BERMUDA MONETARY AUTHORITY

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BASEL III FOR BERMUDA BANKS
NOVEMBER 2017 RULE UPDATE

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I. ABBREVIATIONS

For the purposes of this paper the following abbreviations will be used:

“AT1”	Additional Tier 1 Capital
“Basel Committee”	Basel Committee on Banking Supervision
“CAR”	Capital Adequacy Ratio
“CARP”	Capital Assessment and Risk Profile
“CCB”	Capital Conservation Buffer
“CET1”	Common Equity Tier 1 Capital
“D-SIB”	Domestic-Systemically Important Bank
“HQLA”	High Quality Liquid Assets
“IOSCO”	International Organisation of Securities Commissions
“LCR”	Liquidity Coverage Ratio
“NSFR”	Net Stable Funding Ratio
“OCI”	Other Comprehensive Income
“PIR”	Prudential Information Return
“QIS”	Quantitative Impact Study
“RWA”	Risk-Weighted Assets
“T1”	Tier One Capital

II. PREAMBLE

1. The financial crisis of 2007-2008 was a crisis of both liquidity and capital. Many banks engaged in a funding regime that was excessively weighted in short-term and volatile wholesale liabilities that were invested in illiquid assets, which became a prime causal factor in the crisis and an enduring and valuable lesson that has been carried forward into the creation of Basel III. The crisis also raised significant concerns over the quantity and quality (loss absorbency as a going concern) of bank capital. Accordingly, Basel III addresses the challenges of improving the quantity and quality of bank capital (including by emphasising the going concern importance of common equity), while also addressing the need for a potent liquidity buffer to counteract periods of financial market stress.

2. To introduce Basel III to the Bermuda banking sector, the Bermuda Monetary Authority (the Authority or the BMA) produced a Discussion Paper (DP) in 2011 and a Consultation Paper (CP) in 2013. An extensive formal public consultation process followed to ensure familiarity with and acceptance of the Basel III measures, as adapted for the Bermuda market. The measures focus on three main areas: the quantity, quality, consistency and transparency of capital; the imposition of a prudent leverage ratio and capital buffers; and the adoption of prudential liquidity standards centered on a bank's ability to fund itself during a short-term stress period.

3. In the DP and CP, the Authority provided an overview of the Basel III standards and sought the views of Bermuda's banks and other stakeholders on their implementation in Bermuda. The consultation process that followed the CP included a series of meetings with the banking sector, represented by their Chief Financial Officers. Discussions covered the feedback received on the CP as well as issues relating to a planned leverage ratio, the appropriate level of various capital buffers, the interaction of these new requirements with existing Pillar II guidance, and the specification of the Liquidity Coverage Ratio (LCR) framework to include the allowance of bank-specific and empirically supported deposit behavior assumptions. An additional round of LCR Quantitative Impact Study (QIS) was also conducted as at Q2-2014, to ensure that the banking sector would be able to adopt an LCR reporting template and start meeting the

phased-in requirements commencing in 2015.

4. The Authority has consistently communicated its view that the adoption of these new standards, with minimal deviation from the core Basel framework, is important to protect the interests of a diverse base of depositors, preserve the stability of the Bermuda financial system, and enhance the reputation of the Bermuda banking market and its participants. The Authority was pleased to note that submissions in response to the DP and CP and the follow-on implementation meetings largely supported this position.

5. The Authority assessed respondents' feedback on the implementation of specific elements of Basel III in Bermuda and reflected these views in the capital and liquidity standards put forward in this final rule. In addition, the Authority has incorporated the findings of its QIS analysis of the banking sector's ability to meet these enhanced capital and liquidity requirements on a sustainable basis. The Authority has also analysed the detailed credit information gleaned from its enhanced monitoring efforts to assess the impact of a prolonged period of economic stagnation on the credit quality and capital adequacy of the sector. The Authority believes that the capital buffers, contained in the Basel III framework, will provide the capital base needed to successfully manage through the credit cycle.

6. The final rule appropriately balances prudent risk taken by banks while simultaneously preserving prudent capital buffers and liquidity resilience to protect depositors and preserve the stability of the banking sector within Bermuda.

7. Concerns that have been addressed in the final rule:

a.) Level playing field

Respondents were concerned that the adoption of a revised framework, if inconsistently applied to individual institutions, would lead to artificial barriers to local competitiveness and the ability to compete with other jurisdictions. The Authority has weighed these concerns and is confident that this final rule adopts a framework which adheres to the fundamental components of the Basel approach, such as the definitions of capital, conservation buffers and leverage ratio, balanced against limited jurisdictional adjustments consistently applied to all banks. However, not all banks will be subject to exactly the same capital requirements, which will need to reflect each bank's unique risk profile through the Capital and Risk Assessment Profile (CARP) Pillar 2 process and the setting of capital surcharges for Domestic-Systemically Important Banks (D-SIBs). The Authority is confident that its regime is consistent with international standards and will accomplish the primary goal of strengthening the resilience of the Bermuda banking sector, while enabling it to continue to be globally competitive.

b.) Timetable for implementation

Given the multi-year implementation timetable built into the core Basel III framework and the significant consultation period – including several rounds of QIS and an extensive series of sector outreach meetings to work through identified concerns and facilitate implementation – the Authority is confident it has provided sufficient time for institutions to prepare for the adoption of the new rule, including system adjustments to comply with the new reporting requirements. Annex 1 of this paper sets out the Bermuda implementation timetable.

The banking sector and all interested parties are hereby advised that this final rule will become effective on 1st January 2015, with all provisions coming into effect at that time unless stated otherwise in the body of this document, including Annex 1. All banks will be expected to report in a Basel III consistent manner commencing with the Prudential Information Return (PIR) for the first quarter of 2015.

III. BACKGROUND

8. Bermuda banks and deposit companies are required to meet, on an ongoing basis, the minimum licensing criteria set out in the Second Schedule to the Banks and Deposit Companies Act 1999 (the Act). This provides, among other requirements, that institutions must conduct their business in a prudent manner, including that they maintain capital and financial resources (liquidity) commensurate with the nature and scope of their operations. The setting and monitoring of requirements for capital adequacy and liquidity, including the effective assessment and management of risk within institutions, represent key elements in the framework of prudential oversight and control applied by the Authority to help protect the interests of depositors. The approach developed and applied by the Authority in this regard has reflected applicable regulatory

standards designed and promulgated by the Basel Committee, the international standard-setting body for banks. Since January 2009, banks licensed in Bermuda have been required to comply with the framework set out in the Authority's rules and guidance.

9. At the end of 2010, the Basel Committee agreed to the key elements of a more comprehensive set of standards that not only strengthened the capital adequacy and risk management provisions of the Basel II framework, but also introduced international prudential liquidity standards.

10. The movement to Basel III adoption by Bermuda is consistent with past adoption of Basel I and Basel II and represents Bermuda's adherence to international standards aimed at the aforementioned strengthening of capital and liquidity in the banking sector.

11. In this rule, the Authority adopts the capital and liquidity regulatory requirements consistent with Basel III for this jurisdiction, with implementation to begin 1 January 2015. These requirements should be viewed in the broader context of the Authority's efforts to maintain high standards of risk management and corporate governance within Bermuda's banks. While Pillar 1 of the Basel III standards focuses on quantitative regulatory capital and liquidity requirements, the Authority is of the view that observance of quantitative regulatory prudential minima is only one important element in a comprehensive framework.

12. Of equal importance is the adoption within an institution of a sound framework of governance and risk management under Pillar 2 and appropriate public disclosure under Pillar 3. Consistent with this view, the Authority will continue to promote strengthened internal risk management through the Capital Assessment and Risk Profile (CARP) process and its Pillar 2 authority to prescribe capital levels commensurate with a bank's assessed risk profile.

13. This update sets out the Authority's rules on:

- The application of Interest Rate Risk in the Banking Book (IRRBB) for banks and banking groups in Bermuda in paragraphs 32 to 35
- The application of the Net Stable Funding Ratio (NSFR) for banks and banking groups in Bermuda in paragraphs 43 to 52; and

- The regulatory treatment of accounting provisions in terms of transitional arrangements and interim approach in paragraphs 53 to 64.

IV. REVISED CAPITAL FRAMEWORK

Definition of Capital

14. The Authority adopts Common Equity Tier 1 Capital (CET1) as the primary and predominant form of regulatory capital, and this standard will be deemed the primary capital adequacy measure for Bermuda banks. CET1 is intended to absorb losses on a "going concern" basis with a bank continuing in operation. Additional Tier 1 capital (AT1) will also be allowed in the capital framework, subject to the inclusion criteria contained in section 55 of the June 2011 Basel III framework document1 (Basel III rules). Tier 2 capital will provide an additional measure of regulatory capital, on a "gone concern" basis of impending insolvency and potential liquidation. A condition of AT1 or Tier 2 eligibility will be a clear and unequivocal provision (acceptable to the Authority) requiring the elimination of the capital instrument or its conversion to common equity at the point of non-viability of the bank as determined by the Authority. This loss absorbency feature is key to any component of capital being considered at any tier. Tier 3 capital will no longer qualify as regulatory capital.

Minority Interests

15. The Authority adopts the Basel III rules with respect to the recognition of qualifying minority interests, comprising Tier 1 and Tier 2 qualifying capital issued by consolidated subsidiaries and meeting certain classification criteria, as regulatory capital.

Regulatory Adjustments and Deductions

16. The Authority adopts the Basel III rules with respect to the regulatory adjustments and deductions in the calculation of regulatory capital. These adjustments will be applied in the calculation of CET1.

17. The Authority retains national discretion to allow banks to exclude temporarily from the

[1] Basel Committee on Banking Supervision, A global regulatory framework for more resilient banks and banking systems, December 2010 (revised June 2011).

deduction requirement certain investments where these have been made in the context of resolving or providing financial assistance to restructure a distressed institution.

18. The Authority adopts the one-time and irrevocable election to exclude Other Comprehensive Income (OCI) from CET1 with each bank required to make a definitive election, no later than 31st March 2015.

19. The detailed provisions for all other regulatory adjustments and deductions from CET1, including but not limited to goodwill, all intangibles and certain deferred tax assets can be found in paragraphs 66 to 90 of the Basel III rules.

Minimum Capital Ratios

20. The Authority adopts the Basel III regulatory minimum capital levels as follows:

a) CET1 must be at least 4.5% of Risk-Weighted Assets (RWA) at all times;

b) Tier 1 (T1) capital must be at least 6.0% of RWA at all times; and

c) Total capital (T1 + T2 capital) must be at least 8.0% of RWA at all times.

The regulatory limits above do not include Pillar 2 related add-ons that may be applied by the Authority in connection with its Prudential Supervision.

Capital Conservation Buffer

21. The Authority adopts the Capital Conservation Buffer (CCB), set at the full 25% of RWA, composed of CET1 eligible capital. The CCB is designed to ensure that banks build up and retain capital buffers outside of periods of stress which can be drawn down in exceptional circumstances if severe losses are incurred. Appropriate capital distribution constraints will be imposed on any bank whose capital level falls below this buffer.

Countercyclical Buffer

22. The Authority adopts the inclusion of a Basel III countercyclical buffer to be introduced when macro-economic indicators provide an assessment of excessive credit or other pressures building in the banking sector. At this point, the Authority will assess the need for a capital buffer of up to 2.5% so that banks build up their capital ahead of having to meet possible losses should these pressures be reversed. The countercyclical buffer must

comprise CET1 eligible capital.

Domestic Systemically Important Banks (D-SIB)

23. The Authority will assess the extent to which Bermuda's banks (collectively and individually) pose a degree of material systemic risk to the economy of Bermuda due to their roles in deposit-taking, corporate lending, payment systems and other core economic functions[2]. This assessment will be based on a range of metrics relating to the size, interconnectedness, substitutability and complexity of each bank. The Authority will apply a capital surcharge buffer, specified as a stated percentage of RWA and composed of CET1 eligible capital, for Bermuda banks designated to be a D-SIB on the basis of the assessment. The size of this buffer will vary between 0.5% and 3%, depending on the extent of systemic risk posed by each D-SIB. Each D-SIB will be advised of its specific buffer directly by the Authority.

Counterparty Credit Risk

24. The Authority adopts the Counterparty Credit Risk (CCR) requirements of Basel III, which include the addition of a Credit Valuation Adjustment (CVA) to the capital charge to address potential mark-to-market losses associated with the deteriorating credit- worthiness of any applicable counterparty.

Central Counterparties

25. The Authority adopts the Basel Committee rules relating to exposures to central counterparties[3].

External Credit Assessment

26. The Authority retains the external credit assessment institution eligibility criteria in line with Basel III, which includes the incorporation of key elements of the International Organization of Securities Commission's (IOSCO's) Code of Conduct Fundamentals for Credit Rating Agencies in the criteria. It is anticipated that existing approved external credit assessment institutions will continue to be eligible.

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[2] Basel Committee on Banking Supervision: A framework for dealing with domestic systemically important banks, June 2012.

[3] Basel Committee on Banking Supervision, Capital requirements for bank exposures to central counterparties, April 2014

Market Risk Framework

27. The Authority retains the exemption from reporting under the market risk framework where market risk remains at de minimis levels, with reservation of authority to impose such reporting should material market risk be incurred.

Leverage Ratio

28. The Authority adopts the introduction of a 5% leverage ratio calculated as the ratio of T1 Capital (including AT1) to Total Exposure as calculated in the Basel III rule4. All Bermuda banks currently have T1 capital levels that exceed this limit. Total Exposure will include both on-balance sheet exposures (generally measured following the accounting measure of exposure) and off-balance sheet exposures, as defined under Basel III rules and subject to the credit conversion factors used in the Basel Standardised Approach for credit risk, with a floor of 10%. In computing any of the on-balance sheet or off-balance sheet exposures, collateral netting is not allowed. This leverage ratio has been chosen because it reflects an appropriate capital backstop for a jurisdiction that does not have a central bank or a fully funded deposit insurance scheme, thus ensuring that a robust capital framework is in place to support financial stability.

V. PILLAR 2

29. The Authority will continue to utilise Pillar 2 to cover emerging identified risks that are not captured, or not fully captured, in existing Pillar 1 provisions and to address any departures from the Basel III standard. Potential areas where Pillar 2 may be deployed include but are not limited to the adjustment of Risk-Weighted Assets (RWA) percentages and the continued integration of stress testing results to reveal potential capital shortfalls and to address those shortfalls through a capital charge.

[4] Basel Committee on Banking Supervision, Revised Basel III leverage ratio framework and disclosure requirements, January 2014

Implementation of revised Basel IRRBB standard in Pillar 2

30. The Authority will implement the IRRBB standards set out in the Basel Committee paper of April 2016[5] and its implementation deadlines in its entirety except in one specific area. This is that the Authority will not be providing an option for banks to measure IRRBB using the standardised framework. Instead the Authority is mandating that all Banks at a consolidated level (and at an unconsolidated level where required by the Authority) develop their own Internal Measurement Systems (IMS) as set out in the revised standards to measure IRRBB for both changes in the Economic Value of Equity (EVE) and Net Interest Income (NII) with the expectation that banks will seek to develop a model that is proportionate to the size and complexity of their balance sheet.

Scope of Application

31. The Authority will require all banks to report IRRBB on the basis of their present Capital Assessment and Risk Profile (CARP) reporting requirements. Any bank presently reporting on just a consolidated basis for CARP purposes will continue to be allowed to apply this approach when calculating the new IRRBB requirements. However, the Authority reserves the right going forward to require a bank to report all elements of their Pillar 2 requirements including IRRBB on both a solo and consolidated basis, where, in the opinion of the Authority there exists a material difference between solo and consolidated balance sheets.

IRRBB stress test scenarios

32. For the CARP submission of 2018 banks will need to comply with the required IRRBB standards set out by Basel in relation to interest rate shocks and stress scenarios. Banks should use a wide and appropriate range of shocks that align with their business risk profile, as well as the six prescribed interest rate shock scenarios set out in Basel's standardised framework

33. For the CARP submission of 2018 the Authority will not be setting a BMA mandated additional IRRBB stress test. However, the Authority will continually assess the relevance of these scenarios and when it deems necessary, reserves the right to set additional scenarios.

[5] Standards: Interest rate risk in the banking book – April 2016

VI. LIQUIDITY

Liquidity Coverage Ratio

34. In January 2013, the Basel Committee released a revision to the Liquidity Coverage Ratio (LCR) proposal presented in the original Basel III Liquidity Paper[6]. This revision reflected various refinements to the LCR to address issues identified by national authorities and the international banking community since the LCR was originally published. The major areas of change were: the expansion of the range of assets eligible for inclusion as High Quality Liquid Assets (HQLA) for LCR purposes, through the addition of a new category of Level 2B assets, which national supervisors may elect to recognise as HQLA in their local LCR regulations; a recalibration of the stress assumptions for some cash-flow items; an affirmation of the usability of the stock of HQLA by banks in times of stress; and the adoption of a phase-in timetable for implementing the LCR.

35. The Authority has conducted extensive outreach with the sector concerning the technical implementation issues largely centred on deposit outflow assumptions, and as a result of that effort has refined its final rules (reflected in Items #31-36 below) for the local implementation of the LCR.

36. The Authority adopts the LCR implementation timetable consistent with that published by the Basel Committee beginning on 1st January 2015, with a minimum requirement of 60% rising in equal annual steps to reach 100% on 1st January 2019.

37. The Authority adopts the haircuts for Level 2 assets set consistently with the January 2013 LCR revision, with a reservation by the Authority to employ national discretion in applying a higher haircut percentage or to restrict a class of assets from this group, should unacceptable risk concentrations develop.

38. The Authority will use limited national discretion to widen Level 1 asset eligibility byallowing U.S. dollar assets, qualifying under Basel III as Level 1 assets, to be fully eligible as Level 1 assets in Bermuda. The Authority will also allow a bank to include

[6] Basel Committee on Banking Supervision, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013

certain U.S. dollar balances held in its qualifying correspondent bank to be included as a Level 1 asset to offset the fact that this jurisdiction does not have a central bank. This inclusion of qualifying correspondent bank balances will be subject to a 25% of HQLA Level 1 limit and a demonstration to the bank's Board that the credit quality of the correspondent bank is satisfactory. In addition, the Authority requests that all Bermuda banks continue to work with their existing correspondent banks to identify conduits for bank funds to be placed at the U.S. Federal Reserve, in a pass-through account or into a secured funding vehicle such as a reverse repurchase facility, backed with HQLA Level 1 assets.

39. The Authority also adopts the position that unsecured funding provided by non-financial small business customers, managed as retail exposures and generally considered as having similar liquidity risk characteristics to retail accounts, will be treated as such, provided that the total aggregated funding raised from each single small business customer is less than $500,000. It is further required that such deposits would only be eligible as stable deposits, subject to a 5% run- off, where among other criteria they are fully covered by deposit insurance. Small business deposits that do not meet the necessary eligibility criteria will be classified as less stable and subject to a 10% run-off assumption and those that exceed the $500,000 threshold will be treated as ordinary corporate deposits.

40. Institutions will be expected to begin formal reporting of the LCR from the first quarter of 2015. The Authority may refine the assumptions in the LCR calculation based on the results of monitoring local impact and assessing international developments.

Net Stable Funding Ratio

41. On 31 October 2014, the Basel Committee published its final standard for the Net Stable Funding Ratio (NSFR)[7]. On 22 June 2015, the Basel Committee issued its final NSFR disclosure standard. This aims to improve the transparency of the NSFR requirements, reinforce the Principles of Sound Liquidity Risk Management and Supervision (Sound Principles), strengthen market discipline and reduce uncertainty in the markets as the NSFR is implemented.

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[7] Basel Committee on Banking Supervision, Consultative Document, Basel III: The Net Stable Funding Ratio, January 2014.

42. The Authority supports the Basel Committee's objective of strengthening liquidity frameworks for banking institutions. As set out in the Basel III for Bermuda Banks – Final Rule 2015 it was always the Authority's intention to adopt the proposed NSFR standards and implementation deadlines. In 2015, the BMA implemented the LCR to promote short-term resilience of a bank's liquidity profile under stress periods. The NSFR complements these existing LCR requirements requiring banks to ensure they also fund their balance sheets with stable funding sources so as to reduce funding risk over a longer term horizon.

43. The section below sets out the Authority's rules on the application of NSFR for banks and banking groups in Bermuda. These rules were drafted following consultation with Bermuda's banking sector while also having regard for such factors as the lack of a lender of last resort within the jurisdiction, protecting depositors in the absence currently of a fully funded deposit insurance scheme, financial stability considerations and the Authority's mandate to protect the reputation of Bermuda as an international financial centre.

Scope of application of NSFR rules

44. The Authority requires all banks to report their NSFR on both a consolidated and unconsolidated basis.

NSFR implementation & reporting frequency

45. Both the NSFR and its disclosure requirements become effective for Bermuda banks and banking groups from 1 January 2018. Banks will be required to formally submit their NSFR return on a quarterly basis with the first NSFR submission to be included as part of the quarterly March 31st 2018 Prudential Information Return (PIR) submission. The Authority will issue separate NSFR reporting forms to be completed at both a consolidated and unconsolidated level. Banks will also need to provide an NSFR update as part of their monthly reporting to the Authority from January 2018.

NSFR public disclosure

46. The Authority requires all banks to publically disclose their NSFR within their respective semi-annual Pillar 3 submissions. The Authority has adopted the revised Basel Pillar 3 templates, which include a standardised template for NSFR disclosures. The Authority will require that NSFR Pillar 3 disclosures are made for the first time in the 30 June 2018 reporting period.

NSFR minimum requirements

47. The NSFR is defined as the amount of available stable funding relative to the amount of required stable funding. This minimum ratio has been set by the Authority at equal to or greater than 100%, which means that on an ongoing basis a bank must retain stable funding sources at least equal to that of its assets which require funding. Whilst the NSFR minimum is established at 100%, the Authority would expect Bank senior management to set an internal buffer over and above this minimum requirement and be able to demonstrate why the quantum of this buffer is appropriate for their institution.

48. The Authority will implement the NSFR and disclosure standards set by the BCBS in its entirety except where the Authority believes applying a national discretion or going super-equivalent are appropriate.

NSFR national discretions

49. The Authority is using national discretion to:

- Widen High Quality Liquid Level 1 asset eligibility by allowing US dollar assets, qualifying under Basel III as Level 1 assets to be fully eligible as Level 1 assets in Bermuda.
- Allow unencumbered US dollar balances held with its qualifying correspondent banks to be included as High Quality Liquid Level 1 assets. The inclusion of these unencumbered qualifying correspondent bank balances as HQLA level 1 assets will be subject to a 25% HQLA level 1 limit and a demonstration to the bank's Board of Directors that the credit quality of the correspondent bank is satisfactory.

Super-equivalence

50. When calculating available stable funding the Authority is super-equivalent to BCBS standards on deposits/funding provided by a non-financial small business in excess of $500,000 in aggregate with a tenor of less than 1 year. Any deposits/funding above this $500,000 level must be treated as deposits from non-financial corporate customers rather than as retail deposits. This super-equivalent treatment will be reviewed during the 2020 review of LCR and NSFR standards.

VII. REGULATORY TREATMENT OF ACCOUNTING PROVISIONS – TRANSITIONAL ARRANGEMENTS & INTERIM APPROACH

Scope and timing of application

51. The transitional arrangements and the interim approach to be used when determining general provisions that qualify to be treated as Tier 2 up to a limit of 1.25% of Risk Weighted Assets (RWAs) will only apply to Bermudian banks subject to International Accounting Standards Board (IASB) requirements from 1 January 2018.

52. Banks subject to US Financial Accounting Standards Board (FASB) requirements will continue to use the incurred loss model until they move on to the Current Expected Credit Loss (CECL) model on 31 March 2020. At that time these Banks will be subject to any transitional arrangement prevailing at that time and will be subject to the same interim approach applying to IASB banks when determining general provisions that qualify to be treated as Tier 2 up to a limit of 1.25% of Risk Weighted Assets (RWAs). This is unless at this time the interim approach has been superseded by final standards from the Basel Committee on this issue.

The transitional arrangement offered by the Authority

53. The Authority will make available to Bermudian banks and banking groups on written request a transitional arrangement. The Authority will not mandate use of the transitional arrangement. Its use will be a decision for individual Bank Boards. The rationale for offering this transitional arrangement is to address any potential 'cliff effect' falls in CET 1 capital from initial implementation (Day 1 implementation) of the new Expected Credit Loss (ECL) model.

54. The transitional arrangement must only adjust CET1 capital and the transitional only applies to provisions that are new under an accounting ECL model. The appropriate capital metric to be used is CET 1 capital expressed as a money amount. So, for example, if reduction in CET1 capital under the old incurred loss model was $10m and under the ECL model the CET 1 reduction is now $15m the impact of the new provisions would be a reduction of $5m in CET1 capital. This $5m would be the amount eligible for the transitional arrangement.

Transitional arrangement criteria

55. The Authority is:

- Adopting a static approach in which the transitional amount is calculated just once at the point of transition;
- Allowing the transitional arrangement to run for a period of 5 years commencing for banks subject to IASB standards from 1 January 2018;
- Implementing a straight line amortisation approach to calculating the transitional adjustment each year.
- Requiring banks to take into account tax effects when calculating the impact of ECL accounting on CET 1 capital. Any Deferred Tax Asset (DTA) arising from a temporary difference associated with a non-deducted provision amount should be disregarded for regulatory purposes during the transitional period;
- Requiring that any accounting provision amount not deducted from CET1 capital should not:
    - be included in Tier 2 capital even if the provision meets the definition of 'general' provisions;
    - reduce exposure amounts in the Standardised approach even if it meets the definition of specific provision;
    - reduce the total measure in the leverage ratio.

Conditions to use the transitional arrangement

56. The first condition that must be met to use the transitional arrangement is that the bank's ECL accounting model needs to be independently validated prior to 1 January 2018 to determine the size of the initial CET1 capital transitional adjustment amount. This validation need not be done by the Bank's external auditor but can be done by another external third party provided that third party can demonstrate to the Bank that it has the requisite skills and knowledge to do this validation work. The Authority acknowledge that as this is a new model the initial CET 1 capital amount determined at this point might need to be revised subsequently (for example at the first annual audit post ECL

model implementation).

57. The second condition that must be met is that any bank using the transitional arrangement must disclose publicly in part 2 of their Pillar 3 disclosure and on their website whether the transitional arrangement is being applied by the bank and the impact on the bank's regulatory capital and leverage ratio compared to the bank's fully loaded capital and leverage ratios had the transitional arrangement not been applied.

Calculation of the transitional adjustment amount

58. Where there is a reduction in CET 1 due solely to implementation of the ECL model this decline in CET 1 capital can be spread for regulatory purposes over a 5 year transitional period. The Authority has included an example below to illustrate this.

59. Consider Bank A that calculates that on initial implementation of the ECL model on 'Day 1' there is a $5m reduction in CET1. Under the transitional arrangement:

- only 20% of this $5m reduction would be taken on day 1 of year 1 ($1m);
- 40% on day 1 of year 2 ($2m);
- 60% on day 1 of year 3($3m);
- 80% on day 1 of year 4 ($4m); until
- the full $5m reduction is taken on day 1 of year 5.

Or put another way each year of the transitional arrangement the proportion of the total initial reduction in CET 1 Banks A calculated that is added back reduces on a straight line basis so that:

- 80% of the total $5m reduction is added back on day 1 of year 1 ($4m);
- 60% of the total $5m reduction is added back on day 1 of year 2 ($3m);
- 40% of the total $5m reduction is added back on day 1 of year 3 $2m);
- 20% of the total $5m reduction is added back on day 1 of year 4 ($1m); until
- No adjustment of the full $5m reduction would be taken on day 1 of year 5.

Supervisory assessment of banks using transitional approaches

60. The Authority when undertaking supervisory assessments of the quantity of CET 1 capital resources and other key regulatory ratios by a bank using a transitional arrangement will use the adjusted CET 1 capital number derived from the transitional arrangement rather than assessing CET 1 capital levels on the basis that the transitional arrangement had not been applied.

New interim treatment of accounting provisions

61. Effective 1 January 2018 banks subject to the International Accounting Standards Board IFRS 9 ECL model must only classify as general provisions those assets that fall in stage 1 of the ECL model when determining those provisions that can qualify to be treated as Tier 2 capital up to a limit of 1.25% of RWAs. Assets that fall in stages 2 and 3 of the ECL model must be classified as specific provisions and so do not qualify to be treated as Tier 2 capital.

VIII. PILLAR 3 AND PUBLIC DISCLOSURE

62. Pillar 3 forms part of the Basel regulatory framework and is commonly known as the Market Discipline pillar. The main objective of Pillar 3 is to complement the minimum capital requirements and supervisory review process by developing a set of public disclosure requirements. Such disclosures are designed to allow market participants to gain a better understanding of a bank's capital adequacy, risk exposures, risk management processes and liquidity positions, amongst others.

63. The Authority introduced Pillar 3 to the banking industry in conjunction with the rollout of the Basel 2 in 2009. Pillar 3 requires all banks to publically disclose, on a semi-annual basis, various quantitative and qualitative topics. The requirements for Pillar 3 disclosures have changed to address issues identified in the previous disclosure standards and include new standards related to the implementation of Basel 3. In January 2015 Basel released 'Revised Pillar 3 disclosure requirements'[8] and in March 2017 document 'Consolidated and Enhanced framework'[9]; these documents form the basis of the new

[8] Revised Pillar 3 disclosure requirements – January 2015
[9] Pillar 3 disclosure requirements – consolidated and enhanced framework – March 2017

Pillar 3 requirements and are designed to enhance granularity of the information to be disclosed and increase comparability across bank disclosures.

64. The Authority adopts both the 2015 and 2017 Pillar 3 amendments, which supersede the 2009 Pillar 3 requirements, with the exceptions as outlined in paragraph 68.

Exemptions from disclosures

65. The revised Pillar 3 disclosure standards do not require the following topics to be disclosed at this time:

i. Total Loss Absorbing Capital (TLAC)

ii. Macro-prudential supervisory measures

iii. Remuneration

Scope of application

66. Pillar 3 disclosures apply at a consolidated level only.

Pillar 3 implementation & reporting frequency

67. The new disclosure requirements become effective June 30th 2018 and on a semi-annual basis thereafter. Pillar 3 disclosures must be posted as a standalone document within an easily accessible location on a bank's website 60 calendar days after the end of the period to which they relate.

68. The mandatory Pillar 3 disclosure templates, as outlined in the 2016 and 2017 revisions, can be found on the Authority's website (www.bma.bm).

ANNEX 1. BASEL III IMPLEMENTATION TIMETABLE FOR BERMUDA[10]

All Dates are as of 1st January	2015	2016	2017	2018	2019
Minimum CET1 CAR	4.50%	4.50%	4.50%	4.50%	4.50%
Capital Conservation Buffer	0.00%	0.63%	1.25%	1.88%	2.50%
Minimum CET1 CAR plus Capital Conservation Buffer	4.50%	5.13%	5.75%	6.38%	7.00%
Minimum Total CAR	8.00%	8.00%	8.00%	8.00%	8.00%
Minimum Total CAR plus Capital Conservation Buffer	8.00%	8.63%	9.25%	9.88%	10.50%
Leverage ratio	5.00%	5.00%	5.00%	5.00%	5.00%
LCR	60.00%	70.00%	80.00%	90.00%	100.00%

[10] Does not include the D-SIB buffer