MINISTRY OF FINANCE AND THE PUBLIC SERVICE

Presentation by the Honourable Audley Shaw, CD, MP

At the Jamaica Institute of Financial Services' Seminar

On

'THE EVOLUTION & FUTURE OF CAPITAL ADEQUACY STANDARDS'

Wednesday, April 19, 2017

Knutsford Court Hotel

Salutation: Moderator and Chief Corporate Secretary at GraceKennedy: Mrs. Gail Moss-Solomon; President of the Jamaica Institute of Financial Services, Mr. Nigel Holness; and Mr. Arthur Dania, Manager of Banking Compliance and Risk at IBIS, other specially invited guests, ladies and gentlemen, good morning.

I must say thanks to the JIFS and IBIS for inviting me to speak at this important seminar on Capital Adequacy, which is such a major pillar in maintaining sound financial system.

Ladies and gentlemen, the strength of any financial institution lies not only in its robust and prudential framework but also in the effectiveness and regulatory standards of its supervisor. While globally, the established guidelines proved inadequate to mitigate the impact of the financial crisis of 2008-2009 on global economic growth, in the Jamaican context, we were spared the ravages of that crisis because having learned our lesson from our own financial meltdown in the 1990's, we implemented the mechanisms to guard against such future occurrences.

The lessons of the 1990's served us as a distinct advantage during the crisis of 2008 because we had re-engineered the local financial sector in such a way so as to withstand the type of contagion which precipitated what some have called the greatest crisis since the great depression.

An ambitious reform effort by local regulatory authorities has continued since then to address recognized weaknesses of the frameworks governing the supervision of the financial system. Those measures have contributed to the Jamaican deposit-taking system becoming and remaining well capitalized and liquid throughout the global financial crisis of 2008–2009.

Consequently, Jamaica's current capital adequacy framework is more conservative, and is held to a higher standard, in certain aspects, than the Basel I, II and III capital adequacy standards[1].

For example, in Jamaica we have long had a leverage ratio, a non-risk-based measure to supplement the risk-based minimum capital requirements, which requires Deposit Taking Institutions to fund at least six per cent of their assets from regulatory capital. The Basel Committee, for the first time, has introduced a leverage ratio of three per cent, as part of the measures introduced under Basel III capital standards.

Ladies and gentlemen, you will also recall that Jamaica underwent IMF/World Bank Financial Sector Assessment Programme in 2005. The report indicated an overall improvement in ratings compared with the 2002 assessment conducted by

[1] The Basel Accords are three sets of banking regulations (Basel I, II and III) set by the Basel Committee on Bank Supervision (BCBS), which provides recommendations on banking regulations in regards to capital risk, market risk and operational risk. The purpose of the accords is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses.

the IMF. Jamaica's supervisory framework was rated as fully or largely compliant with 22 of the 25 original Basel Core Principles issued in 1997.

The Bank of Jamaica has further developed an action plan toward the implementation of Basel 11Capital Adequacy Framework.

Furthermore, added conservatism by the Bank of Jamaica comes in the form of its classification of Tier 1 capital. Tier 1 capital is the core measure of a bank's financial strength as it is composed of permanent capital, which by Basel's allowances, is primarily common stock, retained earnings and inventive instruments, subject to strict conditionalities. The BOJ's prescription digresses by the non-inclusion of retained earnings as it opts instead to include retained earnings reserve (a fund from retained earnings that has been put beyond distribution), statutory reserve fund or any other fund so approved by the Supervisor. This means that these funds are set aside purely for the absorption of losses and not for paying out dividends.

Bank of Jamaica in exercising its conservatism was a significant contributor to the financial system remaining adequately capitalized throughout the last crisis of 2008.

Ladies and gentlemen, the following initiatives geared toward ensuring Capital Adequacy have kept the Bank of Jamaica extremely busy.

Firstly, Consolidated Supervision:

The Banking Services Act in September 2015 took into consideration the changes needed, given the shifting dynamics of the landscape. The Act amalgamated the supervisory framework for deposit-taking institutions and extended the regulatory framework to financial holding companies. These measures were taken amid a wider need, identified by the BOJ, to broaden its supervisory scope to keep pace with international standards.

During 2016, work was undertaken in preparation for the implementation of the attendant licensing and supervisory measures for Financial Holding Companies.

Financial groups which contain a deposit-taking entity must re-organize to ensure that the group is headed by a Financial Holding Company. The primary responsibility of the Financial Holding Company is to provide capital and liquidity support for its subsidiaries as well as to manage risks on an enterprise-wide basis.

Additionally, the Bank of Jamaica, in November 2016, issued consultation papers on the Consolidated Capital Adequacy Framework- and the Form of Licence Application for the Financial Holding Company.

These consultation papers will inform the attendant Regulations and Rules, and are consistent with international best practice and standards. These subsidiary legislations are important components of the supervisory toolkit for the effective oversight of financial groups.

Secondly, Consolidated Capital Adequacy:

Ladies and gentlemen, this brings Jamaica into closer alignment with international supervisory principles as the BOJ continues to finalize the proposed framework which should be completed in 2017. As is the case for Deposit Taking Institutions, Financial Holding Companies are expected to maintain leverage or primary ratio of six per cent and a risk-based capital adequacy ratio of ten per cent. The framework is intended to supplement rather than replace the current stand-alone capital adequacy requirements for DTIs.

The third initiative by the BOJ, I want to look at, is the Licensing of Financial Holding Companies:

The licensing framework being developed by the regulator, will guide entities seeking to operate as deposit-taking institutions by crafting a set of protocols that these entities must adhere to.

The transition, re-structuring or creation of Financial Holding Companies should eventually be a seamless one.

The areas covered under the licensing framework include: the ownership and group structure; financial resources and strength; strategic plans and projections; governance structure and arrangements, risk management and internal controls; corporate governance and IT systems.

Of note as well is the recovery plan of the Financial Holding Company that will guide how it handles and resolves problems within the group, if and when they arise.

The fourth initiative speaks to Risk-based Supervision:

The BOJ is reforming its methodology for supervising licensees as it seeks to improve the efficiency and effectiveness of the supervisory process. This aspect of reform was started in 2015, is expected to be fully rolled out by 2018 and will extend to consolidated supervision.

Supervisory attention is therefore focused on understanding at a fundamental level, the business of a licensee, the various risks that are inherent in their key business lines and importantly, how licensees identify, measure, mitigate and manage those risks.

To this end, ladies and gentlemen, the BOJ is placing significant attention, as the supervisor, on the corporate governance structure and the level of oversight given by the company's Board of Directors.

I began my presentation with a look at the impact of the 1990's meltdown and how our financial system fared and has evolved. In this context, Crisis Management is another important aspect of the BOJ's initiatives toward the evolution of our Capital Adequacy Standards.

When the economy is growing, banks are inclined to take increasing levels of risks. The appetite for this is no doubt bolstered by the rise and comforting trends of the market. However, when things or not so good, or begin to deteriorate, everybody cries wolf and runs to the treasury, and for us in the Jamaican context, the Ministry of Finance.

This is one of the remaining challenges that must be addressed with proper supervision.

In keeping with international regulatory reform initiatives pursued to enhance the resilience and stability of the financial system, the Bank of Jamaica in conjunction with the Ministry of Finance, the Financial Services Commission and the Jamaica Deposit Insurance Corporation, are developing the framework to manage the resolution of a failing financial institution.

This should minimize the cost to the public purse.

The framework being developed will ensure that a failing entity exits the system in an orderly manner, with minimal disruption to the public in terms of access to financial services and with minimal draw down on public funds, which will be a last resort.

The Ministry of Finance and the Public Service, Bank of Jamaica, Financial Services Commission and Jamaica Deposit Insurance Corporation jointly issued a consultation paper in February this year, outlining proposals to enhance the current legal framework for the resolution of regulated non-viable financial institutions in Jamaica.

This will inform the drafting of a policy proposal to introduce appropriate legislation regarding the reform of the current resolution framework for financial institutions and when complete, will be submitted to nation’s Parliament.

Several players such as Financial Holding Companies under the Banking Service Act and the members of that group; commercial banks; merchant banks; and building societies regulated by Bank of Jamaica as well as securities dealers and life and general insurance companies regulated by the Financial Services Commission, will fall under the supervision of this framework.

Credit Unions designated as specified financial institutions under The Bank of Jamaica Act will also be included in the scope once the regulatory framework for credit unions is finalized.

The proposals under the consultation paper advocate a hybrid approach to resolution. It suggests that systemically important financial institutions would be resolved under the proposed special resolution regime while those institutions that are not systematically important, would be allowed to exit utilizing a modified insolvency framework specific to the nature of the financial institutions.

The consultation period will end sometime in the middle of this month, and the legislation scheduled to be in place by the end 2018.

In addition, a Micro-Credit Bill will shortly be tabled in parliament to regulate the micro-finance sector. This is necessary as Jamaica seeks to expand formal financial inclusion that sis consistent with international best practices of transparency.

We turn now to the Implementation of the Basel Accords:

The Bank of Jamaica has drafted a Basel implementation guideline taking into consideration the various types of financial entities operating locally and their scale of operations.

While new elements will be introduced in respect of capital management, risk management and disclosure requirements, the BOJ has, at present, established some of the preconditions for Basel II implementation.

These preconditions align with Pillar 2 requirements – for minimum capital, supervisor review and market discipline and are consistent with the development of the BOJ's Risk-based Supervisory Framework.

The Bank of Jamaica will continue to build on its earlier initiatives by focusing attention on the adoption of supervisory policies and systems that will enable an inclusive and realistic implementation of Basel II and III Capital Accords. Full implementation of the Basel II and III frameworks is expected by end-December 2019 and the end of December 2020, respectively.

In closing, the improved performance of the economy underscores the need for resilience in the financial system.

The year ending 2016 saw the approval for the granting of three banking licenses to qualified applicants. Two of these approvals involved institutional upgrades to commercial banks from a merchant bank and a building society, while the third relates to the acquisition of an existing licensee by a new investor.

This widening of the playing field stresses the need for the Bank of Jamaica to continuously safeguard the financial system's resilience by raising the quantity, quality and consistency of bank capital and liquidity based on international standards. This must be done within the context of supporting the continuous improvement in the risk-management functions of licensees as they manage the risks to which they are predisposed given the activity in the financial sector that they engage in.

Equally, it is the intention of Government to require a review of such issues as the existing Cash Reserve Ratio requirements and the assets tax for commercial banks among other things.

With a high cash reserve ratio and no interest paid, combined with assets taxes on banks, and a 33.3 per cent profit tax, this leads to over 50 per cent taxation on banks, and is one of the reasons that banks try to claw back profits by way of excessive bank charges.

Ladies and gentlemen, these issues require further forensic investigation going forward and as Minister, I will ensure that this is done.