- Strong presence of Canadian banks, with stringent capital requirements discouraging excessive leverage, credited with limiting the local impact of the GFC

- Limited credit crunch

Total Capital/RWA (%)



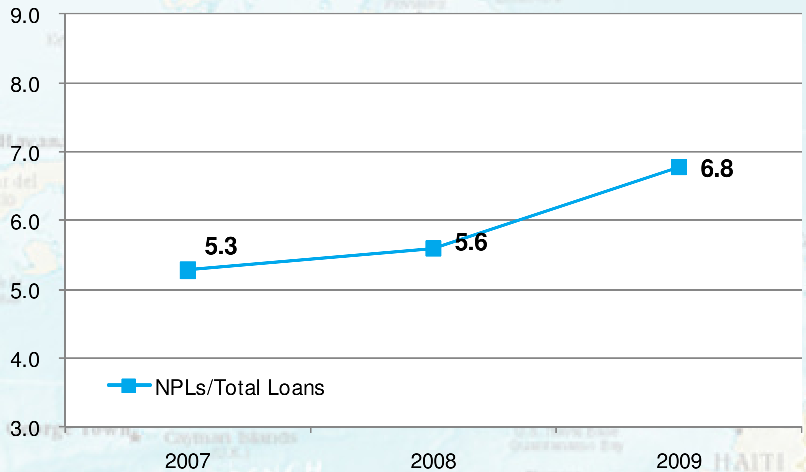
Liquid Assets/Total Assets (%)



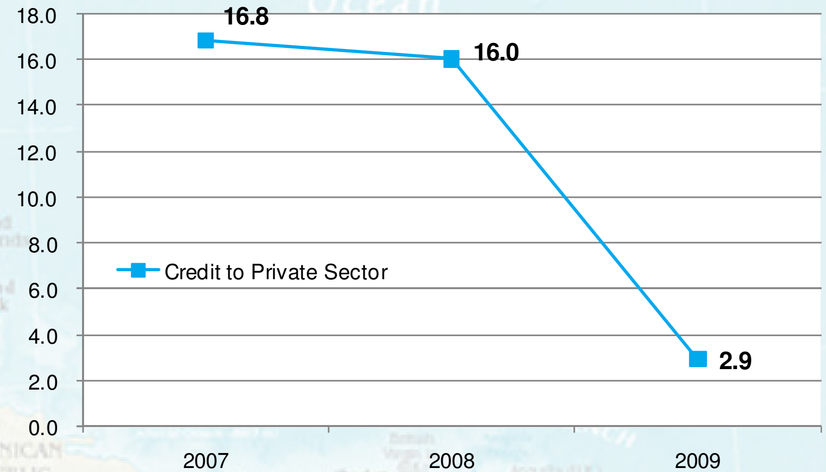
Source: IMF Article IV Consultation Reports and respective Central Banks' publications.

However, Financial Sector Affected By Economic Deterioration

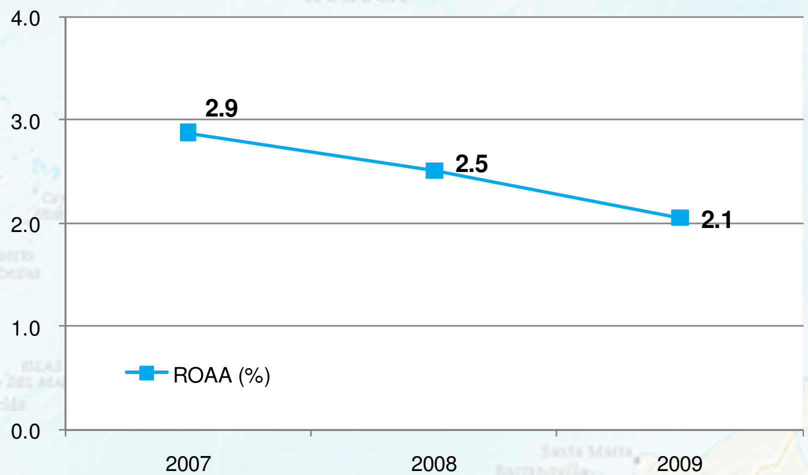
Non-Performing Loans Increasing (%)



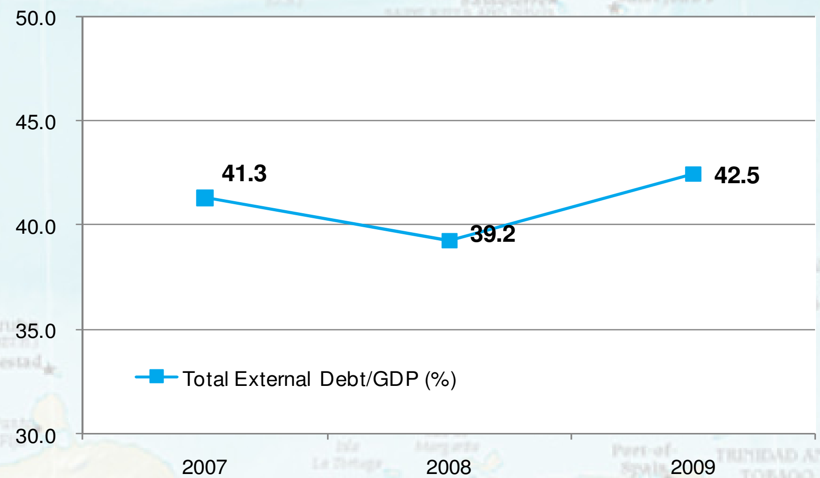
Credit Growth Declining (%)



Profitability Deteriorating (%)



External Debt Creeping Up (%)



Source: IMF Article IV Consultation Reports and respective Central Banks' publications.
(1) Simple regional averages excluding Haiti. All ratios represent y-o-y % change.

Caribbean OFC Activity Has Decreased

- Massive deleveraging resulting from the GFC has led to declining activity in Caribbean OFCs and has not yet rebounded
- The Bahamas is the only IDB member country to have a large OFC
- Barbados' OFC is relatively small, but its corporate offshore center / IBC is large

External Liabilities of Select Caribbean OFCs

(US$M)	Dec-07	Dec-08	Dec-09	Mar-10
The Bahamas	427,815	495,297	383,676	347,087
(% change)		*15.8*	*(22.5)*	*(9.5)*
Barbados	39,527	24,034	32,968	34,034
(% change)		*(39.2)*	*37.2*	*3.2*
Bermuda	111,811	72,470	77,792	74,997
(% change)		*(35.2)*	*7.3*	*(3.6)*
Cayman Islands	1,882,666	1,859,828	1,838,770	1,784,628
(% change)		*(1.2)*	*(1.1)*	*(2.9)*
Netherlands Antilles	155,602	143,490	126,957	122,187
(% change)		*(7.8)*	*(11.5)*	*(3.8)*
West Indies UK	251,880	231,406	229,482	223,024
(% change)		*(8.1)*	*(0.8)*	*(2.8)*
Select Other OFCs				
Singapore	513,137	489,058	442,520	446,199
(% change)		*(4.7)*	*(9.5)*	*0.8*
Jersey	588,316	454,063	414,248	398,250
(% change)		*(22.8)*	*(8.8)*	*(3.9)*

Source: BIS.

(1) West Indies UK includes Anguilla, British Virgin Islands, Montserrat, and Turks & Caicos.

GFC Exposed Structural & Institutional Vulnerabilities

- Caribbean financial sector impacted by GFC, but mainly by the resulting global economic slowdown and global deleveraging
- Decline in quality of loan portfolios problematic if trend not reversed
- Weakness in consolidated supervision and variances in legislation encouraged regulatory arbitrage and increased systemic risk
  - Consolidated risk-based regulation and supervision remains a challenge
- Financial conglomerates operating across markets and across borders
- NBFIs: Under-regulated and under-supervised
- Difficulty assessing exposure to contagion channels due to quality and availability of financial information and lack of crisis management plans

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Global Financial Reform & Implications

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Global Financial Reform Issues — In a Glance

- **Bank Capital (“Basel III”)**
  - Raise quality, consistency, and transparency of capital
  - Limit size (balance sheet, market share, activities) and leverage
  - Strengthen abilities to absorb losses
- **Pay & Taxation**
  - Risk-adjust compensation to align incentives with long-term returns
  - Charge financial institutions to recover the costs of resolving failed institutions
- **Liquidity**
  - Level of liquid assets banks required to hold up during stressful market conditions
- **“TBTF” / Banks & Systemic Risk**
  - Limit size (balance sheet, market share, activities), moral hazard
  - Establish resolution mechanism (“livings wills”)
- **Shadow Banking — Derivatives, Hedge Funds & Private Equity**
  - Trade OTC derivatives on regulated exchanges and clear through central counterparties
  - Registration of HFs & PE and limit bank investments in HFs &PE

Process & Timing Of Global Financial Reforms

- **United States ("Dodd-Frank Law")**
  – *Largely completed*, via legislation, which required significant compromises on initial proposals
- **United Kingdom**
  – *Largely completed*, via regulatory and executive measures, which allowed for more comprehensive reform
- **European Union**
  – *In process*, but moving ahead; combination of legislative and regulatory
- **Asia**
  – *Less comprehensive reforms*; concern about competitiveness
- **Canada**
  – *No significant reforms*; limited effect of GFC on financial system demonstrated effectiveness of regulatory framework (1)
- **G-20**
  – Increased capital requirements; leverage ratio, liquidity ratio and revision of RWA to come
    - Some major decisions delayed due to: (a) renewed focus on growth, and (b) differences within G-20 about depth of reform

(1) In October 2008, Canada's bank regulator (the Office of the Superintendent of Financial Institutions, "OSFI") imposed a conservative overlay on the capital management practices at Canadian banks. It is believed that the OSFI strongly discouraged common equity share repurchases, dividend increases, and acquisitions.

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Basel III – Less Stringent Than Expected With Generous Phase-In

- National implementation to begin in 2013 with full implementation by January 1, 2019 (excluding the phase-out of certain capital instruments over 10 years)
  - 4.5% common equity (7.0% with conservation buffer) (1) not required till January 1, 2019 though making gradual progress towards target is required
  - Stricter capital deductions to be phased in from January 1, 2014 to January 1, 2018 at 20% of the total deduction (2) amount per year
  - Countercyclical buffer within a range of 0 to 2.5% will be implemented *according to national circumstances* during periods of excess aggregate credit growth

- ***Canadian banks*** well-capitalized heading into the Basel III framework [3]
  - Strongly capitalized relative to peers and already Basel III compliant

Basel III Capital Requirements	Common Equity [1]	Tier 1 Capital	Total Capital
Minimum	4.5%	6.0%	8.0%
Capital Conservation Buffer	2.5%	2.5%	2.5%
Minimum + Buffer	*7.0%*	*8.5%*	*10.5%*
Countercyclical Buffer Range [1]	0 to 2.5%		

(1) Common equity after deductions such as DTAs, MSRS, and financials.
(2) Common equity or other fully loss absorbing capital.

- ***SIFIs*** will be subject to additional capital requirements (yet specified, but estimates of additional 100-200 bps to minimum capital standards)

Source: Basel Committee on Banking Supervision, Bloomberg, FT, US Treasury, and Wall Street research reports.
(1) Before GFC, banks were implicitly required to hold common equity equal to 2% of RWA. With Basel III, banks will effectively be required to hold tangible common equity of 7% (4.5% minimum plus 2.5% buffer).
(2) Quality of capital to be increased. Investments in financial institutions are limited to 10% stakes or 10% of the banks' common equity. Deferred tax assets ("DTAs") arising from timing differences and mortgage servicing rights ("MSRs") are also capped at 10% of the banks' common equity component. DTAs arising from factors other than timing differences are excluded from regulatory capital. DTAs, MSRs, financials combined cannot exceed 15% of adjusted TCE. No adjustments for unrealized securities gains. TRuPs eliminated from Tier 1. Goodwill and intangibles fully deducted.
(3) Large Canadian banks have an average tangible common equity of 9.7% and an average Tier 1 of 13.0%.

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Effects of Global Financial Reforms

- Provides greater tools for earlier and more effective intervention
- Potential tradeoff between reduced risk and volatility of markets, with overall access to finance, in particular credit, and thereby rate of economic growth
- Tradeoff between establishing a level playing field and having regulations adapted to the specific needs of a country and / or regions
- **Authorities**
  - More effective and efficient financial markets – higher long term growth
  - Reduced access for overly risky projects and borrowers, but improved access for less risky projects and borrowers
  - But, slower pace and depth of reform due in part to concerns about pace of economic rebound
- **Financial Institutions**
  - Regulations / deleveraging will reduce profitability leading to more difficult access and higher financing costs
  - Incentives shift from banks to capital markets financing – hurts smaller firms and households
  - Create competitive disadvantage for institutions in reforming countries

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Financial Reform in The Caribbean

Global Financial Reforms – Challenges for The Caribbean

- Deleveraging
- Consolidated supervision
  - NBFI regulations need to be strengthened
- Systemic risk management
  - Cross-border supervision and financial conglomerates
  - Linkages between banks and NBFIs
  - Wind-up plans
- Information availability and quality
  - Accounting and reporting standards need to be reinforced and harmonized
- Reforms could increase risk premiums, and thereby potentially increase costs and impede access for those that are considering greater external financing (1)
  - To date, however, country risk spreads have declined

Source: IMF Staff Position Note 10/10 (August 16, 2010). (1) Lowering risks and raising costs will likely lower profitability of the financial sector.

Financial Reform Initiatives In The Caribbean

- National reforms focusing on enhanced consolidated supervision, systemic risk monitoring, and intervention mechanisms
- **Barbados**
  - Legislation in process to enhance non-bank supervision and facilitate better consolidated supervision
- **Jamaica**
  - Reform of banking act focusing on enhanced consolidated supervision, prompt corrective actions, and reduction of risks from securities trading
- **Trinidad and Tobago**
  - Enhanced non-bank and consolidated supervision
  - Facilitation of cross-border sharing of information
- **Regional**
  - Caribbean Financial Action Task Force established to enhance monitoring of systemic risk and to coordinate intervention measures during GFC

Caribbean OFCs Now OECD Compliant

- Size of the OFC business in the Caribbean, as estimated by the size of the external balance sheet at end-2007 was over US$13 trillion (over 40x of combined 2007 GDP for a population of roughly 1.9M)
- All identified Caribbean OFCs (with the exception of Belize) are part of the "White List" of the OECD international tax standard on transparency and exchange of information
  - Only Barbados, Bermuda, BVI, and the Cayman Islands were on the White List as of August 2009

	Main International Financial Activity				
	International Banking (1)	Insurance (2)	Asset Management (3)	Structured Finance (4)	OECD TIEA Status (as of 7/2010) (5)
Aruba	X	X	X		Yes, White
The Bahamas	X	X	X		Yes, White
Barbados	X	X	X		Yes, White
Belize	X	X	X		**Yes, Gray**
Bermuda	X	X	X		Yes, White
Cayman Islands	X	X	X	X	Yes, White
Netherlands Antilles	X	X	X		Yes, White
Select OECS (6)	X	X	X	X	Yes, White
Turks and Caicos	X	X	X		Yes, White

Source: IMF Working Paper WP/10/38, "Cross-Border Investment in Small International Financial Centers", February 2010.
(1) International Banking = Use of SIFCs for "off balance sheet" activities such as the establishment of conduits and structured investment vehicles and for overnight asset sweeps.
(2) Insurance = Primarily captive insurance established by onshore firms to offer insurance for group-wide activities.
(3) Asset Management = Primarily hedge fund investments where feeder funds gather contributions from clients and are typically managed by onshore master funds. Also includes mutual funds which are funds in the Bahamas, Barbados, Belize, Bermuda, BVI, Cayman Islands.
(4) Structured Finance = Special purpose vehicles and investment vehicles are typically established in an SIFC to hold a specific asset or bundle of assets.
(5) OECD TIEA status as of July 2010. Countries on the OECD TIEA "Gray List" have yet signed over 12 TIEAs and have committed to the internationally agreed tax standard, but have yet substantially implemented. Countries on the "White List" have signed over 12 TIEAs and have substantially implemented the internationally agreed tax standard. Montserrat is on the "Gray List".
(6) Select OECS includes Anguilla, Antigua and Barbuda, British Virgin Islands, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

Concluding Remarks

The Way Forward

Strengthen Regional Regulatory Institutions

- CARICOM Financial Services Agreement and Investment Code
- Regional entity for consolidated cross-border, cross-functional supervision and criteria for all types of financial institutions, financial conglomerates, and financial activities
  - College of Regulators
  - Regional crisis resolution plan to enable prompt corrective action
  - Sharing / pooling of resources given human capital and resource constraints

The Way Forward – Fundamentals

Build Strong Financial Infrastructure

- Caribbean Financial Stability Report, Financial Soundness Indicators, and Early Warning Indicators (Crisis Management Plan)
  - IDB and UWI-CCMF regional financial stability project
  - IDB regional enterprise surveys
- Regional credit bureau
- Consumer protection watchdog agencies (i.e., anti-trust bodies, deposit insurance corporations)
- Canadian Banks – leverage strong regional presence to gain business, regulatory, and risk management knowhow

"An institution can never have enough capital or liquidity if there are material flaws in its risk management practices" and "supervision needs to be intrusive, adaptive, skeptical, proactive, comprehensive, and conclusive" to be effective. (1)

(1) Viñals, J., and J. Fiechter, 2010. "The Making of Good Supervision: Learning to Say "No"," IMF Staff Position Note 10/08 (Washington: International Monetary Fund).

IDB Support for Financial Reforms in The Caribbean

- IDB is currently funding 7 technical assistance programs in the region for a total of US$4.6M aimed at improving financial stability. Activities include:
  - Institutional strengthening, regulatory and supervisory reforms, and capacity building
- ***Regional***
  - Caribbean peer-led effort to enhance compliance with Basel Core Principles US$741K
  - Application of General Principles to Remittance Markets US$1.7M
  - Support for the establishment of a Caribbean Credit Rating Service US$325K
- ***Barbados***
  - Institutional strengthening of the savings and loan sector in Barbados US$840K
- ***Belize***
  - Institutional strengthening of the credit union sector US$577K
- ***Guyana***
  - Technical assistance for financial sector reform US$300K
- ***Suriname***
  - Improving skills standards in accounting and financial management US$135K

IDB has also supported the Caribbean with policy-based loans ("PBLs") structured under a comprehensive approach for government-led regulatory, legal institutional reforms. For example, US$15M has been lent to Guyana for financial sector reform programs.

"IDB is committed to the Caribbean development process and looks to further the collaboration and dialogue necessary to engender innovation, sustained growth, productivity, and prosperity"

Thank you for your attention

Kurt Focke
Division Chief
Capital Markets & Financial Institutions
Institutional Capacity & Finance
Tel: 1-202-623-3580
E-Mail: KURTF@iadb.org

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Appendix

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Main Characteristics Of The Caribbean Financial Sector

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  - Insurance supervision and regulation strengthened with CL Financial failure and GFC
- GFC and global slowdown have prompted new and existing regional financial reform initiatives to address systemic risk and to harmonize regional financial legislation and supervision
  - Impact on the financial sector almost exclusively felt via the deterioration of the real economy

	Non-Bank Financial Institutions		
Commercial Banks	**Insurance**	**Securities**	**Credit Unions**
• Highly concentrated with foreign dominance • Robust CAR & strong liquidity	▪ Highly concentrated ▪ Increased risks, ALM mismatch with bank-insurance linkages & conglomeration ▪ Significant in Guyana	▪ Capital raising mainly on exchanges in Barbados, Jamaica, & Trinidad ▪ Low liquidity & turnover ▪ Limited product range	▪ Significant investors in local financial markets ▪ Growth in assets & business model prompting regulation ▪ Significant in ECCU
Degree of Supervision & Regulation			
▪ Medium to high	▪ Low to medium (underdeveloped); credit unions largely unsupervised		
Regional Supervisory Organization			
▪ CGBS	▪ CAIR	▪ CGSR	▪ None

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Global Financial Reform Overview

Bank Capital ("Basel III")

- Basel Committee on Banking Supervision to introduce tougher capital requirements that require banks to hold more capital and tighten the criteria for common equity and Tier 1 capital
- Main Issues:
  - Minimum ratios and phase-in timing
  - Countercyclical buffer
  - Tier 1 eligibility (issues such as DTA, minority interest, hybrids)
- Basel Committee has imposed higher capital requirements for proprietary trading that will come into effect at end-2011

Pay & Taxation

- Tax and bonus reform are two areas where individual countries are largely going their own way, increasing the possibility of regulatory arbitrage
- IMF has suggested two different methods for bank tax though global agreement is unexpected:
  - Global financial stability levy on balance sheets to pay for future failures
  - Financial activities tax ("FAT" tax) on bonuses or profits for countries that want to raise more money
- G-20 nations have all agreed to require their banks to link pay more closely to risk, defer large bonuses, and make claw back possible

Liquidity

- Short-term liquidity requirement to increase under Basel III; banks will need to hold enough liquid assets to survive a 30-day severe stress scenario
- Long-term liquidity issues to be addressed by a net stable funding ratio (to align timespan of assets and liabilities) has been dropped by the G-20

"TBTF" / Banks & Systemic Risk

- FSB spearheading review of systemic risks posed by global banks and markets
- Higher capital buffers for SIFIs
  - Higher Tier 1 requirements
  - Contingent capital that converts from debt to equity in case of crisis
- Weighting of proprietary trading activities for calculating capital requirements to be increased
- "Resolution and Recovery Plans":
  - FSB to require multinational banks to come up with resolution plans
  - For wind-up of a multinational bank to work national bankruptcy laws need to be harmonized

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Basel III – Less Stringent Than Expected With Generous Phase-In

- National implementation to begin in 2013 with full implementation by January 1, 2019 (excluding the phase-out of certain capital instruments over 10 years)
  - 4.5% common equity (7.0% with conservation buffer) (1) not required till January 1, 2019 though making gradual progress towards target is required
  - Stricter capital deductions to be phased in from January 1, 2014 to January 1, 2018 at 20% of the total deduction (2) amount per year
  - Countercyclical buffer within a range of 0 to 2.5% will be implemented *__according to national circumstances__* during periods of excess aggregate credit growth

- ***__Canadian banks__*** well-capitalized heading into the Basel III framework (3)
  - Strongly capitalized relative to peers and already Basel III compliant

Basel III Capital Requirements	Common Equity (1)	Tier 1 Capital	Total Capital
Minimum	**4.5%**	**6.0%**	**8.0%**
Capital Conservation Buffer	**2.5%**	**2.5%**	**2.5%**
Minimum + Buffer	***7.0%***	***8.5%***	***10.5%***
Countercyclical Buffer Range (1)	**0 to 2.5%**		

(1) Common equity after deductions such as DTAs, MSRS, and financials.
(2) Common equity or other fully loss absorbing capital.

- ***__SIFIs__*** will be subject to additional capital requirements (yet specified, but estimates of additional 100-200 bps to minimum capital standards)

Source: Basel Committee on Banking Supervision, Bloomberg, FT, US Treasury, and Wall Street research reports.
(1) Before GFC, banks were implicitly required to hold common equity equal to 2% of RWA. With Basel III, banks will effectively be required to hold tangible common equity of 7% (4.5% minimum plus 2.5% buffer).
(2) Quality of capital to be increased. Investments in financial institutions are limited to 10% stakes or 10% of the banks' common equity. Deferred tax assets ("DTAs") arising from timing differences and mortgage servicing rights ("MSRs") are also capped at 10% of the banks' common equity component. DTAs arising from factors other than timing differences are excluded from regulatory capital. DTAs, MSRs, financials combined cannot exceed 15% of adjusted TCE. No adjustments for unrealized securities gains. TRuPs eliminated from Tier 1. Goodwill and intangibles fully deducted.
(3) Large Canadian banks have an average tangible common equity of 9.7% and an average Tier 1 of 13.0%.

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Basel III – Requirements & Phase-In Timeline

Basel III Capital Requirements	Common Equity [1]	Tier 1 Capital	Total Capital
Minimum	4.5%	6.0%	8.0%
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Minimum + Buffer	*7.0%*	*8.5%*	*10.5%*
Countercyclical Buffer Range [1]	0 to 2.5%		

(1) Common equity after deductions such as DTAs, MSRS, and financials.
(2) Common equity or other fully loss absorbing capital.

7.0% TCE, rather than Tier 1, now the effective benchmark for capital adequacy [1]

Phase-In Timeline (all dates as of January 1)

(yellow shading indicates transition periods)	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio	Supervisory Monitoring		Parallel Run: 1-Jan-2013 to 1-Jan-2017 Disclosure Begins 1-Jan-2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.5%
Minimum + Buffer			*3.5%*	*4.0%*	*4.5%*	*5.125%*	*5.75%*	*6.375%*	*7.0%*
Phase-In of Deductions from CET1 [1]				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Tier 1 Capital + Buffer			*4.5%*	*5.5%*	*6.0%*	*6.625%*	*7.25%*	*7.875%*	*8.5%*
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital + Buffer			*8.0%*	*8.0%*	*8.0%*	*8.625%*	*9.125%*	*9.875%*	*10.5%*
Capital No Longer Qualifying as Tier 1 or Tier 2			Phased-Out Over 10 Year Horizon Beginning 2013						
Liquidity Coverage Ratio	Observation Period Begins				Introduce Minimum Standard				
Net Stable Funding Ratio		Observation Period Begins						Introduce Minimum Standard	

Source: Basel Committee on Banking Supervision, "Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards", September 12, 2010, page 10.
(1) Including amounts exceeding the limit for DTAs, MSRs, and financials.

(1) Preferred and hybrid capital are excluded from Tangible Common Equity ("TCE"), as are all intangible assets and most current deductions from Tier 1 capital.

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Financial Reform In The US

Federal Reserve

- Government Accountability Office ("GAO") of Congress enabled to audit emergency Fed actions
- Fed must disclose details of certain loans and cannot bailout individual firms

"TBTF" / Banks

- "Volcker Rule" prohibits banks from proprietary trading, but are allowed to invest up to 3% of their Tier 1 capital in third-party HFs and PE; non-banks may engage in proprietary trading but face higher capital charges if they do so

Systemic Risk

- Financial Stability Oversight Council ("FSOC") comprising major regulators and chaired by the Treasury secretary will look for risks and track looming problems
- FSOC will have the power to seize and break up troubled financial firms whose collapse could endanger the economy
- FDIC to run liquidation processes and FIs with at least US$50B in assets must write "living wills"
  - FDIC and Fed to write a joint rule governing the drafting of living wills by July 2011

Shadow Banking – Derivatives, HFs & PE

- SEC and CFTC will regulate derivatives with most trades having to run through clearing houses and exchanges
  - Position limits to counter excessive speculation
- HFs & PE must register with the SEC and companies that sell products like MBS must have "skin in the game" (1)

Consumer Protection

- Consumer Financial Protection Bureau ("CFPB") created within the Federal Reserve, but with its own budget and head appointed by the President
  - Elizabeth Warren appointed as adviser to assist in establishing the CFPB (2)
- Consumer finance rules, from mortgages to credits cards, to be written by CFPB
- Banks will be required to ensure that borrowers can repay and new loan disclosure requirements introduced

Credit Ratings Firms

- Office of Credit Ratings ("OCR") to be formed at the SEC to monitor ratings firms
- Investors can sue ratings firms and are encouraged to conduct their own analysis

(1) Banks are required to hold 5% of asset-backed securities on their books and securitizations of residential mortgages are limited to no more than six capital tranches, beginning Jan. 1, 2011.
(2) By appointing Warren an adviser to the President and Treasury Secretary (not as CFPB director/head), Obama avoided the need for a potentially lengthy Senate confirmation process.

US Financial Regulatory Structure

- The US has a complex regulatory framework, with federal and state institutions sharing regulatory responsibility and some federal institutions charged with overlapping responsibility
- Changes Under the 2010 Wall Street Reform and Consumer Protection Act ("Dodd-Frank")
  - **Office of Thrift Supervision ("OTS"):** Eliminated through merger with the Office of the Comptroller of the Currency ("OCC") (1)
  - **Federal Deposit Insurance Corporation ("FDIC"):** Given "resolution authority" to seize and break up troubled financial firms whose collapse may pose a threat to the financial system
  - **Financial Stability Oversight Council:** Established to monitor and address risks to financial stability
  - **Consumer Financial Protection Bureau:** Established *within* the Federal Reserve ("Fed""), with rule-making powers and some enforcement control over banks and other financial firms (2)
  - **Office of Financial Research:** Established at the Treasury to examine systemic risk
  - **SEC and CFTC:** Both assigned regulation of OTC derivatives—*responsibilities TBD*

Banks	Insurance	Equities / Securities	Commodities & Futures	Consumers
• Fed, FDIC, OCC, NCUA (3), State Bank Regulators, & Financial Stability Council (NEW)	• State Insurance Regulators	• SEC, State Securities Regulators, & FINRA (3)	• CFTC & SEC (4)	• Consumer Financial Protection Bureau (NEW) (5)

(1) Fed retains oversight of community banks and supervises complex firms. (2) Consumer Financial Protection Bureau to examine and enforce regulations for all mortgage-related businesses; banks and credit unions with assets of more than $10B; payday lenders, cashers and certain other non-bank financials firms (auto dealers are exempted). (3) NCUA=National Credit Union Association; FINRA=Financial Industry Regulatory Authority. (4) Regulation of OTC derivatives assigned to both the CFTC and SEC with imprecise guidance on responsibilities. (5) On July 21, 2011, US federal banking regulators will lose their powers to write consumer protection rules to the CFPB.

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Financial Reform In The UK

Bank Capital

- UK bank supervisors have already begun requiring banks to hold more capital and liquid assets but are awaiting global rules before formally rewriting the formal requirements

Proprietary Trading

- Banking Commission established in June 2010 to consider whether the UK banking market needs to be restructured and whether banks should be prevented from engaging in proprietary trading and other risky investment banking activities

Systemic Risk

- Systemic risk review to be given to the new Financial Policy Committee ("FPC") based within the Bank of England
- FPC to monitor and deflate asset bubbles, possibly by limiting certain types of lending to specific sectors
- Big banks required to write "resolution and recovery plans" to make it easier to unwind banks in case of failure

Levies

- Tax to be levied on the balance sheets (1) of UK banks and building societies as well as the UK operations of foreign banks

Bonuses

- FSA to continue imposing its remuneration code on the 26 largest banks and building societies, requiring them to link bankers' pay to risk and defer between 40-60% of large bonuses for three years

Consumer Protection

- Financial Services Authority ("FSA") being eliminated and its consumer protection responsibilities will be given to a new Consumer Protection and Markets Authority within the Bank of England

Short Selling

- Disclosure of short positions greater than 0.25% of outstanding shares in UK financial services companies and for companies engaged in rights issues

(1) Tax to be levied on total liabilities minus Tier 1 capital, retail deposits and any 'repo' funding secured by government debt, but levy will only apply to banks with £20B after the deductions. The levy starts at 4 basis points (0.04%) in January 2011 and will rise to 7 basis points (0.07%) in 2012.

UK Financial Regulatory Structure

Consolidation of Power from a Tripartite to Bipartite System

- The UK financial sector is currently regulated by a tripartite system consisting of the Bank of England (BoE), the Financial Services Authority (FSA), and the Treasury
  - BoE is responsible for monetary policy and monitors systemic risk
  - FSA focuses on supervision of banks and other financial institutions and consumer protection
  - Treasury acts as the guardian of the public purse
  - Commission on Banking, an independent group established in June 2010, will focus on financial-stability issues

Present Structure

Bank of England	Treasury	FSA	Commission on Banking
		To Be Eliminated	Independent (Est. 6/2010)

Proposed Structure (implementation by the end of 2012)

Bank of England	Treasury	Consumer Protection	Law Enforcement
		New	New

- The FSA will be eliminated and its functions will be assumed by the BoE and two new agencies for consumer protection and law enforcement
  - BoE to supervise banks and other financial institutions

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Financial Reform In The EU

Bank Capital

- Tighten capital rules for securitizations, large exposures and trading book risks
- Considering liquidity standards, leverage ratios, measures to deal with the risks posed by SIFIs, and dynamic provisioning

Systemic Risk

- Establish a new "European Systemic Risk Board", comprised of central bankers, which would warn about high-level risks to the EU
- Establish three pan-EU financial watchdogs for banking, insurance, & securities markets

Levies

- EC wants to establish an EU-wide network of national bank resolution funds to be financed by a levy on the banking sector
- Proposals on a 'crisis management framework' are expected later in 2010, followed by legislation in 2011

HFs & PE

- Authorization to sell products in the EU and operating & custodial standards requirements expected

Commodity Speculation

- Revision of Markets in Financial Instruments directive ("MiFID") to curb excessive speculation activity and increase transparency
  - Impose position limits

Bonuses

- Between 40-60% of bonuses would have to be deferred for three to five years, and half of any upfront bonus would have to be paid in shares or securities linked to the bank's performance
- Bonus rules to be implemented by January 1, 2011
- Higher capital requirements for banks which run excessively risky remuneration policies is required

Consumer Protection

- Bank depositors will be covered, in the event of a bank failure, for up to €100,000 from 2011
- Investor compensation schemes must guarantee pay out of up to €50,000 per investor in the event of investment firm fraud

Derivatives

- Standardized OTC derivative contracts to be cleared through central counterparties and mandatory reporting to trade repositories
- Non-centrally cleared contracts will be subject to higher capital requirements

Short Selling

- Discussing rules to make short selling activities more transparent and rules to reduce naked short selling

EU Financial Regulatory Structure

- The European Commission will overhaul Europe's system for supervising banks and insurers, emphasizing micro-prudential and macro-prudential supervision to oversee both individual institutions and the overall banking framework
  - The European Commission, Parliament, and Council ("Level 1 Committee") are responsible for drafting legislation to cover financial institutions and the EBC, EIOPC, ESC, and EFCC ("Level 2 Committee") assist in implementing measures for EU Directives and provide policy advice [1]; *<u>however, supervision remains a member state responsibility</u>*
  - "Level 3 Committee" of supervisors (EBA, EIOPA, ESMA) to be given increased responsibilities for the banking, insurance, and securities sectors to ensure their contribution to supervisory cooperation and regulatory convergence at the EU level [2]

(1) EBC=European Banking Committee; EIOPC=European Insurance and Occupational Pensions Committee; ESC=European Securities Committee; EFCC=European Financial Conglomerates Committee. (2) EBA=European Banking Authority (based in London); EIOPA=European Insurance and Occupational Pensions Authority (based in Frankfurt); ESMA=European Securities and Market Authority (based in Paris).

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Financial Reform In Hong Kong & Singapore

Hong Kong

Consumer Protection

- Securities and Futures Commission ("SFC") focused on sales practices of financial institutions:
  - Mandate disclosure of main features and risks of investment products
  - Provide investors a post-sale 'cooling-off' period for certain unlisted structured products to exit from investments

Bonuses

- Hong Kong Monetary Authority ("HKMA") issued guidelines in 2009 to reform pay practices in line with G-20 standards
  - Both local banks and HK operations of foreign banks have until end-2012 to demonstrate that they are in compliance with the HKMA

Singapore

Systemic Risk

- Considering including macro-prudential assessments such as credit growth or the systemic importance of a financial institution in the determination of appropriate regulatory treatment
- Increase minimum collateral and exposure requirements for bank real estate loans and investments

HFs & PE

- Capital requirements and business conduct rules are being imposed on smaller funds, while bigger ones (AUM>$250M) will have to be fully licensed
- All fund management companies will have to keep customers' funds and assets with independent custodians

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