

REPORT ON THE STATUS OF IMPLEMENTATION OF THE BASEL STANDARDS IN LATIN AMERICA AND THE CARIBBEAN

2022



*“Strengthening banking regulation
and supervision in the Americas”*



A S B A

ASSOCIATION OF SUPERVISORS
OF BANKS OF THE AMERICAS

**REPORT ON THE STATUS OF IMPLEMENTATION OF THE BASEL STANDARDS
IN LATIN AMERICA AND THE CARIBBEAN**

July 2022

All rights reserved. Reproduction of the material contained in this publication is authorized only for educational, research, or other non-commercial purposes without prior authorization of the Association of Supervisors of Banks of the Americas provided the source is acknowledged. The information contained in this publication has been compiled by the Association so that no representation is made on its relevance or certainty.

For additional information: asba@asbasupervision.org
asbasupervision.com

Calle Picacho Ajusco #238, oficina 601
Colonia Jardines en la Montaña, C.P. 14210
Ciudad de México, México
(+52) 55 5662 0085

BOARD OF DIRECTORS

CHAIRMAN

Paulo Sérgio Neves de Souza

Deputy Governor for Supervision
Banco Central do Brasil

VICE CHAIRMAN

Jorge Alexander Castaño Gutiérrez

Superintendent
Superintendencia Financiera de Colombia

REGIONAL DIRECTORS

Jorge Mogrovejo González

Deputy Superintendent of Banking and Microfinance
Superintendencia de Banca, Seguros y AFP, Perú

Prudence Edwards

Director, Bank and Trust Department
Turks & Caicos Islands Financial Services Commission

Mario Ernesto Menéndez Alvarado

Superintendent
Superintendencia del Sistema Financiero, El Salvador

Juan Pedro Cantera Sención

Superintendent of Financial Services
Banco Central de Uruguay

Jesús de la Fuente Rodríguez

Chairman
Comisión Nacional Bancaria y de Valores, México

SECRETARY GENERAL

Pascual O'Dogherty

TABLE OF CONTENTS

INTRODUCTION	5
I. GENERAL PERSPECTIVE ON REGULATION	6
Proportionality approaches	7
II. PILLAR 1 - MINIMUM CAPITAL REQUIREMENTS	10
a. Regulatory Capital	10
b. Risk Coverage	11
c. Leverage and Liquidity Standards	14
III. PILLAR 2 - SUPERVISORY REVIEW	16
Risk-Based Supervision	16
FINAL CONSIDERATIONS	26
ANNEX	27
TERMS AND ACRONYMS	30
WORKING GROUP	31
ASBA MEMBERS	32

INTRODUCTION

In December 2021, the Association of Supervisors of Banks of the Americas (ASBA) distributed the Survey on the Implementation of Regulatory and Supervisory Standards among its associate members. ASBA received responses from 30 financial supervisory authorities in Latin America and the Caribbean¹.

This report follows up on the initial survey implemented in 2017 depicting the most important findings with regards to the implementation status of the Basel standards, and the potential importance of developing a proportional regulatory framework in the region. It should be noted that member jurisdictions have made significant efforts to implement the Basel standards in recent years even when the health emergency delayed various regulatory processes in the region.

The report is divided into three sections. The first section provides a general perspective on regulation, including the main Basel framework on which regulation is based in the different jurisdictions and how the region applied proportionality in regulation. The second section examines the standards' implementation status corresponding to Pillar 1 of the Basel standards. That is, the definition of regulatory capital, capital requirements for risk coverage, and leverage. Finally, the third section analyzes the implementation of the four main principles that comprise Pillar 2 of the Basel standards².

¹ Antigua & Barbuda, Argentina, Bahamas, Belize, Bolivia, Brazil, British Virgin Islands, Cayman Islands, Chile, Colombia, Costa Rica, Curaçao, Ecuador, Spain, El Salvador (Central Bank and Superintendence), Guatemala, Guyana, Haiti, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Dominican Republic, Suriname, Trinidad & Tobago, Turks & Caicos Islands, Uruguay.

² The Association of Supervisors of Banks of the Americas feels grateful for the comments and suggestions made by Stefan Hohl, Senior Member of the Secretariat of the Basel Committee on Banking Supervision. The Association wishes to express its gratitude to the banking supervisory authorities that responded to the Survey on the Implementation of Regulatory and Supervisory Standards.

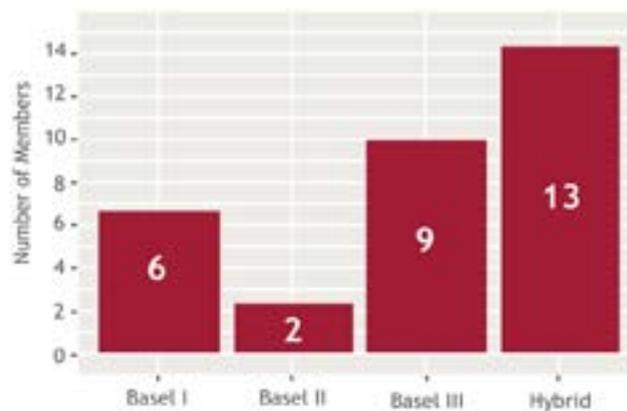
I

GENERAL PERSPECTIVE ON REGULATION

In recent years, jurisdictions in the region have made great efforts to align their banking regulatory and supervisory frameworks with the international Basel standards. Even though the health emergency postponed, or even stopped the implementation of some of these standards in several jurisdictions, great progress has been observed as compared to the last survey carried out by ASBA in 2017.

In the first place, we asked authorities about the Basel iteration in which their prudential regulation is mostly aligned. As Figure 1 shows, most jurisdictions consider their regulatory frameworks to be hybrid, in the sense that they combine standards from the different iterations of the Basel framework, as well as local adaptations. Among the main differences in these hybrid models are risk weights, the possibility and manner in which internal models are used, as well as disclosure requirements.

FIGURE 1. MAIN BASEL FRAMEWORK



For example, in the case of Peru, the credit and operational risk capital requirements are based on Basel II. Market risk requirements is under analysis to be aligned to Basel III. Furthermore, some of the Basel III standards have already been implemented, as is the case of capital buffers (2011), a minimum LCR ratio (2014), and the leverage ratio (2021)³.

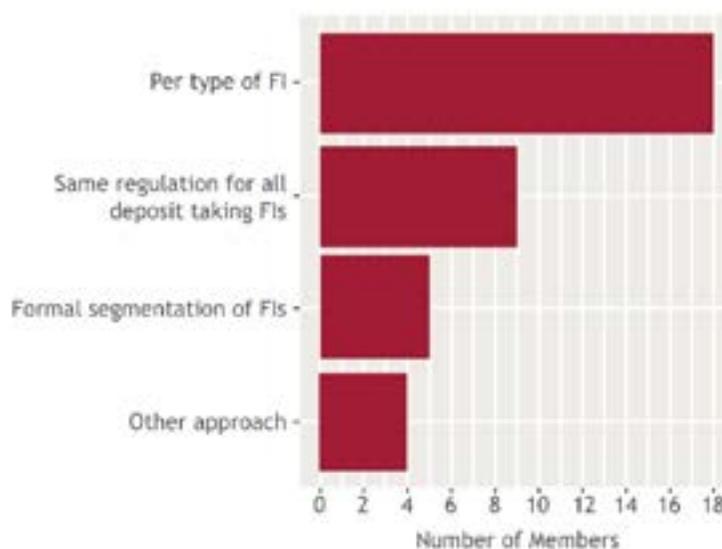
In comparison to 2017, a greater number of jurisdictions consider their regulatory framework increasingly aligned with the Basel III standards. Furthermore, several jurisdictions with hybrid models show an intention to move forward and better align their regulation to the latest standards.

³ For the leverage ratio, the authority and Peru has not defined a minimum because it would require a change in the Banking Law.

PROPORTIONALITY APPROACHES

Considering the relevance of the discussions on the proportional implementation of prudential regulation, the survey asked Authorities about the type of proportionality approaches used in their jurisdictions. Although the initial impression was that there were no formal proportionality approaches being implemented in the region (besides the one implemented in Brazil), ASBA identified several proportionality practices in regulation that are worth mentioning (Figure 2).

FIGURE 2. PROPORTIONALITY APPROACH



First, most jurisdictions implement differentiated regulations according to the various types of financial institutions (FIs) that take deposits and that carry out financial intermediation. For instance, the regulation that applies to banks is generally different from that of cooperatives, microfinance institutions, and other similar institutions.

On the other hand, five jurisdictions mentioned having a formal segmentation for the application of differentiated prudential rules according to certain characteristics. In general, the differentiated implementation occurs under a “bottom-up” approach. That is, there is a prudential basis for all institutions, and more sophisticated regulations are implemented as the complexity of the institution scales.

Unlike the common “bottom-up” approach, the Central Bank of Brazil proposed a regulatory framework that aligns the largest and most complex entities (Segment 1) with Basel III. For the other segments, simplifications of these standards apply. In particular, institutions with the most simplified profile (Segment 5) have their own rules, although always inspired by the Basel standards. In addition, in principle, financial entities in Brazil can switch from one segment to another, provided that predefined exposure and size criteria are met.

Finally, we identified a few other proportionality approaches, such as the issuance of different types of banking licenses, or even the differentiated application of prudential rules that do not depend on formal segmentation, but rather on a case-by-case supervisory judgment of an institution’s risk profile. Table 1 shows a selection of proportionality approaches in regulation which are in use by some countries in the region.

TABLE 1. SELECTION OF PROPORTIONALITY APPROACHES

COUNTRY	APPROACH
Argentina	<p>The approach is based on the size of the entity (entities are divided into three groups: A, B, and C according to the relative size of their assets) and applies different rules for each group: (i) those only applicable to D-SIBs (for example, data aggregation); (ii) group A entities, disclosure requirements (pillar 3); (iii) risk calculation uses more than one rule: group A entities calculate risk according to Basel definitions, while the remaining entities use a local standard (for example, liquidity or operational risk).</p>
Brazil	<p>The segmentation of the National Financial System is defined in Resolution CMN 4.553 of January 30, 2017. There are five segments (S1 to S5) classified according to their systemic importance (size) and the relevance of their international activity. The Basel standards are fully applied to financial institutions in the S1 segment, the largest and most complex institutions.</p>
Cayman Islands	<p>The applicability of various rules depends on the type of banking license or complexity, among other factors. For example, the LCR and NSFR rules apply to category A retail banks (banks authorized to provide domestic banking services without restrictions), while all other banks use an alternative national measure called the Minimum Liquidity Ratio (MLR).</p> <p>Similarly, for the application of Pillar 3 disclosure requirements, the Cayman Islands Monetary Authority (CIMA) designates entities as group A or group B depending on the size and complexity of the financial institutions. CIMA anticipates that all entities that are Deposit-taking Institutions of Systemic Importance to the domestic economy will be designated as group A once the framework is finalized.</p>
Colombia	<p>The Financial Superintendency of Colombia (SFC) has a methodology for the identification of systemically important entities (Annex 3 of Chapter XIII-16 of the Basic Accounting and Financial Circular), which is based on the criteria of size, interconnectedness, substitutability and complexity; with the purpose of increasing the regulatory demands related to capital requirements and risk management.</p> <p>Likewise, the SFC classifies all supervised entities into groups according to the intensity of supervision required (N1 to N4, with N1 being the most intense) in order to prioritize supervisory efforts and efficiently allocate resources for their execution.</p>
Mexico	<p>Regarding commercial banking institutions, the elements of the Mexican prudential regulation are applicable, in general, to all institutions authorized to operate in the jurisdiction. However, there are certain differences that are applicable based on the following criteria:</p> <ul style="list-style-type: none"> • Based on the Single Bank Circular (CUB, according to its acronym in Spanish), the minimum subscribed and paid-in capital applicable to multiple banking institutions must be 90, 54 or 36 million Investment Units (UDIS, according to its Spanish acronym) depending on the operations they carry out. • Commercial banking institutions of Local Systemic Importance must maintain an additional percentage of Total Weighted Assets Subject to Risk. Additionally, they must comply with the Total Loss Absorption Capacity (TLAC) requirements, in accordance with a gradual implementation.
Turks & Caicos Islands	<p>Banking regulation allows the issuance of two different types of banking licenses: international (which allows banks to incorporate non-residents) and national (banks exclusively for residents).</p> <p>On the other hand, there is also specific legislation and standards for savings and credit cooperatives. Microfinance is not regulated as they are not allowed to accept deposits.</p>

II

PILLAR 1 - MINIMUM CAPITAL REQUIREMENTS

Pillar 1 of the Basel framework establishes minimum standards for the quality and level of capital for three main components of risk faced by a bank: credit risk, market risk, and operational risk. In addition, it also includes more recent standards related to loss absorption capacity, countercyclical and capital conservation buffers, as well as the leverage standard.

a. REGULATORY CAPITAL

First, ASBA member supervisory authorities were consulted about the definition of capital in its prudential regulation. It is interesting to note from Figure 3 that two main capital definition models prevail in the region: that aligned with Basel I (10 countries) and that aligned with Basel III (11 countries).

The main difference is that the Basel III definition has a greater focus on common equity (Tier 1) and limits the inclusion of certain types of debt and hybrid instruments. A smaller number of countries consider that their definition of capital is more in line with Basel II and II.5, which considers the possibility of including a Tier 3 capital. The latter is not considered a best practice today since this type of capital does not constitute an adequate loss absorbing instrument.

Finally, jurisdictions that mentioned having a “hybrid” definition of capital, generally referred to national adaptations that modify the type of specific instruments that can be considered primary capital.

FIGURE 3. DEFINITION OF CAPITAL

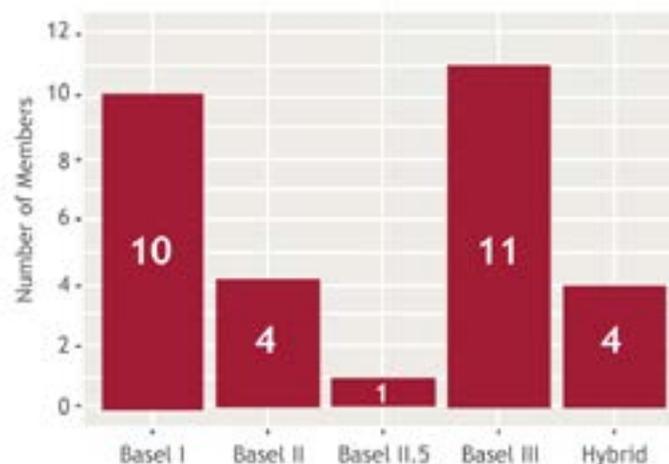
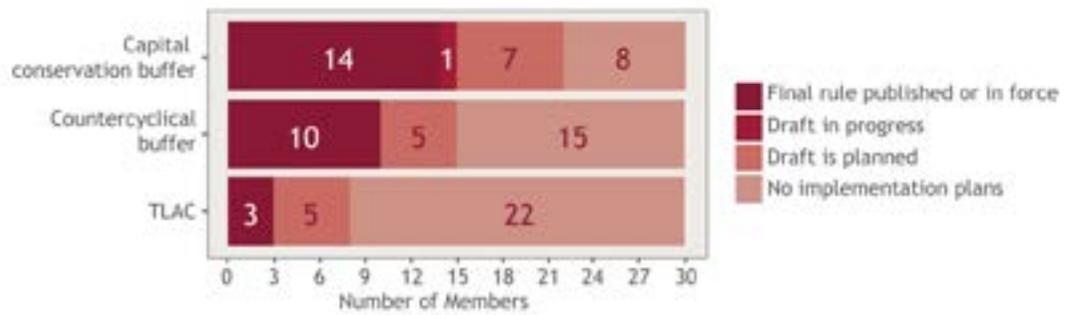


Figure 4 shows that a significant number of jurisdictions implement or intend to implement the most recent standards regarding countercyclical and capital conservation buffers, included in the Basel III framework. It is interesting to note that, even though several jurisdictions base their regulation mainly on Basel I and do not plan to adopt the full most recent Basel framework, they do consider capital buffers to be relevant and useful for their jurisdictions. Finally, we can observe that the Total Loss Absorbing Capacity (TLAC) standard does not generally apply in the region’s jurisdictions, and that in most cases there are no plans to implement this standard in the short or medium term.

FIGURE 4. ADDITIONAL ELEMENTS OF CAPITAL

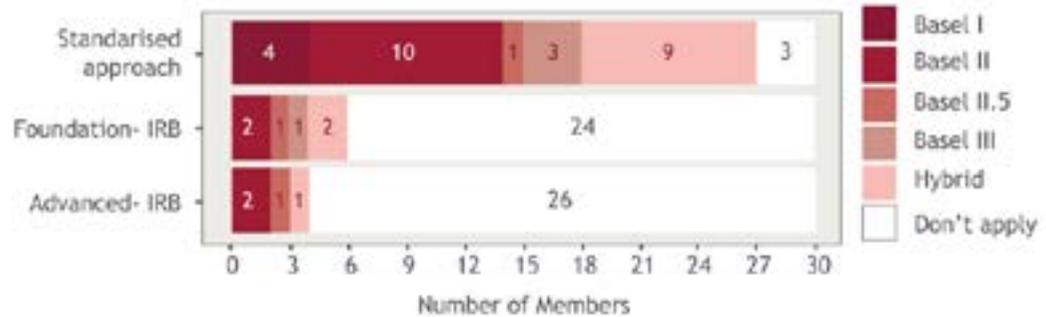


b. RISK COVERAGE

In line with what was found in the 2017 survey, standardized approaches for credit, market, and operational risk prevail in the region’s jurisdictions.

With respect to credit risk (Figure 5), most authorities implement the standardized approach from some of the iterations of the Basel framework, including Basel III. For jurisdictions that consider their methodology to be “hybrid,” they usually mean a combination of Basel (I, II and III) standards. For example, the risk weighting of assets is carried out, in some cases, in accordance with Basel I. While certain types of loans are weighted based on the Basel II debtor’s risk rating. In cases where authorities mentioned “not applicable,” the authority usually designs methodologies and performs national calculations.

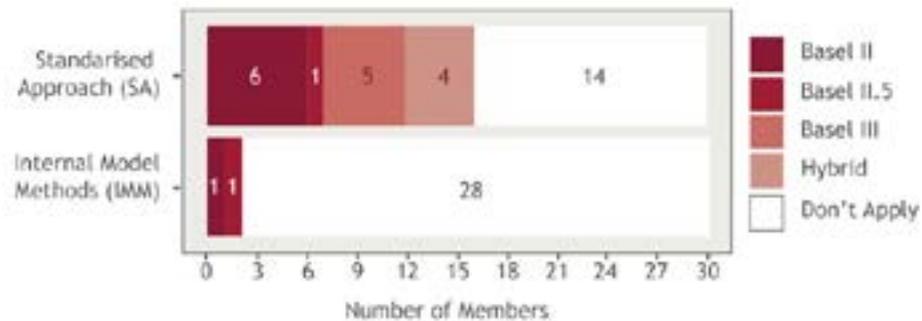
FIGURE 5. STANDARDS FOR CREDIT RISK



The implementation of the internal ratings standards is less common in the region. Most jurisdictions do not have plans to implement these in the short or medium term, with some exceptions⁴.

On the other hand, authorities have been advancing in the implementation of counterparty credit risk standards (CCR). While most jurisdictions implement, or plan to implement, the standardized approach, fewer jurisdictions consider internal model methodologies (Figure 6).

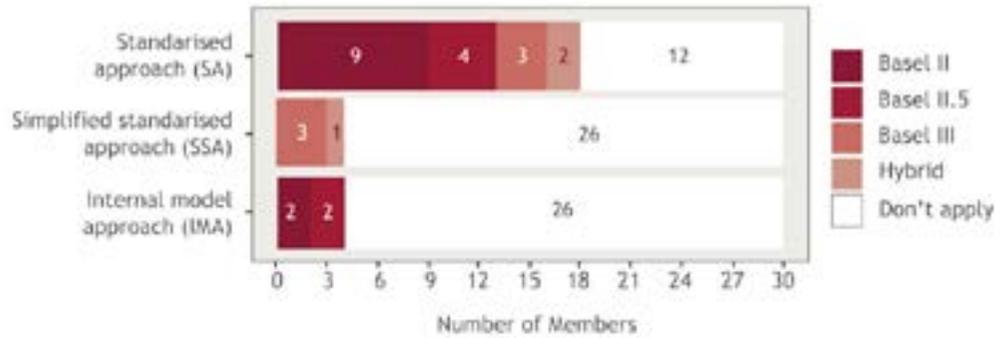
FIGURE 6. STANDARDS FOR COUNTERPARTY CREDIT RISK



Similarly, although to a lesser extent, authorities usually implement the standardized approaches for market risk (Figure 7). For jurisdictions where market risk requirements are not currently applied, authorities mentioned they are in the process of designing or implementing either the standardized approach or the simplified standardized approach in the short to medium term.

⁴ For example, the authorities of Peru, El Salvador, and Bolivia mentioned having plans to review the relevance of these standards between 2023 and 2025.

FIGURE 7. STANDARDS FOR MARKET RISK



It is worth mentioning that standards related to the use of internal models for market risk are not common in the region. Some authorities clarified that although there are no restrictions on the use of internal models for banks' internal capital planning, only standardized methods are allowed for prudential regulatory and supervisory purposes. In jurisdictions where regulation contemplates the use of internal models, authorities explained that entities must meet a series of requirements in order to be eligible to use these approaches. In many cases, and since the requirements are highly rigorous, to date, very few institutions have asked to apply this approach to calculate their capital requirements.

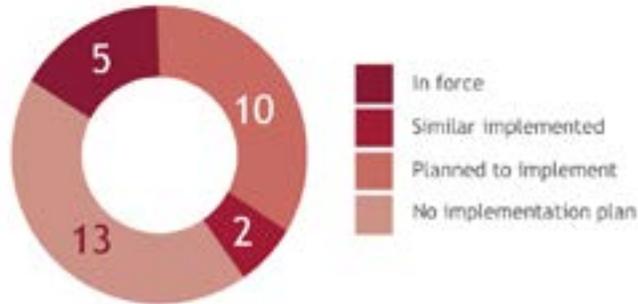
In the case of operational risk, few authorities implemented the basic, standardized, and advanced approaches of Basel II and II.5. However, we observed a willingness to implement the new Basel III standardized approach for operational risk (Figure 8)⁵.

FIGURE 8A. STANDARDS FOR OPERATIONAL RISK



⁵ This standard has two main components: the Business Indicator Component (BIC) and the Internal Loss Multiplier (ILM).

FIGURE 8B. STANDARDIZED MEASUREMENT APPROACH (SMA)

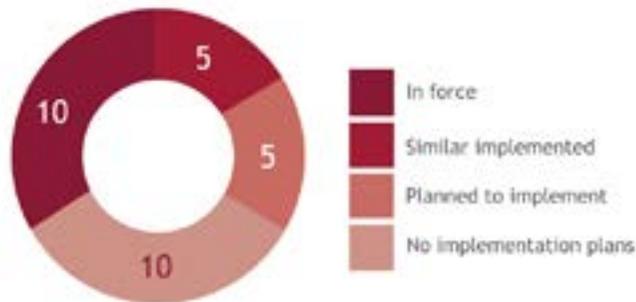


Finally, authorities were consulted on the progress in the implementation of the credit valuation adjustment (CVA) standards for counterparty credit risk and the securitization framework. These standards are depicted in more detail in the Annex, which shows that very few jurisdictions implement or plan to implement these, as the financial systems in the region have not, in general, reached that degree of sophistication.

c. LEVERAGE AND LIQUIDITY STANDARDS

In comparison to the survey conducted in 2017, a larger number of jurisdictions in the region have adopted the Leverage Ratio (LR, Figure 9) within their regulation or have adopted a similar requirement (15 jurisdictions). In addition, five jurisdictions mentioned having implementation plans in the short or medium term, while 10 jurisdictions mentioned not having any plan to implement this requirement.

FIGURE 9. LEVERAGE RATIO



For jurisdictions that have implemented a requirement similar to the LR, some differences are mentioned with respect to the Basel standard, mainly in relation to the minimum value of the ratio⁶; the criteria for the treatment of derivatives⁷; and, in some cases, there is differentiated treatment by banks' status as global or local systemically important banks. Finally, in some jurisdictions, such as Peru, the LR requirement is currently non-binding and is implemented only for monitoring purposes.

Similarly, an increasing number of jurisdictions have implemented or are planning to implement the liquidity standards from the Basel III framework or a similar requirement (Figure 10). In particular, for the Liquidity Coverage Ratio (LCR), 17 jurisdictions have fully implemented the standard or have done so with few modifications, while seven jurisdictions have an implementation plan. On the other hand, only eight jurisdictions have implemented the Net Stable Funding Ratio (NSFR) or similar requirement, while nine jurisdictions have plans to do so. In contrast, 12 jurisdictions mentioned not having implementation plans for the NSFR.

FIGURE 10A. LIQUIDITY COVERAGE RATIO (LCR)

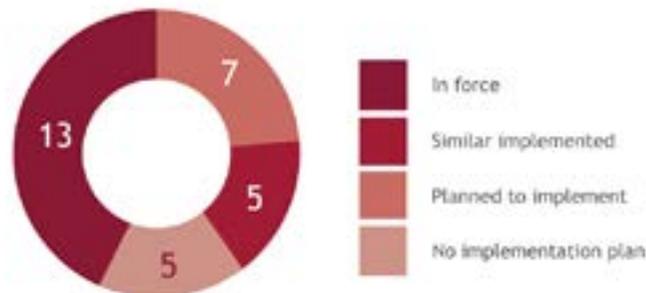
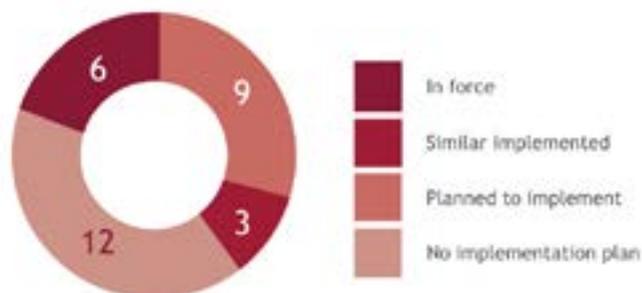


FIGURE 10B. NET STABLE FUNDING RATIO (NSFR)



⁶ While the Basel framework establishes the minimum requirement at 3%, some jurisdictions establish this coefficient at 4%, and even up to 5%.

⁷ For example, in Costa Rica, the treatment for derivatives is based on the settlement price methodology, so its scope is limited to foreign exchange derivatives. In addition, it uses the replacement cost criterion, but does not add the Potential Future Exposure (PFE) component.

III

PILLAR 2 - SUPERVISORY REVIEW

The objective behind Pillar 2, of the Basel framework, is for banks to have efficient infrastructures to monitor and manage risks in accordance with their risk profile and risk appetite, in addition to having sufficient capital to absorb losses (Pillar 1). The Basel Committee has identified four key principles for supervisory review under this Pillar⁸:

- Banks should have an internal capital adequacy assessment process (ICAAP) as well as a strategy for managing and mitigating risks.
- Supervisors should have a formal review process of the ICAAP and take appropriate supervisory actions if they are not satisfied with the results of the process.
- Supervisors should have sufficient capacity and powers to require additional capital in excess of the minimum.
- Supervisors should have sufficient ability and powers to intervene in a timely manner, and to apply corrective measures to prevent capital from falling below the minimum levels required by regulation.

RISK-BASED SUPERVISION

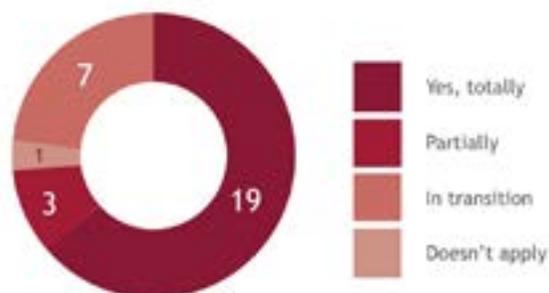
In general, supervisory authorities in the region consider Pillar 2 to be a mechanism to better associate capital with risk and, therefore, as a broader element in a risk-based supervisory review process.

In this regard, in recent years, the Americas region has shifted from the traditional compliance-oriented approach, where the priority was for banks to comply with various laws and regulations in a rigid manner, towards a Risk-Based Supervisory approach (RBS). This transition is explained by the strength of the adoption of the RBS methodology, which allows for a flexible and risk-based allocation of scarce supervisory resources under a principles-based approach.

Therefore, we considered it reasonable to ask authorities about the prevailing supervisory approach in their jurisdiction. Figure 11 shows that from a total of 30 ASBA members who participated in the survey, 22 jurisdictions fully or partially operate under the RBS approach, while seven are in a transition process. This fact is relevant given that the RBS approach is a fundamental element for the implementation of Basel's Pillar 2.

⁸ Basel Committee on Banking Supervision. "Overview of Pillar 2 supervisory review practices and approaches", June 2019

FIGURE 11. RISK BASED SUPERVISION (RBS)



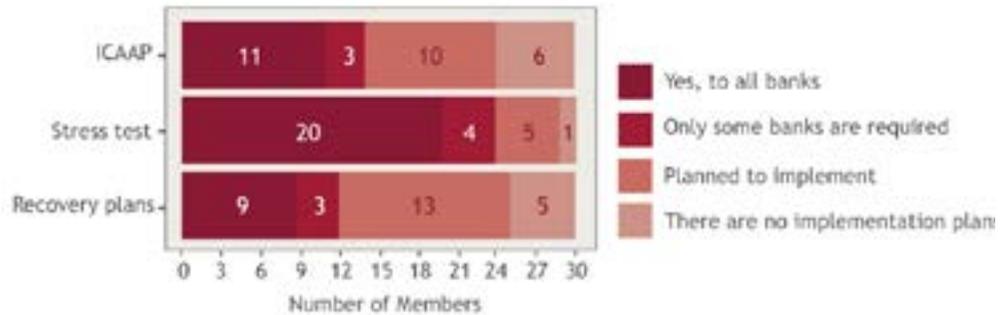
PRINCIPLE 1. ICAAP

Principle 1 of Pillar 2 determines that banks are responsible for developing an internal assessment process for their capital adequacy. This principle also includes requirements related to conducting stress testing exercises. Furthermore, although it is not a formal requirement, authorities commonly include the requirements on recovery and resolution plans as part of this principle.

In the case of ICAAP, we observed that 14 jurisdictions implemented this requirement, while 10 more plan to do so in the short or medium term (Figure 12). In addition, although this requirement is mainly intended for internationally active banks, 11 jurisdictions mentioned they implement it to all banks under their supervision, while three jurisdictions do make a difference in its implementation.

In the latter case, the differentiated application of the ICAAP requirement, i.e. applying proportionality, is based mainly on the size and complexity of the entities. For example, in the case of Brazil, ICAAP is required only for entities that belong to Segment 1, and a more simplified version to the Segment 2 entities. On the other hand, authorities in the Bahamas allow subsidiaries of larger banking groups to use the ICAAP of their parent company, but they are required to have a deep understanding of how risk management at the local level fits into the group's ICAAP approach. The Cayman Islands allows subsidiaries of foreign banks to leverage off consolidated group methodologies for assessing risks but requires the institutions to reflect their own circumstances and ensure internal capital targets and capital plan are relevant for the institution.

FIGURE 12. STANDARDS PRINCIPLE 1



On the other hand, 24 authorities mentioned that they have implemented stress testing requirements for banks under their supervision, while five have implementation plans. Although most of the jurisdictions that implement stress testing requirements applies them to all the banking entities, in practice we have observed that their scope is adapted to the size, risk profile, complexity of operations, and systemic importance of the different financial entities.

For example, in Brazil and Argentina all banks must conduct sensitivity analyses. However, only the largest and most complex banks are required to carry out scenario analysis, as well as reverse stress testing. Furthermore, in the case of Brazil, every year entities in Segments 1 and 2 must conduct stress testing exercises under scenarios designed by the Central Bank.

In addition, we also noted that the approach to stress testing differs among jurisdictions by type of risk. For example, while in the case of Bolivia or Paraguay the authorities focus stress testing on liquidity risk scenarios, in other jurisdictions, such as Mexico or Peru, stress testing is oriented towards credit and market risk. However, the regulation in Mexico also considers liquidity risks.

Finally, although it is not a formal element of this principle, most authorities implement requirements regarding recovery plans (24 jurisdictions), while an additional five jurisdictions have plans to implement this type of requirements. Also, in this case there are some proportionality approaches.

For example, in Argentina, domestic systemically important financial institutions (D-SIBs) must have recovery and resolution plans aligned with the Key Attributes of Effective Resolution Regimes issued by the Financial Stability Board (FSB). However, all financial institutions must have contingency plans that include strategies to deal with emergency situations and manage stress situations. On the other hand, in Colombia, recovery planning operates through the Stress Testing Scheme (EPR, according to its acronym in Spanish). These tests are applied to all credit institutions, including systemic, non-systemic and publicly owned entities. In addition, this jurisdiction has the authority to require supervised entities to prepare and submit resolution plans (RP), meeting requirements that correspond to the FSB's Key Attributes of Resolution Regimes. The four systemically important banks in Colombia were the first to be required to submit RPs.

⁹ In the case of Paraguay, entities must also carry out stress tests for market risk scenarios

PRINCIPLE 2. ICAAP AND RISK PROFILE RATING SYSTEMS REVIEW

Principle 2 establishes that supervisors must have a formal review process for ICAAP, in order to determine the ability of banks to meet capital adequacy requirements both currently and over a given horizon, under normal and stress conditions. As shown in Figure 13, 14 ASBA members conduct an ICAAP review process, while in the remaining jurisdictions, it is in the process of being implemented, or other methodologies and approaches are used to assess the risk profile of the entities under their supervision. In jurisdictions that already implement the ICAAP, the supervisory review criteria roughly align with the seven guiding principles of the European Central Bank (ECB)¹⁰.

FIGURE 13. SUPERVISORY REVIEW OF ICAAP



In addition, the ICAAP review process is closely related to the rating systems developed by supervisory authorities. We observed that in some jurisdictions the ICAAP assessment is integrated into a broader mechanism for the comprehensive assessment of entities' risk profile, while in other cases it seems that the ICAAP review is the main criterion to establish an entity's risk profile. In jurisdictions where the ICAAP requirement is not formally implemented, supervisors have other rating systems to comprehensively assess banks' risk profile and capital adequacy that include similar assessment elements.

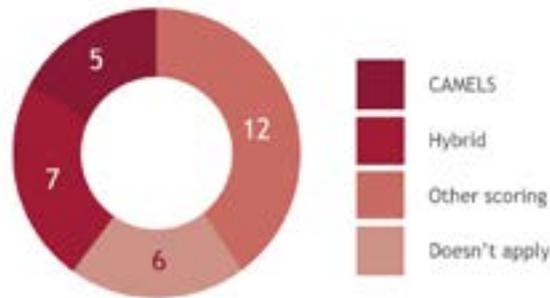
Banks' risk rating systems are a fundamental mechanism for the implementation of Pillar 2, as they help in clearly identifying risk profiles and adjusting the intensity of supervision for an efficient use of resources. Thus, authorities were asked about their rating approaches. In general, three main categories were identified: i) jurisdictions that use the CAMELS¹¹ methodology as their main approach; ii) those that use other variations of CAMELS that integrate material non-financial risks, such as operational or reputational risk; and iii) jurisdictions that have developed their own rating system.

¹⁰ These include 1) The management body is responsible for the sound governance of the ICAAP; 2) The ICAAP is integral part of the overall risk management framework of an entity; 3) The ICAAP contributes fundamentally to the continuity of the entity by ensuring its capital adequacy from different perspectives; 4) The ICAAP identifies and takes into account all material risks; 5) Internal capital is of high quality and is clearly defined; 6) ICAAP risk quantification methodologies are adequate, consistent, and independently validated; 7) Regular stress testing ensures capital adequacy in adverse circumstances.

¹¹ CAMELS is a methodology that assesses six components: (i) capital adequacy, (ii) assets quality, (iii) management capability, (iv) earnings, (v) liquidity, and (vi) sensitivity to market risk.

Figure 14 shows that five members use the CAMELS methodology as a risk rating system, seven members use hybrid CAMELS methodologies, where they integrate other material non-financial risks, while 12 jurisdictions have developed their own methodologies.

FIGURE 14. RATING SYSTEMS



In general, the methodologies developed by authorities consider roughly the same elements, including: i) sound governance and internal control structures for risk management and internal audit, ii) risk management and mitigation policies and procedures; iii) definition of strategies that align the entity’s activities with their risk appetite statement; iv) early warning and timely action systems; v) structures for the mitigation of operational, reputational, and strategic risks; vi) assessment of the quality of mitigation systems and governance structures; among others.

Another element closely related to rating systems and the ICAAP requirement is the risk appetite statement. In fact, supervisors would expect a well-articulated risk appetite statement to be closely linked to the ICAAP and to be the cornerstone of banks’ capital and risk management strategy.

As seen in Figure 15 below, 17 supervisory authorities require their banks to declare a risk appetite statement. In general, these statements should cover all material risks to which the institution is exposed, while being aligned with the bank’s business plan, strategy, capital planning, and employee compensation practices. In addition, some authorities require a link between a banks’ risk appetite statement and a set of objectives that includes limits, tolerance, triggers or thresholds.

FIGURE 15. RISK APPETITE EXPECTATIONS



It is worth mentioning that in several jurisdictions there is no prescriptive guidance on risk appetite. This is, they do not establish rigid rules or processes, but recommendations that are open to interpretation. However, authorities describe their expectations regarding the process that entities must follow to determine and monitor their risk appetite, so the approval of the risk appetite statement and its supervision widely vary around the degree of exposure, banking license, and systemic impact.

Finally, authorities agree that the boards of directors and senior management need to understand the nature and level of risk assumed by the bank while that risk is consistent with its capital levels, albeit to varying degrees of detail. That is, while the implementation of a risk management framework is usually delegated to senior management, the main objectives of the ICAAP must be reviewed and approved by the board. For this reason, authorities were asked about the requirements regarding the monitoring of decisions made by the board of directors and senior management, and whether these were implemented in a differentiated manner.

In this sense, Figure 16 shows that more than half ASBA members require banks to have a formal internal system to monitor senior management decisions, such as management dashboards or key performance indicators that are aligned with the entity's risk profile and risk appetite. Please note that these requirements usually apply to all banks and not proportionally in terms of regulation.

FIGURE 16. BOARD AND SENIOR MANAGEMENT OVERSIGHT



PRINCIPLE 3. ADDITIONAL CAPITAL REQUIREMENTS

Principle 3 of Basel's Pillar 2 establishes the supervisory expectation that all banks must operate above the regulatory minimum defined in Pillar 1 of the Basel framework. In the region, this principle is addressed through the combination of two complementary approaches.

The first approach refers to the fact that various ASBA jurisdictions establish a minimum capital risk weighted asset ratio above the established in the international standards. That is, various authorities establish the regulatory minimum in the range above 8% up to 10%.

As for the second approach, most jurisdictions (22 authorities) mentioned they have the necessary powers to impose capital requirements above the minimum regulatory requirements set in Pillar 1, in case the supervisory judgment deem it necessary (Figure 17). In this sense, the approaches used to calculate these additional requirements were consulted. In particular, we examined the cases in which the authority calculates these requirements, either through the use of predefined quantitative methods, based on supervisory judgement in a case-by-case manner, or a combination of both approaches.

FIGURE 17. PWERS FOR CAPITAL ADD-ONS

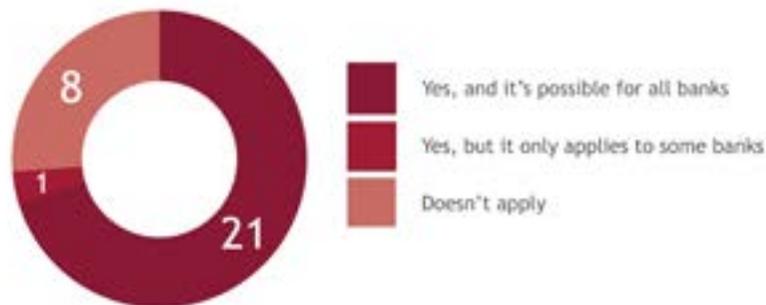
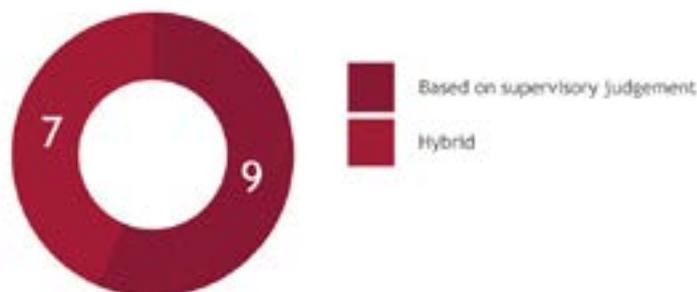


Figure 18 shows that the most common approach among members is the one based entirely on supervisory judgment on a case-by-case basis. On the other hand, some members consider their approach to be a combination of qualitative elements related to supervisory judgment and predefined methods. In no case is the calculation of capital carried out entirely through predetermined quantitative methods.

FIGURE 18. CAPITAL ADD-ONS CALCULATION APPROACHES



In practice, we observed that there is a great variety of approaches in the region regarding the type of risks covered by the additional capital requirements regulations, as well as the mechanisms to implement such requirements. In addition, we identified that in some jurisdictions, capital buffers are considered additional capital requirements similar to Pillar 2, where their application and level depend on the supervisory review process. Table 2 shows some of the approaches shared by ASBA member authorities.

TABLE 2. ADDITIONAL CAPITAL APPROACHES IN PILLAR 2	
COUNTRY	APPROACH
Argentina	<p>Financial entities must conduct an ICAAP process which considers all risks to which entities are exposed to (Pillar 2). From the joint analysis of the ICAAP, the stress tests, the in/on site inspections, among other data, the supervisors assess whether the level of capital maintained by financial institutions is adequate, according to their expert judgement, and based on their size, as well as the nature and complexity of their operations. In the event that supervisors consider the entity's level of capital to be insufficient, the respective additional capital procedures are applied.</p> <p>In the case of small and less complex entities, which use simplified methodologies, the calculation is mostly predefined in accordance with the Guidelines for the Risk Management of Financial Entities issued by the Central Bank.</p> <p>In general, the methodology applies a "k" factor locally, which is similar to an additional capital requirement for Pillar 2. This factor is based on a coefficient that increases the capital requirement resulting from Pillar 1 and varies according to the rating assigned to the entity during the CAMELBIG inspection.</p>
Bolivia	<p>The regulation issued by the Autoridad de Supervisión del Sistema Financiero (ASFI) establishes that capital add-ons above the minimum regulatory capital will be estimated based on the additional risk incurred by the entity. However, this additional capital cannot exceed two percentage points from the level that was maintained at the time the measure was applied.</p>
Brazil	<p>According to the regulation Res.4019, there are several situations in which the application of the add-on is justified, among which the following stand out: i) the entity has a risk exposure that is incompatible with its current internal control and management structures; and ii) the entity has a risk exposure not included or inadequately considered in the determination of the regulatory capital requirement.</p> <p>In this sense, two criteria were developed for the application of the add-on:</p> <ul style="list-style-type: none"> • Structured add-on. This add-on applies to banks in any segment when the supervisory assessment verifies that the entity does not have management and internal control structures compatible with its risk exposure. It can vary between 0.5% to 2.5% of risk-weighted assets. • Add-on by reference. This add-on applies to banks in segments S1 and S2, and is intended to address situations in which the current level of capital is considered insufficient to cover credit concentration risk or IRRBB. In this case, the following elements are considered: (a) a quantitative approach, in which the level of exposure to the specific risk of the entity is examined; and (b) a qualitative approach, in which the criteria and processes surrounding the respective risk management practices are examined. The results are arranged in a matrix that indicates the application of additional capital.
Cayman Islands	<p>In accordance with the Cayman Islands' Banks and Trust Companies Act, CIMA has the power to vary the capital adequacy ratio applicable, based on the risks arising from the entity's activities. The criteria used to calculate the additional capital requirement depends on the nature of the entity and on a case-by-case basis.</p>

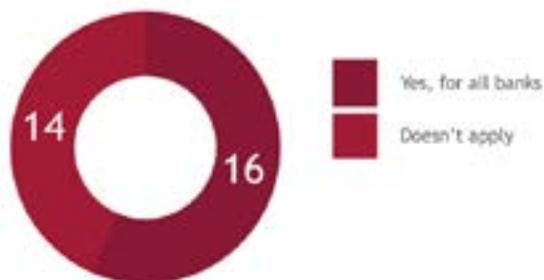
Colombia	<p>The Financial Superintendency of Colombia (SFC) evaluates the capital adequacy of supervised entities at two levels. First, compliance with regulatory capital requirements. Second, having adequate and sufficient capital to support their risk profile.</p> <p>For the evaluation of the second level mentioned, the SFC considers as a best practice that supervised entities have a capital self-assessment program (ICAAP), which allows them to generate as a result a sufficient level of capital to cover their risks, so each supervised entity is responsible for developing and implementing its own ICAAP, in order to establish internal capital targets, and develop strategies to meet them that are consistent with its business plan, risk profile and environment.</p>
Mexico	<p>The Comisión Nacional Bancaria y de Valores (CNBV) has the power to require capital buffers from banks such as the conservation, systemic, and countercyclical buffers, which are set above the minimum capital requirements.</p> <p>In addition, the General Provisions applicable to Financial Institutions (CUB) grants the power to the CNBV, with the opinion of the Bank of Mexico, to demand additional capital requirements to any institution, based on the CNBV supervisory judgement. The former, taking into account, among other aspects, the composition of capital, the composition of its assets, the efficiency of its internal control systems, and compliance with its Remuneration System.</p>
Uruguay	<p>In general, banks can apply their own methodologies to determine their capital needs for Pillar 2, within the framework of the ICAAP. The regulator provides some guidelines as means of suggestions. In any case, before imposing an additional mandatory requirement for Pillar 2, supervisors make their own calculations and compare them with what is determined by the bank in the ICAAP framework.</p>

Principle 3 of Pillar 2 also considers an additional capital requirement for the Interest Rate Risk in the Banking Book (IRRBB), which is usually not fully captured by Pillar 1 requirements.

In this case, Figure 19 shows that 16 ASBA member jurisdictions set expectations regarding the management of IRRBB for all banks. Although each financial authority has its own mechanisms to assess compliance with these provisions, they have some common elements. In general, when assessing IRRBB exposures, supervisors expect banks to consider measures based on both economic value and earnings-based measures, supported by adequate and reasonable modeling and behavioral assumptions. Supervisors also consider data sufficiency and data quality, as well as the use of sound modeling techniques.

Additionally, in the case of the approach based on economic value, most jurisdictions mention that they require banks to be aligned with the standardized or simplified standardized methodology of the Basel framework.

FIGURE 19. IRRBB REQUIREMENTS



PRINCIPLE 4. EARLY SUPERVISORY INTERVENTION

Principle 4 establishes that supervisors must intervene in a timely manner to prevent an institutions' capital from falling below the minimum levels required according to a bank's risk characteristics.

In this case, practically all authorities mentioned having mechanisms for early supervisory intervention in cases where the supervisor suspect that capital does not cover an entity's risk profile. In this sense, we identified that the first line of defense by supervisors in these cases include, measures such as: modification of the entity's risk profile; reconfiguration of the entity's corporate governance and internal organization; modification of capital levels; requirement of a recovery plan or the adoption of working plans, among others.

Once supervisors consider the initial measures to be insufficient, authorities mention having additional powers, i.e. second line of defense, including: the restriction of dividends, the cessation of risky operations, imposing limits on the type of investments carried out by entities, and even total cessation of operations in specific branches (Figure 20). Simultaneously and independently from these measures, some authorities have the power to impose sanctions and penalties against entities, their administrators, employees and other related persons, taking into account the type of finding and its materiality level.

FIGURE 20A. POWERS FOR CORRECTIVE ACTIONS 1

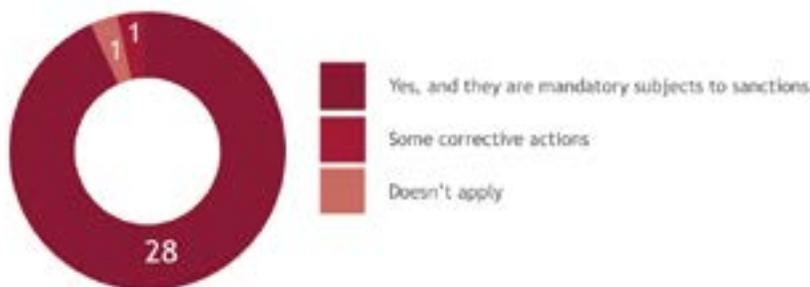
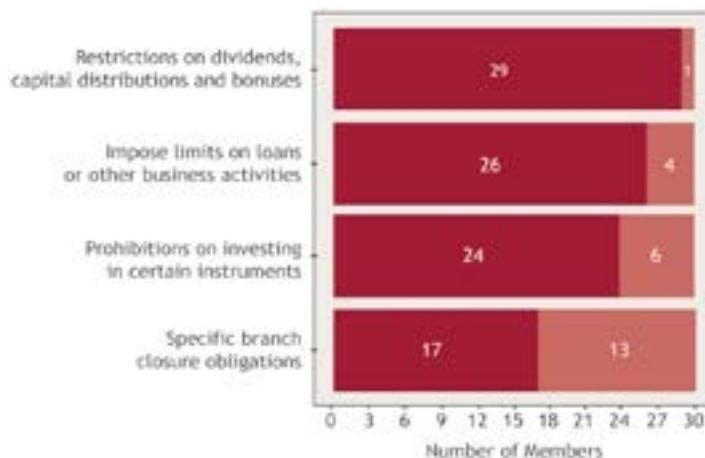


FIGURE 20B. POWERS FOR CORRECTIVE ACTIONS 2



FINAL CONSIDERATIONS

The region has made significant progress in implementing the Basel banking regulatory and supervisory standards. Countries in the region, that are not members of the Basel Committee, have generally adopted these standards under some form of applying proportionality, adapting international standards as a whole or combining rules from various iterations of the Basel framework.

Under this proportionality approach, countries in the region have mainly focused on the adoption of standardized approaches for credit, market, and operational risk. In general, we observed that the approaches based on internal models do not apply in most of the jurisdictions in the region, and in the cases where they are allowed, their applicability is limited.

In a similar vein, we observed that most jurisdictions base their prudential regulation on the Basel I or Basel II frameworks. However, they are currently implementing or plan to adopt standards included in Basel III which they consider to be relevant and useful for their jurisdictions. This is the case, for example, of the implementation of capital buffers, particularly the conservation buffer, as well as the leverage and liquidity standards.

The region has made significant progress regarding the role and powers of the supervisor. Most jurisdictions in the region are turning away from the traditional compliance-based supervisory approach and move towards a risk-based approach (SBR). This element is essential for the implementation of standards included in Pillar 2 of the Basel framework; as a result, we expect more jurisdictions will adhere to these standards within the next few years.

Regarding Pillar 2, an increasing number of jurisdictions implement or plan to implement the fundamental principles of this pillar. For example, the most important are banks' self-assessment capital requirements (ICAAP), the ICAAP supervisory review process, and additional capital requirements beyond those established by Pillar 1.

In this context, a wide variety of methodologies and approaches were observed among the jurisdictions that fully or partially implement Pillar 2. As a consideration for future work, it will be important for ASBA to explore the different approaches and tools available to supervisors in the region for the implementation of Pillar 2.

IMPLEMENTATION OF THE BASEL STANDARDS										
	Capital definition	Credit risk			Market Risk			Operational Risk		
COUNTRY		SA	IRBA Basic	IRBA Advanced	SA	SSA	Internal Modelos	BIA or SA	AMA	New SA
Antigua & Barbuda	B I	B II			B II		B II	B II		
Argentina	B III	B II			B II.5			B II		B III
Bahamas	H	H			B II			B II		
Belize	B III	H			B II	H		B III		H
Bolivia	B I	H	H							B III
Brazil	B III	B III	B III	B III	B II.5	B III	B II.5	B II	B II (revocado)	B III
British Virgin Islands	B I									
Cayman Islands	B II.5	B II.5			B II.5	B III		B II.5		B III
Chile	B III	B III	B III			B III				B III
Colombia	B III	B III			H					B III
Costa Rica	B I	H						B II		
Curaçao & Saint Maarten	B II	B II			B II			B II		B III
Ecuador	B II	H			B II					B III
El Salvador	B I	H								
Spain ¹	B III	B II	B II.5	B II.5	B II.5	B III	B II.5	B II	B II	B III
Guatemala	B II	H								B III
Guyana	B III	B II			B II			B II		H
Haiti	B III	B II			B II			B II		
Jamaica	B I	B I				B III				B III
Mexico	B III	H	H	H	B II			H	H	B III
Nicaragua	H	H								
Panama	B III	B III			B III	B III				B III
Paraguay	H	B I								
Peru	B II	B II	B II	B II	B II	B III	B II	B II		
Dominican Republic	B I	B I				B III				B III
Suriname	B I	B I			B III					
Trinidad & Tobago	H	B II			B II			B II		
Turks & Caicos Islands	B I	B II								
Uruguay	B III	B II			B II	B III				B III

<ul style="list-style-type: none"> Implemented (standardized or hybrid) With plans to implement No plan to implement 	<ul style="list-style-type: none"> B I. Basel I B II. Basel II B II.5 Basel II.5 B III. Basel III H. Hybrid 	<ul style="list-style-type: none"> SA. Standardised Approach IRBA. Internal Ratings Based Approach SSA. Simplified Standardized Approach BIA. Basic Indicator Approach AMA. Advanced Measurement Approach
---	---	---

¹ In the case of Spain, the Basel III standards for Credit Risk (SA), Basic IRB, Advanced IRB, Standard Market Risk (SA) and Internal Market Risk models are currently in the process of being implemented in the European Union.

IMPLEMENTATION OF THE BASEL STANDARDS								
COUNTRY	Credit Valuation Adjustment (CVA) in derivatives		Counterparty Credit Risk (CCR)		Securitization			Output Floor
	SA	BA	SA	Internal Models (IMM)	ERBA	IRBA	SA	
Antigua & Barbuda			B II		B II		B II	
Argentina	B III		B III				B III	
Bahamas			H				H	
Belize								
Bolivia								
Brazil			B III				B III	
British Virgin Islands								
Cayman Islands			B II.5				B II.5	
Chile			H		B III			B III
Colombia	B III	B III			H			
Costa Rica			H					
Curaçao & Saint Maarten			B II					
Ecuador								
El Salvador								
Spain	H	H	B III	B II.5	B III	B III	B III	
Guatemala								
Guyana			B II					
Haiti			B III					
Jamaica								
Mexico	B III		B II		B III		B II	
Nicaragua								
Panama	B III	B III	B III					
Paraguay								
Peru			B III					
Dominican Republic								
Suriname			H					
Trinidad & Tobago			B II				B II	
Turks & Caicos Islands								
Uruguay		B III	B III		B III			

 Implemented (standardized or hybrid)	B I. Basel I	SA. Standardised Approach
 With plans to implement	B II. Basel II	BA. Basic Approach
 No plan to implement	B II.5 Basel II.5	ERBA. External Ratings Based Approach
	B III. Basel III	IRBA. Internal Ratings Based Approach
	H. Hybrid	

IMPLEMENTATION OF THE BASEL STANDARDS			
COUNTRY	Leverage Ratio	LCR	NSFR
Antigua & Barbuda			
Argentina	B III	B III	B III
Bahamas			
Belize			
Bolivia			
Brasil	B III	B III	B III
British Virgin Islands			
Cayman Islands	B III	B III	B III
Chile	B III	B III	B III
Colombia	B III	B III	B III
Costa Rica	H	B III	
Curaçao & Saint Maarten			
Ecuador		B III	
El Salvador	H	H	
Spain	B III	B III	B III
Guatemala		B III	
Guyana			
Haiti	H		H
Jamaica	H	B III	
Mexico	B III	B III	B III
Nicaragua	B III	H	
Panama	B III	B III	
Paraguay			
Peru	B III	B III	
Dominican Republic			
Suriname		H	
Trinidad & Tobago			
Turks & Caicos Islands		H	
Uruguay	H	B III	B III

 Implemented (standardized or hybrid)	B I. Basel I
 With plans to implement	B II. Basel II
 No plan to implement	B II.5 Basel II.5
	B III. Basel III
	H. Hybrid
	LCR. Liquidity Coverage Ratio
	NSFR. Net Stable Funding Ratio

TERMS AND ACRONYMS

AMA: Advanced Measurement Approach

ASBA or Association: Association of Supervisors of Banks of the Americas

BIA: Basic Indicator Approach

CCR: Counterparty Credit Risk

CVA: Credit Valuation Adjustment

D-SIB: Domestic Systemically Important Banks

G-SIIB: Global Systemically Important Banks

ICAAP: Internal Capital Adequacy Assessment Process

IMA: Internal Models Approaches

IRBA: Internal Ratings Based Approach

LCR: Liquidity Coverage Ratio

NSFR: Net Stable Funding Ration

RBS: Net Stable Funding Ration

SA: Standardised Approach

SSA: Simplified Standardised Approach

TLAC: Total Loss Absorbing Capacity

WORKING GROUP

ASBA SECRETARIAT

Pascual O'Dogherty

Secretary General

Marcos Fabián

Research and Implementation Director

Antonio Pineda

Research and Implementation

María José Baqueiro

Communication and Coordination of
Projects with External Financing

ASBA MEMBERS

ASSOCIATE MEMBERS

Andean Region

Autoridad de Supervisión del Sistema Financiero, Bolivia
Superintendencia Financiera de Colombia
Superintendencia de Bancos del Ecuador
Superintendencia de Banca, Seguros y AFP, Perú

Caribbean Region

Financial Services Regulatory Commission, Antigua y Barbuda
Centrale Bank van Aruba
Central Bank of the Bahamas
Central Bank of Barbados
Central Bank of Belize
Financial Services Commission, British Virgin Islands
Cayman Islands, Monetary Authority
Banco Central de Cuba
Centrale Bank van Curaçao en Sint Maarten
Eastern Caribbean Central Bank
Bank of Guyana
Banque de la République d' Haïti
Bank of Jamaica
Centrale Bank van Suriname
Central Bank of Trinidad and Tobago
Turks & Caicos Islands Financial Services Commission

Central American Region

Superintendencia General de Entidades Financieras, Costa Rica
Superintendencia del Sistema Financiero, El Salvador
Superintendencia de Bancos, Guatemala
Comisión Nacional de Bancos y Seguros, Honduras
Superintendencia de Bancos y de Otras Instituciones Financieras de Nicaragua
Superintendencia de Bancos de Panamá
Superintendencia de Bancos de República Dominicana

ASBA MEMBERS

North American Region

Comisión Nacional Bancaria y de Valores, México

Federal Deposit Insurance Corporation, United States of America

Board of Governors of the Federal Reserve System, United States of America

Office of the Comptroller of the Currency, United States of America

Southern Cone Region

Banco Central de la República Argentina

Banco Central do Brasil

Comisión para el Mercado Financiero, Chile

Banco Central del Paraguay

Banco Central del Uruguay

Non Regional

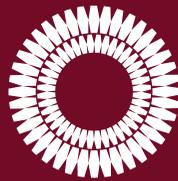
Banco de España

COLLABORATOR MEMBERS

Banco Central de Reserva de El Salvador

*Comisión Nacional para la Protección y Defensa
de los Usuarios de Servicios Financieros, México*

Comisión Nacional de Microfinanzas, Nicaragua



Λ S B Λ

ASSOCIATION OF SUPERVISORS
OF BANKS OF THE AMERICAS