APPENDIX “2”

Cayman Islands Monetary Authority

PRIVATE SECTOR CONSULTATION

BASEL II – MARKET DISCIPLINE DISCLOSURE REQUIREMENTS (PILLAR 3)

A. Introduction

1. Section 34(1)(a) of the Monetary Authority Law (2016 Revision) (as amended) (“MAL”) states that –

   After private sector consultation and consultation with the Minister charged with responsibility for Financial Services, the Authority may –

   (a) *issue or amend rules or statements of principle or guidance concerning the conduct of licensees and their officers and employees, and any other persons to whom and to the extent that the regulatory laws may apply;*

2. Requirements specific to the private sector consultation are outlined in section 4(1) of the MAL as follows:

   When this Law requires private sector consultation in relation to a proposed measure –

   (a) the Authority shall give to each private sector association a draft of the proposed measure, together with –

   i. an explanation of the purpose of the proposed measure;

   ii. an explanation of the Authority’s reasons for believing that the proposed measure is compatible with the Authority’s functions and duties under section 6;

   iii. an explanation of the extent to which a corresponding measure has been adopted in a country or territory outside the Islands;

   iv. an estimate of any significant costs of the proposed measure, together with an analysis of the benefits that will arise if the proposed measure is adopted; and

   v. notice that representations about the proposed measure may be made to the Authority within a period specified in the notice (not being less than thirty days or such shorter period as may be permitted by subsection (3));and

   (b) before proceeding with the proposed measure, the Authority shall have regard to any representations made by the private sector associations, and shall give a written response, which shall be copied to all the private sector associations.

3. The Cayman Islands Monetary Authority (“the Authority”) seeks consultation and comment from the private sector associations concerning the following:

a. Basel II – Market Discipline Disclosure Requirements (Pillar 3)

B. Background

4. In 2004, the Basel Committee on Banking Supervision ("BCBS") issued the International Convergence of Capital Measurement and Capital Standards – A Revised Framework, more commonly known as Basel II. The aim of this framework was to secure international convergence on revisions to supervisory regulations governing the capital adequacy of internationally active banks and create more robust and effective capital standards.

5. Basel II is comprised of three (3) pillars, Pillar 1 – Minimum Capital Requirements, Pillar 2 – Supervisory Review Process and Pillar 3 – Market Discipline. The purpose of the latter is to complement Pillar 1 and 2 and aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information, capital, risk exposure, risk assessment processes, and hence the capital adequacy of the institution.

6. Subsequent to the 2008 financial crisis, BCBS took numerous steps to further enhance global capital standards, having identified systemic failings post-crisis. *Revisions to Basel II Market Risk Framework* (a part of "Basel 2.5") and *The Basel III – A Global Regulatory Framework for more Resilient Banks and Banking Systems* were both originally issued in 2010 and represented a key supplement to the existing Basel II framework. Amongst these improvements were the releases of specific standards related to market discipline, achieved through comprehensive targeting of disclosure requirements. These included:

    a. *Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework Standards* issued in 2017;
    b. *Revised Pillar 3 Disclosure Requirements* issued in 2015;
    c. *Net Stable Funding Ratio ("NSFR") Disclosure Standards* issued in 2015;
    d. *Liquidity Coverage Ratio ("LCR") Standards* issued in 2014;
    e. *Basel III Leverage Ratio Framework and Disclosure Requirements* issued in 2014; and
    f. *Pillar 3 Disclosure Requirements for Remuneration* issued in 2011.

7. Importantly, NSFR, LCR and Leverage Ratio disclosure requirements are not included in the proposed Pillar 3 requirements as these Basel capital standard components have not yet been implemented in the Cayman Islands. These components, and related disclosure requirements, will be implemented as appropriate in the future.

8. In keeping with these international developments, the Authority commenced the implementation of the Basel II framework, in the Cayman Islands, in 2008. This undertaking was to be completed in two phases. The first phase was to include Pillars 1 (standardised approaches), 2 and 3, with the completion of Pillar 1 taking priority. The second phase of the Authority's Basel II implementation would include the advanced approaches of Pillar 1. Though the framework has not been completed, the Authority continues to progress towards full implementation.

9. The Authority issued *Rules, Conditions and Guidelines on Minimum Capital Requirements (Pillar 1)* and *Guidance Notes for the Completion of the Basel II Forms and the Quarterly Prudential Returns* in 2010, *The Supervisory Review Process (Pillar 2) Rules and Guidelines* in 2012 and is now seeking to issue *Market Discipline Requirements (Pillar 3).*

10. Broadly, and particularly relevant to the Authority's current undertaking to achieve an internationally comparable disclosure requirements framework,

comprehensive Pillar 3 implementation embodies the promotion of increased transparency which allows for independent and timely scrutiny by stakeholders and other market participants. In turn, due to enhanced periodic monitoring, banks' board of directors and senior management become more aligned with the interests of stakeholders. Furthermore, the strengthening of core business practices that mitigate the bank's exposures to risks and actively considers the level of capitalisation is encouraged.

11. BCBS Pillar 3 standards are a fundamental component of Basel II and III capital requirements and represent an important foundation for improved comparability and consistency of disclosures between internationally active banks, in the promotion of market discipline.

C. <u>Purpose of Proposed Measure and Consistency with Authority's Functions</u>

12. Section 6(1) of the MAL provides that the principal responsibilities of the Authority include its regulatory functions, inter alia, "to regulate and supervise financial services business carried on in or from within the Islands …"

13. Section 6(3) of the MAL provides that in performing its regulatory functions, the Authority shall, inter alia:

    a. endeavour to promote and enhance market confidence and the reputation of the Islands as a financial centre;
    b. recognise the international character of financial services and markets and the necessity of maintaining the competitive position of the Islands, vis a vis both consumers and suppliers of financial services, while conforming to internationally applied standards insofar as they are relevant and appropriate to the circumstances of the Islands;
    c. recognise the principle that a burden or restriction which is imposed on a person or activity should be proportionate to the benefits, considered in general terms; and
    d. recognise the desirability of facilitating innovation in financial services business.

14. The proposed Pillar 3 requirements will ultimately further the regulatory function of the Authority in line with Sections 6(1) and 6(3) of the MAL, as stated above.

D. <u>International Standards</u>

15. As highlighted above, Pillar 3 disclosure requirements are core to Basel International Capital Standards. This is further evidenced in the Basel Core Principles ("BCP"). *BCP 28: Disclosure and Transparency* states *"The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposure, risk management strategies and corporate governance policies and processes."* The specific criteria of the BCP are outlined below:

BCP 28: Disclosure and Transparency	***<u>Essential Criteria</u>*** *1. Laws, regulations or the supervisor require periodic public disclosures of information by banks on a consolidated and, where appropriate, solo basis that adequately reflect the bank's true financial condition and performance, and adhere to standards*

	promoting comparability, relevance, reliability and timeliness of information disclosed. 2. *The supervisor determines that the required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, aggregate exposures to related parties, transactions with related parties, accounting policies, and basic business, management, governance and remuneration. The scope and content of information provided and the level of disaggregation and detail is commensurate with the risk profile and systemic importance of the bank.* 3. *Laws, regulations or the supervisor require banks to disclose all material entities in the group structure.* 4. *The supervisor or another government agency effectively reviews and enforces compliance with disclosure standards.* 5. *The supervisor or other relevant bodies regularly publishes information on the banking system in aggregate to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on the balance sheet indicators and statistical parameters that reflect the principal aspects of bank's operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles).* ***Additional Criterion*** 1. *The disclosure requirements imposed promote disclosure of information that will help in understanding a bank's risk exposures during a financial reporting period, for example on average exposures or turnover during the reporting period.*

E. Jurisdictional Comparisons

16. As would be expected, the developed jurisdictions reviewed, Australia, Canada, United States and United Kingdom, all have comprehensive Basel II/Basel III frameworks inclusive of Pillar 3 disclosure requirements. The Bank for International Settlements website also has the status of Basel II, Basel 2.5 and Basel III adoption in Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, The Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States and the European Union, as October 2015.

17. Notably, the Bahamas and Bermuda, representing Caribbean counterparts, both have made significant strides in implementing Pillar 3 requirements.

Bahamas

18. The Central Bank of the Bahamas, in 2016, issued supervisory and regulatory guidelines on minimum disclosures, in line with Basel II Pillar 3 Disclosure Requirements. The guidelines apply, as appropriate, to all public licensees of the central bank who are subject to Basel II reporting. The guidance outlines minimum disclosure requirements (including *Scope of Application, Capital Structure Basel III, Capital Adequacy, Credit Risk, Securitization, Market Risk, Operational Risk, Corporate Governance etc.*), remuneration disclosure requirements and financial statement disclosures.

Bermuda

19. In 2008, the Bermuda Monetary Authority ("BMA") issued the *Revised Framework for Regulatory Capital Assessment* which effectively represented the jurisdiction's implementation of Basel II. Pillar 3 requirements, within this new framework, apply to all Bermuda licensed banks and deposit companies as well as those investment businesses which have agreed with the BMA to fall within the scope of the framework.

20. Pillar 3 disclosure requirements include *Scope of Application, Capital Structure, Capital Adequacy, Credit Risk, Securitization, Market Risk, Operational Risk, Equities and Interest Rate Risk in the Banking Book*. Notably, this framework preceded Basel III and recent revisions to Pillar 3 and as result did not include remuneration, LCR, the Leverage Ratio and the NSFR. However, the BMA captured these enhancements through in its *Basel III for Bermuda Banks – Final Rule* issued in 2015. This is covered in *Section VII – Pillar 3 and Public Disclosure* of the Rule with a capture-all rule that states "*The Authority adopts the amendments to Pillar 3 under Basel 2.5 and Basel III*".

F. Scope of Application and Rationale for Pillar 3 Requirements

21. BCBS remains the globally recognised and respected standard-setter for international banking activity. Compliance with Basel standards, particularly its capital standards and core principles, represents a hallmark of prudent and sound operations. As the Cayman Islands seek to maintain its standing as a world leading financial centre, alignment with international best practice is crucial.

22. More specifically, and as previously mentioned, Pillar 3 of the Basel framework aims to promote market discipline through regulatory disclosure requirements. These requirements enable market participants to access key information relating to a bank's regulatory capital and risk exposures in order to increase transparency and confidence about a bank's exposure to risk and the overall adequacy of its regulatory capital.

23. The Pillar 3 disclosure requirements apply, on a solo and consolidated level, to banks incorporated in the Cayman Islands and regulated by the Authority under the Banks and Trust Companies Law (2013 Revision). A banking group, through consolidation, includes all majority-owned or controlled banking entities, and other relevant financial activities[1] (both regulated and unregulated). Securities entities (where subject to broadly similar regulation or where securities activities are deemed banking activities) and other financial entities[2] should be fully consolidated.

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[1] Financial activities do not include insurance activities and financial entities do not include insurance entities.

[2] Examples of the types of activities that financial entities might be involved in include financial leasing, issuing credit cards, portfolio management, investment advisory, custodial and safekeeping services and other similar activities that are ancillary to the business of banking.

24. Importantly, the current regulatory framework does not require banks to publish their financial statements but, with the implementation of Pillar 3 disclosure requirements, all banks will now have to make broad disclosures fundamental to their core operations. The scope of these disclosures is more expansive than those of typical financial statements, but still very much interrelated.

G. Proposed Inclusions – Pillar 3 Requirements

25. The proposed *Basel II – Market Discipline Disclosure Requirements (Pillar 3)* have comprehensive inclusions on presentation and disclosure requirements relating to:

    a. Capital;
    b. Credit Risk;
    c. Credit Risk Mitigation;
    d. Credit Risk – Standardised Approach;
    e. Counterparty Credit Risk;
    f. Securitisation;
    g. Market Risk;
    h. Operational Risk;
    i. Interest Rate Risk in the Banking Book; and
    j. Remuneration.

26. The document also provides contextually important information relating to guiding principles of Pillar 3, risk management and risk weighted assets, linkages between financial statements and regulatory exposures and key definitions.

27. The frequencies of required disclosures vary between quarterly, semi-annual and annual reporting depending on the specific disclosure requirement and the type of bank. All Category "A" banks and Category "B" banks with total assets greater than US$500 million (as per the latest audited statement of financial position) must adhere to varying frequencies based on the particular disclosure. All remaining Category "B" banks are required to make disclosures annually.

28. Fundamentally, the proposed Pillar 3 requirements, including frequency of disclosures, mirror those in the *BCBS Revised Pillar 3 Disclosure Requirements* and other relevant Basel documents in all material and applicable respects.

H. Cost-Benefit Assessment of Implementing Pillar 3 Requirements

29. The relevant costs and benefits associated with these new disclosure requirements are highlighted below:

	Costs	**Benefits**
The Authority	The Authority will incur the usual administrative costs associated with conducting industry consultation, publication and amending supervisory manuals. These costs are not deemed to be overly burdensome and represent usual costs of the Authority carrying out its mandate. More significantly, with these new and broadened disclosure requirements, the Authority will	Mandated Pillar 3 disclosures will represent a useful supplement to regular prudential reporting and the onsite examination process. This additional information will allow the Authority to have a deeper, and more comprehensive, insight into the operations of relevant banks. From this insight, the Authority may identify risk exposures, inherent in licensees, which were not evident in prudential filings and examinations.

	Costs	Benefits
	need to dedicate staffing resources to confirm compliance with issued Pillar 3 requirements. Additionally, these checks will need to extend beyond simple verification and include detailed analysis of material entity risk exposures which may not be clearly evident in prudential reporting.	Additionally, other market participants and stakeholders will also benefit from increased transparency created by entity disclosures and will be able to scrutinise and identify substantial risk exposures. A combination of the above may result in less future regulatory burden due to the facilitation of earlier identification and mitigation of material risks, on single entity, group and systemic levels.
Cayman Islands	There are no costs to the jurisdiction as a whole with the implementation of these requirements.	As mentioned in paragraph 21 above, compliance with Basel standards represents an important element indicative of prudent and sound banking operations. This perceived strength and safety is at the core of the stability of any financial system, including that of the Cayman Islands. Also, the improvement of market discipline referenced above will holistically promote greater confidence and a more efficient, stable and resilient financial market which is less susceptible to failures. This will be partly evidenced through improved consumer confidence and empowerment of customers to make more informed decisions as it relates to their personal banking relationships, including choice of bank. Additionally, bank counterparts' own risks related to exposures to respective banks are reduced. This in turn reduces cost of capital and extends to widespread financial and economic stability. As the jurisdiction moves towards full Basel compliance, the implementation of Pillar 3 requirements will significantly and positively impact confidence in the Cayman Islands as a strong world leading financial centre.
Banks	Bank licensees will face costs associated with the implementation of these new disclosure requirements. Chief amongst these, are expenditures relating to the actual preparation of information to be disclosed.	The information necessary for compliance with disclosure requirements will contribute to improved risk management processes in many entities. This is because some banks will not routinely, if any at all, produce and analyse risk exposure information in the way that

	Costs	Benefits
	The scope of Pillar 3 requirements are extensive and will warrant dedicated staffing and technological resourcing to achieve full compliance. Notwithstanding, much of the information required is expected to be housed internally at many banks and will just need to be fit-for-purpose to achieve disclosure standards.	comprehensive Pillar 3 adoption prescribes. Consequently, this requirement will foster banks' abilities to develop this capacity and will ultimately strengthen operations. Additionally, banks will benefit from the positive spill-overs associated with the improvement of market discipline, a stronger financial system and heightened confidence. This may positively impact, in both separate and related ways, profitability, customer growth and satisfaction and all-encompassing bank performance.
Summary	Consequent on the above, it is determined that benefits far outweigh costs and the implementation of Basel II – Market Discipline Disclosure Requirements (Pillar 3) should proceed.	

I. Comments and Consultation

30. The Authority seeks consultation through written comments and representations from the private sector associations concerning:

- Basel II – Market Discipline Disclosure Requirements (Pillar 3)

31. The Authority must receive representations by 23 June 2017.

32. Comments and representations must be addressed to

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33. The Authority shall have due regard to any representation made by the private sector associations and industry stakeholders. The Authority shall provide a written response collating the feedback received and the Authority's position on this feedback. This response shall be copied to all relevant private sector associations only.