FINANCIAL SERVICES COMMISSION

GUIDELINES FOR INTERIM CAPITAL STANDARDS FOR SECURITIES DEALERS

1.0 BACKGROUND

Regulations 2A and 2B of the Securities (Licensing and Registration) Regulations ("the Regulations")[1] give the Commission the ability to specify a capital adequacy ratio that must be maintained by its licensees. The capital adequacy ratio to be maintained by each licensee is expressed as a percentage and is determined by comparing the entity's capital base with its risk-based assets, and risk exposures after applying respective weights specified by the Commission. In addition, the Regulations state that in the event that a licensee's capital adequacy ratio falls below a percentage specified by the Financial Services Commission ("FSC"), then the licensee must forthwith notify the Commission in writing of this fact.

The FSC will be commissioning a study to identify the appropriate risk-based capital adequacy weights and percentages to be determined and specified by the FSC. This study will also assist the FSC in a broader review of the capital adequacy provisions applicable to all licensees in the securities industry. The FSC anticipates, for example, that the minimum capital requirement for securities dealers, currently $5 million of net free assets, will be substantially increased.

The FSC has determined that the capital adequacy requirements of the industry require amendment in order to enhance protection of the interests of investors. Accordingly, the FSC is now determining the risk-based capital adequacy weights and specifying the percentages in accordance with regulations 2A and 2B. This determination and specification together with the Guidelines for Margin Requirements for Repurchase Agreements (SR-GUID-04/07-0010) are referred to as the Interim Capital Standards for Securities Dealers.

The previous capital requirements set out in the Regulations did not cover certain important aspects of a dealer's business and the attendant risks. Specifically, they

[1] Regulations 2A and 2B where inserted in the principal regulations by the Securities (Licensing and Registration) (Amendment) Regulations, 2001.

took no account of default, market, liquidity and settlement risks. Capital markets everywhere require securities firms to hold capital that is commensurate with the attendant risks accepted by the firms.

The interim capital standards are made up of two components:

i) Capital Adequacy Ratio of not less than 10 percent; and

ii) Margin requirements for repurchase agreements[2].

The FSC is broadly applying, with slight modification, the capital base and risk-based capital adequacy weights as they are defined and set out in the Basel I capital standard used internationally. The margin requirements for repurchase agreements are designed to supplement this capital base and to take account of the additional interest rate and liquidity risks to which the securities dealers are exposed and which are not otherwise mitigated, and to ensure that investors who provide credit to dealers are adequately protected.

2.0 DEFINITION OF TERMS

For the purpose of these guidelines, the following terms are defined as follows:

"Custodial arrangement" (including non-discretionary FUM) means that the licensee has the responsibility only for the safekeeping of securities or financial instruments on behalf of its investors, pursuant to a safekeeping agreement. Custodial arrangements (including non-discretionary FUM) can also apply to securities or financial instruments held in safekeeping which were acquired through brokered transactions based on specific instructions provided by the investor to the broker.

"Funds under Management" ("FUM") means all situations where customers provide a licensee with cash, securities, financial instruments or contracts for the purpose of investing/dealing in investments or other assets in a manner as may be agreed between the parties; or in a pool of investments or any variation or combination of these. This includes the following situations:

a) where the terms of agreement or arrangement allow the licensee full, partial or no discretion with regard to the investment activity to be carried out on behalf of investors; or

b) where the funds are invested together with the funds of other investors in a collective manner or are to be invested in a segregated manner;

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[2] For guidance on these requirements, see FSC release entitled "Guidelines for Margin Requirements for Repurchase Agreements", numbered SR-GUID-04/07-0010. This document, "Guidelines for Interim Capital Standards for Securities Dealers" should be read in conjunction with the "Guidelines for Margin Requirements for Repurchase Agreements".

“General provisions for loss” means all the accumulated provisions for loss which are prudential in nature and cannot be determined on an item-by-item basis.

“Licensee” means a dealer licensed under the Securities Act.

“Ordinary shares” means that sole class of shares in the capital base of a licensee which are non-redeemable and in which the rights of the holders thereof are equal in all respects.

These rights include:

(a) the right to vote at all meetings of shareholders except where only shareholders of a specified class of shares are entitled to vote;

(b) the right to receive dividends declared on those shares; and

(c) the right to receive the remaining property of the licensee on liquidation

“Preferred shares” means shares in the capital base of a licensee other than ordinary shares, which are preferred in matters of the distribution of profits, payment of dividends and the liquidation of assets in winding-up proceedings and such other matters.

“Prescribed deductions” means the aggregate of:

(a) the licensee’s investments in unconsolidated subsidiaries of the licensee and in any other unconsolidated entities in which the licensee has a substantial investment;

(b) the licensee’s proportionate share of the amount of the accumulated losses of any unconsolidated subsidiary or any other unconsolidated entity in which the licensee has a substantial investment;

(c) other facilities provided by the licensee that are treated as capital by unconsolidated subsidiaries and by any other unconsolidated entities in which the licensee has a substantial investment;

(d) new and existing capital issues between two or more companies that represent, either directly or indirectly, back to back securities[3].

[3] An example of a back to back security is as follows: If company A purchased shares valued at $10,000 in company B and company B whether simultaneously or some time in the future purchased shares valued at $10,000 in company A, the new capital of $10,000 in both companies would not be treated as additional capital. Instead, the new capital of $10,000 would be deducted from the total capital base of both companies in order to determine the capital base for the risk-based capital calculation.

"Subordinated debt" means an instrument evidencing an indebtedness of a licensee that by its terms provides that the indebtedness will, in the event of the insolvency or winding up of the licensee, be subordinated in right of payment to all client liabilities and all other liabilities of the licensee except those that, by their terms, rank equally with or are subordinate to such indebtedness.

"Subsidiary" means a company of which more than 50 percent of the voting shares are owned by another company, called the parent company.

"Substantial investment" means **-**

a) a licensee's investment in a body corporate where:

   i) the voting rights attached to the aggregate of any voting shares of the body corporate beneficially owned by the licensee and by entities controlled by the licensee represent 20 percent or more of the voting rights attached to all of the outstanding voting shares of the body corporate; or

   ii) the aggregate of any shares of the body corporate beneficially owned by the licensee and by any entities controlled by the licensee represent ownership of 20 percent or more of the shareholders' equity of the body corporate; and

b) a licensee's investment in an entity other than a body corporate where the aggregate of ownership interests, however designated, into which the entity is divided and which are owned by the licensee and by any entities controlled by the licensee represent 20 percent or more of all of the ownership interests into which the entity is divided**.**

"Tier 1 capital" means the aggregate of:

a) issued and fully paid-up capital in the form of ordinary shares;

b) issued and fully paid-up capital in the form of perpetual non-cumulative preference shares;

c) capital paid in excess of par value of qualifying ordinary and perpetual non-cumulative preference shares (share premium);

c) capital raised by the licensee from an issue of its shares to a Government agency or undertaking pursuant to an arrangement for the provision of financial assistance to the licensee for the purpose of its restructuring;

d) eligible reserves, as approved by the Commission.

LESS the aggregate of:

i) any accumulated losses for previous years as well as losses for the current year; and

ii) any goodwill, start-up expenses and other intangible assets. "Intangible assets" for the purpose of these guidelines do not include computer software.

"Tier 2 capital" means the aggregate of -

a) qualifying paid-up capital in the form of perpetual cumulative preference shares;

b) qualifying paid-up capital in the form of term preference shares with an original term to maturity of five years or more;

c) capital paid in excess of par value of qualifying perpetual cumulative and term preference shares (share premium);

d) remaining balances on subordinated debt;

e) subordinated debt issued to the Government of Jamaica ("GOJ") or an agency of the GOJ for the purpose of effecting financial assistance;

f) general provisions for loss on assets up to a maximum of one and one quarter percent (1.25%) of the licensee's risk weighted assets

g) other reserves as approved by the Commission

3.0 CAPITAL ADEQUACY RATIO

3.1 The Regulations

Regulations 2A and 2B read as follows:

"2A. (1) Every licensee shall maintain at all times a capital adequacy ratio between its capital base and its risk-based assets and other risk exposures, of not less than the percentage specified by the Commission by notice in writing.

(2) The Commission shall determine the respective weights to be applied to the risk-based assets and other risk exposures.

2B. Where the capital adequacy ratio of any licensee falls below the percentage specified by the Commission in writing the licensee shall forthwith notify the Commission in writing."

3.2 The Capital Base

For the purpose of these guidelines, the definition of capital base for calculating the Capital Adequacy Ratio shall be measured by reference to the aggregate of all of the licensee's Tier 1 and Tier 2 capital less prescribed deductions.

Each licensee shall maintain at all times a capital base comprising of not less than fifty percent (50%) Tier 1 capital provided that such percentage may be varied from time to time by notice issued by the Commission.

3.3 Risk-based Assets, Risk Exposures & Weights

The Risk-based Assets and other Risk Exposures referred to in regulation 2A(1) of the Regulations are set out in column 1 of Table 1. The weights to be applied to these assets and exposures, determined by the Commission in accordance with regulation 2A(2) of the Regulations, are set out in column 2 of Table 1.

Table 1

Column 1 **Risk-based Assets and Risk Exposures**	Column 2 **Weights**
Assets:	
Cash on Hand	0%
Bank of Jamaica ("BOJ") Deposits and Instruments (including BOJ Repurchase Agreements)	0%
Government of Jamaica ("GOJ") Debt Securities	0%
Loans granted to or which are guaranteed by the GOJ	0%
Debt securities issued by statutory bodies or	0%

[4] Applies to G-10 countries other than the US, UK and Canada.
[5] Applies to foreign countries other than the US, UK and Canada

Column 1 **Risk-based Assets and Risk Exposures**	**Column 2** **Weights**
companies owned or controlled by the GOJ, or an agency of the GOJ, and which are guaranteed by the GOJ (including undertakings)	
United States ("US"), United Kingdom ("UK") and Canadian Debt (Government and Central Bank)	0%
Other G-10 Debt[4] (Government and Central Bank)	0% – subject to the approval of the FSC[6]
CARICOM Debt (Government and Central Bank)	0% – subject to the approval of the FSC[7]
Loans (100% cash or GOJ debt secured)	0%
Goodwill	0%
Back-to-back Securities	0%
Investments in Unconsolidated Subsidiaries	0%
Deposits and Other Amounts Due from Local Banks	20%
Deposits and Other Amounts Due from Regulated Banks in the US, UK and Canada	20%
Deposits and Other Amounts Due from Regulated Foreign Banks in other countries[5] - subject to the approval of the FSC	20%
Due from Other Governments, Other Central Banks and Development Banks	20% – subject to the approval of the FSC
Residential Mortgages (First charge and current or arrears less than 3 months)	50%
Other Mortgages and Loans	100%

[6] Debt not approved for a 0% weight will normally be categorized as "Due from Other Governments, Other Central Banks and Development Banks" which attracts a 20% weight.
[7] See footnote immediately preceding this one.

Column 1 **Risk-based Assets and Risk Exposures**	Column 2 **Weights**
Equity Investments (Ordinary and Preference)	100%
Other Securities	100%
Fixed Assets	100%
Other Assets	100%
Foreign Exchange Risk Exposure (see paragraph 3.5 of these guidelines)	100%

3.4 Off-Balance Sheet Exposures

The activities of licensees give rise to a number of off- balance sheet exposures. Credit conversion factors for off-balance sheet exposures take account of the credit risk for the different types of off-balance sheet instruments or transactions. The credit conversion factor would be multiplied by the risk weight applicable to the category of the asset for an on-balance sheet transaction in order to determine the related capital requirements.

The Commission intends to assign a credit conversion factor of 25 percent to discretionary FUM and zero percent to securities held in custody. The view has been expressed by members of the securities industry that the credit conversion factor of 25 percent for the discretionary FUM category is too high. The FSC is deferring implementation of the capital adequacy requirement for these items until further research to determine the appropriate credit conversion factors has been completed.

In assigning credit conversion factors to these categories the FSC expects that consideration will be given to the existence of insurance coverage on custody assets in arriving at the specific capital requirement. In addition, if the funds under management include repurchase liabilities (“repos”) of the same dealer, then these repos would be deducted to arrive at the total funds under management that would be used for the purpose of calculating the capital adequacy ratio.

3.5 Foreign Exchange Risk Exposure

Foreign exchange risk exposure for capital requirement purposes is calculated using a two-step process.

a) The first is to measure the exposure in each single currency position.

b) The second is to measure the risks inherent in the licensee's mix of long and short positions in different currencies.

In order to measure the licensee's exposure in a single currency, the net open position in each currency should be calculated by totaling: -

- the net spot position (i.e. all asset items less all liability items, including accrued interest, denominated in the currency in question);

- the net forward position (i.e. all amounts to be received less all amounts to be paid under forward foreign exchange transactions);

- guarantees (and similar transactions) that are certain to be called and are likely to be irrevocable;

- any other item representing a profit or loss (e.g. accrued interest or expenses) in the foreign currency

In order to measure the exposure in the mix of long and short positions, the nominal amount (or net present value) of the net open position in each foreign currency is converted at spot rates into Jamaican dollars. The overall net open position is determined by totalling the net short positions and comparing it to the sum of the net long positions. The greater of the two is weighted 100% to which the capital requirement is applied.

3.6 Specified Percentages

The minimum capital adequacy ratio to be specified as a percentage by the Commission in accordance with regulation 2A(1) of the Regulations is set out in column 1 of Table 2. The percentage to be specified by the Commission below which the licensee is required to notify the Commission in writing in accordance with regulation 2B of the Regulations is set out in column 2 of Table 2.

Table 2

Column 1 Minimum Ratio of Capital Base to Risk-Based Assets and other Risk Exposures	**Column 2** Ratio of Capital Base to Risk-Based Assets and other Risk Exposures below which the Commission is to be notified
10%	12%

4.0 IMPLEMENTATION AND TRANSITIONAL ARRANGEMENTS

4.1 Each dealer is required to comply by December 31, 2004 with the interim capital requirements consisting of the guidelines contained in this document and the Guidelines for Margin Requirements for Repurchase Agreements (SR-GUID-04/07-0010).

4.2 Each dealer is required to prepare an assessment of their capital position as at September 30, 2004 and to present a 12-month projection of the position over the following 4 quarters. This is to be submitted to the FSC by October 31, 2004.

4.3 In addition

a) Dealers that anticipate difficulty in meeting the requirements by the due date must apply to the FSC for permission by September 30, 2004, to meet the requirements on an extended plan. Each application should contain a plan showing how they will meet the new requirements by December 31, 2005.

b) The FSC is likely to impose additional requirements and conditions on dealers needing to take advantage of the extended plan.

c) No dealer will qualify for the extended plan unless it is in compliance with all requirements of the Securities Act and Regulations at the time of application, or is deemed by the FSC to be making satisfactory progress in correcting deficiencies previously identified by the FSC or its predecessor.

4.4 Dealers, except those on the extended plan, are required to certify to the FSC by January 31, 2005 that they have met the requirements as at December 31, 2004.