CAYMAN ISLANDS MONETARY AUTHORITY

PRIVATE SECTOR CONSULTATION

BASEL II FRAMEWORK
RULES AND GUIDELINES: MARKET DISCIPLINE DISCLOSURE REQUIREMENTS (PILLAR 3)

A. Introduction

1. Section 34(1)(a) of the Monetary Authority Law (2020 Revision) ("MAL") states:

   "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 ("CIMA" or "the Authority") seeks consultation and comment from the private sector associations concerning the *proposed Basel II Framework – Rules and Guidelines: Market Discipline Disclosure Requirements (Pillar 3)*, attached as Appendix A.

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) fundamental pillars, Pillar 1 – Minimum Capital Requirements, Pillar 2 – Supervisory Review Process and Pillar 3 – Market Discipline. The purpose of the latter is to complement Pillars 1 and 2. The Pillar 3 framework aims to encourage market discipline by incorporating a set of disclosure requirements, which will allow market participants to assess key pieces of information on the 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. Revisions to Basel II Market Risk Framework (a part of "Basel II.5") and The Basel III – A Global Regulatory Framework for more Resilient Banks and Banking Systems were both originally issued in 2010 and represented key supplements to the existing Basel II framework. Among these improvements were the release of specific standards related to market discipline, achieved through comprehensive targeting of disclosure requirements. These included:
   (1) *Pillar 3 Disclosure Requirements - Updated Framework* issued in December 2018;
   (2) *Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework Standards* issued in 2017;
   (3) *Revised Pillar 3 Disclosure Requirements* issued in 2015;
   (4) *Net Stable Funding Ratio ("NSFR") Disclosure Standards* issued in 2015;
   (5) *Liquidity Coverage Ratio ("LCR") Standards* issued in 2014;
   (6) *Basel III Leverage Ratio Framework and Disclosure Requirements* issued in 2014; and
   (7) *Pillar 3 Disclosure Requirements for Remuneration* issued in 2011.

7. The disclosure requirements in the December 2018 standards capture the following elements:
   (1) *Revisions and additions to the Pillar 3 framework arising from finalisation of the Basel III post-crisis regulatory reforms in December 2017;*
   (2) *New disclosure requirements on asset encumbrance; and*
   (3) *New disclosure requirements on capital distribution constraints.*

8. CIMA's implementation of the Basel III framework commenced in 2019 with the liquidity risk management and leverage components being effective on June 1 and December 1, respectively. The disclosure requirements for these components have been included in the proposed measure.

9. The proposed implementation date of the measure is 1 January 2021. Therefore, the disclosure reporting requirement will commence as at this date. The frequency of the reporting is as stipulated in the measure.

10. The Authority previously issued the proposed measure for consultation in 2017, which has since been revised to include Basel's 2018 updates to the Pillar 3 disclosure framework.

C. Purpose of Proposed Measure and Consistency with the Authority's Functions

11. Section 6(1)(b) of the MAL establishes the responsibilities of the Authority with respect to its regulatory functions, namely:

    (i) to regulate and supervise financial services business carried on in or from within the Islands in accordance with this Law and the regulatory laws;
    (ii) to monitor compliance with the money laundering regulations; and
    (iii) to perform any other regulatory or supervisory duties that may be imposed on the Authority by any other law;

12. 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, consumer protection and the reputation of the Islands as a financial centre;
    (…)
    (c) recognise the international character of financial services and markets and the necessity of maintaining the competitive position of the Islands, from the point of view of 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;
    (d) recognise the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction; [and]
    (…)
    (f) recognise the need for transparency and fairness on the part of the Authority.

13. CIMA's broad objective with the issuing of this measure is to achieve an internationally comparable disclosure requirements framework. A comprehensive implementation of the Pillar 3 framework reflects the promotion of increased transparency which allows for independent and timely scrutiny by stakeholders and other market participants. This is expected to

result in banks' improving key metrics and enhancing their processes due to the market's expectations.

14. 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 amongst internationally active banks, in the promotion of market discipline.

D. International Standards

15. Pillar 3 disclosure requirements are core to Basel International Capital Standards. This is evidenced in the Core Principles for Effective Banking Supervision published by the Basel Committee on Banking Supervision. Basel Core Principle ("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 in Table 1.

Table 1: Basel Core Principle 28 – Disclosure and Transparency

BCP 28: ***Disclosure and Transparency***	***Essential Criteria*** *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. Implementation in Other Jurisdictions

16. The developed jurisdictions reviewed - Canada, the United States of America and the United Kingdom - have comprehensive Basel II/Basel III frameworks inclusive of Pillar 3 disclosure requirements. The Bank of International Settlements' ("BIS") website, in its progress report dated 30 September 2019, on the adoption of the Basel regulatory framework confirms the adoption of Pillar 3 in Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, Japan, South Korea, Russia, Saudi Arabia, Singapore, South Africa, Turkey, the United States and the European Union.

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

<u>Bahamas</u>

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 which 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.

<u>Bermuda</u>

19. In 2008, the Bermuda Monetary Authority ("BMA") issued the Revised Framework for Regulatory Capital Assessment which effectively represented the jurisdictions 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.

20. Pillar 3 disclosure requirements include 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 a result do 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 II.5 and Basel III".

F. Significant Costs and Benefits

21. The relevant costs and benefits associated with these new disclosure requirements are highlighted in Table 2.

Table 2: Cost-Benefit Factors of the proposed Pillar 3 Rules and Guidelines

	Costs	Benefits
CIMA	1. The Authority will incur the usual administrative costs associated with conducting industry consultation, publication and amending supervisory manuals. 2. With these new and broadened disclosure requirements, CIMA will need to dedicate staffing resources to confirm compliance with issued Pillar 3 measure.	1. Mandated Pillar 3 disclosures will represent a useful supplement to regular prudential reporting and the onsite examination process. This additional information will allow CIMA 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. 2. A combination of the above may result in a lessened future regulatory burden due to the facilitation of earlier identification and mitigation of material risks, on single entity, group and systemic levels.
Cayman Islands	1. The potential increases in costs/ administrative burden may result in banks exiting the jurisdiction, as banks perform very robust cost and benefit analysis for each legal entity. 2. Potential adverse reactions to the	1. 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.

	Costs	Benefits
	jurisdiction when unfavourable disclosures are publicised.	2. Also, the improvement of market discipline, will holistically promote greater confidence and a more efficient, stable and resilient financial market which is less susceptible to failures. 3. The transparency introduced by the Pillar 3 framework will aid in improving consumer and investor confidence. 4. 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. 5. The Islands will be in a better position to receive more favourable results coming out of international assessments, such as the International Monetary Fund's Financial System Stability Assessment (FSSA).
Banks	1. 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. 2. The scope of the Pillar 3 measure is extensive and will warrant dedicated	1. The information necessary for compliance with disclosure requirements will contribute to improved risk management processes in many entities. This requirement will foster banks' abilities to develop their capacity to produce and analyse risk exposure information using the Basel criteria.

	Costs	Benefits
	staffing and technological resourcing to achieve full compliance. Notwithstanding, much of the information required is expected to be housed internally at many banks and the additional requirement will be to fit-for-purpose to achieve disclosure standards.	2. 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. 3. 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 Framework – Rules and Guidelines: Market Discipline Disclosure Requirements (Pillar 3)* should proceed.	

G. Comments and Consultation

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

Basel II Framework – Rules and Guidelines: Market Discipline Disclosure Requirements (Pillar 3)

23. The Authority must receive representations by 1700hrs on **Friday, March 20, 2020.**

24. Comments and representations must be addressed to:

The Managing Director
Cayman Islands Monetary Authority
P.O. Box 10052
SIX, Cricket Square
171 Elgin Avenue
George Town
Grand Cayman KY1-1001

Cayman Islands
Tel: 345-949-7089
Fax: 345-946-5611
Email:
consultation@cima.ky
and copied to kourtneigh-michellenicholson@cima.ky

25. 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.