



**SECURITIES INDUSTRY ADVISORY FOR
STRATEGY FOR PRUDENTIAL TIGHTENING
(MARCH 2016)**

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FINANCIAL SERVICES COMMISSION STRATEGY FOR PRUDENTIAL TIGHTENING (MARCH 2016)

1.0 Background

- 1.01 In keeping with the requirements of the Memorandum of Economic and Financial Policies (MEFP) pursuant to the Extended Fund Facility extended by the International Monetary Fund (IMF) to the Government of Jamaica (GOJ), the Financial Services Commission (FSC) is required to introduce and gradually tighten the prudential standards for the securities sector which it regulates. The MEFP makes allowance for the FSC to take into consideration feedback received from industry consultation as well as the impact of the minimum transaction size which was established at end-December 2015 prior to the commencement of the implementation of a strategy to achieve this prudential tightening, by March 2016.
- 1.02 The transition of the retail repo market to a trust-based arrangement which was accomplished at end-August 2015 may be classified as the Phase I objective of the Retail Repo Reform, while the implementation of a strategy for prudential tightening may be regarded as the Phase II objective.
- 1.03 The primary rationale for the Phase II objective is to ensure that in the near- to medium-term, the retail repo portfolios of individual firms and the securities industry as a whole will be at a level deemed by the Bank of Jamaica (BOJ) and the FSC to be systemically safe and prudentially manageable.
- 1.04 This document outlines a strategy which intends to achieve the Phase II objective.

2.0 Introduction

- 2.01 In light of feedback received from the securities industry in relation to an initial strategy proposal which was circulated on October 23, 2015, it became necessary to re-assess the FSC's intended strategy for prudential tightening.

- 2.02 Consideration was given to the fact that the trust-based arrangement, which was effected at end-August 2015, introduced greater transparency and clarity into the relationship between securities dealers and their retail repo clients. Restrictions were also placed on the quality and type of assets which may underlie retail repo contracts. Additionally, these securities are now kept separate from, and are easily identifiable from, all the other assets of a securities dealer. However, whereas the Trust addresses the legal and operational risk concerns of the traditional framework, the financial risk (namely balance sheet risk) still remains.
- 2.03 Notwithstanding, any approach to prudential tightening or strengthening should not be too aggressive so as to result in market instability and increased systemic risk, but should rather be implemented in a methodical manner which achieves the strategy objective, while carefully assessing its impact on a continuous basis.
- 2.04 Against this background and in light of the recent passing of the Securities (Prudential Regulations), 2014 the FSC is of the view that it is prudent at this time to provide more clarity on already existing prudential requirements which are embedded in the Securities (Prudential) Regulations, 2014. These regulations, which were enacted on December 30, 2014, serve to strengthen the FSC's prudential supervision of the Securities Industry. Although several prescriptive measures are mentioned in the regulations, there is need for more clarity with respect to the method of computation for some quantitative metrics and the benchmark to be applied as well as how other areas of the regulations will be implemented.
- 2.05 In the absence of this clarity, the Industry has been allowed to continue doing business in the manner which predated the regulations. The delay in providing this well needed clarity primarily resulted from the fact that, in recent times, focus was placed on developing the legal and regulatory framework for retail repos, operationalizing the transition of retail repos to the trust-based arrangement, and addressing any post-transition matters that arose.
- 2.06 It is now deemed to be an appropriate time to provide the well needed clarity in the regulations. Accordingly, there is need for formal guidelines to be developed and circulated to the Industry.

3.0 Strategy Outline

- 3.01 In light of the foregoing, the FSC now proposes to achieve the Phase II objective of the Retail Repo Reform by enhancing its prudential supervision of the securities industry via the following broad steps:
- (i) Developing Prudential Guidelines for the securities industry which complement the Securities (Prudential) Regulations, 2014;
 - (ii) Implementing the Prudential Guidelines in tranches;
 - (iii) Utilizing a new ratio, the Retail Repo Leverage Ratio (RRLR) as a supervisory tool by monitoring the trend in values of this ratio for securities dealers without establishing a prudential benchmark at the outset of the strategy implementation; and

- (iv) On a continuous basis, assessing the market impact of the prudential strategy and determining whether or not the systemic risk posed by the retail repo market warrants further prudential strengthening.

4.0 Detailed Strategy Implementation

- 4.01 Please see Attachment 1 - Details of Strategy for Prudential Tightening document for more details on the strategy implementation.

5.0 Benefits to Be Derived From the Strategy for Prudential Tightening

- 5.01 The development and implementation of Prudential Guidelines will assist in achieving the objective of Phase II of the Retail Repo Reform by addressing, among other things:

- (i) Capital adequacy -The introduction of an operational risk weighted assets component in the computation of the capital adequacy ratio i.e. the capital base to risk-weighted assets and other risk exposures ratio will result in dealers having to hold more capital in direct proportion to the size of their asset base (both on and off the balance sheet).The trust arrangement mitigates some of the operational risks that were evident in the old retail repo framework. However, the addition of an operational risk weighted assets component to determining capital adequacy will serve to add an additional layer of risk mitigation.

In addition, the Securities (Prudential) Regulations, 2014 has other measures which are aimed at enhancing the nature and quality of the regulatory capital which dealers must hold. In particular, the regulations only recognize 'retained earnings reserve' and not 'retained earnings' as a component of 'tier 1 capital'. Generally speaking, 'retained earnings' forms a significant component of a securities dealer's 'tier 1 capital'. Securities dealers will have to be allotted a sufficient timeframe in order to transfer amounts from their retained earnings account to a 'retained earnings reserve' account. This will increase the permanent nature of their capital and reduce the ability to withdraw capital. This measure is strengthened even more by the requirement of regulation 7 of the Securities (Prudential) Regulations, 2014 which stipulates that: *"The licensee shall notify and seek permission from the Commission prior to the withdrawal of its equity capital or the equity capital of any subsidiary or affiliate of the licensee, where such withdrawal results in the licensee's capital base falling below such percentage specified by the Commission"*. Careful assessment needs to be done prior to specifying this percentage.

- (ii) Liquidity risk - The main emphasis will be on dealers' developing, implementing and maintaining sound liquidity management practices, and providing the FSC with sufficient evidence to substantiate any claims to this effect.

The introduction of a regulatory liquidity metric will also serve to compel a securities dealer to practice prudent asset-liability management by ensuring that their assets and liabilities are sufficiently matched.

- (iii) Early encashment concerns - The Prudential guidelines will emphasize steps which are geared towards reducing the volatility of retail repo funding. This is particularly important in light of the fact

that the main risks remaining unaddressed after the advent of the trust-based arrangement arise not from the size and/or structure of the underlying assets but from the structure of the retail repo liabilities.

- (iv) Concentration risk - The large exposure provision in the Securities (Prudential) Regulations, 2014 allows the FSC to specify the limit for all credit exposures that a securities dealer may have with other counterparties. This serves to limit concentration risk.
- (v) The need for regular stress testing - Stress Testing Guidelines will establish a basis for dealers to adopt a set of assumptions for use in conducting stress tests on their investment portfolios. This will encourage dealers to make better informed investment decisions in light of the potential impact of certain variables on their continued viability.
- (vi) The need for a supervisory tool specific to retail repos - The RRLR will assist the FSC in its prudential supervision of the retail repo market by introducing a capital buffer which will serve to protect retail repo dealers from extreme movements in the value of the assets which underlie their retail repo obligations.

6.0 CONCLUSION

- 6.01 Taking the approach of implementing Prudential Guidelines which complement the Securities (Prudential) Regulations, 2014 appears to be a prudent measure which will not only enhance the FSC's prudential supervision of the entire securities industry but will also achieve the Phase II objective of the Retail Repo Reform while reducing the likelihood of the occurrence of any negative consequences which could cause market disruption.
- 6.02 The FSC is of the view that the introduction and enforcement of the Prudential Guidelines will sufficiently address the remaining financial risk with the retail repo model, and will, in the near- to medium-term, result in the retail repo portfolios of securities dealers naturally adjusting to levels that can be considered to be systemically safe and prudentially manageable.
- 6.03 The FSC remains committed to:
 - (i) developing its prudential supervision in a way which provides incentives for securities dealers to broaden the range of products that they can offer to the public; and
 - (ii) ensuring that prudential reforms are implemented in a manner which preserves the stability and viability of the securities sector.
- 6.04 The FSC will continuously assess the impact of the Strategy for Prudential Tightening on securities dealers' financial viability, and reserves the right to amend, suspend, cease or reverse the phased implementation schedule. In addition, the pace of the implementation will be subject to a continuous review of market conditions.

- 6.05 The FSC may take enforcement action in the event that licensees fail to comply with any aspect of the Strategy for Prudential Tightening.



**FINANCIAL SERVICES COMMISSION
APPENDIX I - DETAILS OF STRATEGY FOR PRUDENTIAL TIGHTENING
MARCH 31, 2016**

	KEY DELIVERABLES	DETAILED STEPS	REFERENCE IN SECURITIES (PRUDENTIAL) REGULATIONS, 2014	IMPLEMENTATION START DATE	TARGET DATE FOR FULL IMPLEMENTATION
1	Strategy Implementation through Development & Implementation of Prudential Guidelines on a Phased Basis	Bring effect to the contents of the Strategy for Prudential Tightening via the following steps: <ul style="list-style-type: none"> (i) The FSC will develop and release Prudential Guidelines which complement the Securities (Prudential) Regulations, 2014. (ii) The Prudential Guidelines will be developed in tranches. The end result will be fully comprehensive guidelines which factor in all sections of the Securities (Prudential) Regulations, 2014. (iii) See 1a to 1g below for more details. 		March 31, 2016	April 1, 2019
1a	Strengthen the capital adequacy of	(i) In computing its capital adequacy ratio, a	Regulation 17 – “A licensee shall	April 1, 2016	April 30, 2016

	KEY DELIVERABLES	DETAILED STEPS	REFERENCE IN SECURITIES (PRUDENTIAL) REGULATIONS, 2014	IMPLEMENTATION START DATE	TARGET DATE FOR FULL IMPLEMENTATION
	licensees by including an Operational Risk Weighted Assets component in the computation of the capital adequacy ratio.	<p>licensee shall include an Operational Risk Weighted Assets (ORWA) amount in the denominator of the capital adequacy ratio.</p> <p>(ii) In computing the ORWA, a licensee shall multiply its total balance sheet assets and off balance sheet funds under management by a factor, alpha = 0.40%.</p> <p>(iii) As a result of steps (i) and (ii),</p> <p>Capital Adequacy Ratio =</p> $\frac{\text{Capital Base}}{\text{CRWA} + \text{MRWA} + \text{ORWA} + \text{FXE}}$ <p>Where:</p> <p>Capital base = (Tier 1 Capital + Tier 2 Capital) – prescribed deductions. CRWA = total credit risk weighted assets MRWA = total market risk weighted assets ORWA = total operational risk weighted assets; and FXE = foreign exchange exposure</p> <p>(iv) The FSC will revise the C1 form reporting template to ensure that licensees' financial submissions reflect the inclusion of the ORWA in the capital adequacy ratio computation. (C1 forms prepared as at April 30, 2016 and reporting periods going forward should include the</p>	<p><i>determine the total operational risk-weighted assets amount by applying to the aggregate value of total balance sheet assets and off balance sheet funds under management, a factor that the Commission may specify, from time to time, by notice published in the Gazette or by other written means”.</i></p> <p>Schedule, Part A</p>		

	KEY DELIVERABLES	DETAILED STEPS	REFERENCE IN SECURITIES (PRUDENTIAL) REGULATIONS, 2014	IMPLEMENTATION START DATE	TARGET DATE FOR FULL IMPLEMENTATION
		<i>ORWA requirement in the capital adequacy ratio computation.)</i>			
1b	Further strengthen the capital adequacy of licensees by enforcing the requirement that only retained earnings reserve shall be included in "Tier 1 capital".	<p>(i) The FSC will hold consultations with the Bank of Jamaica, securities dealers and other stakeholders with the objective of developing an appropriate methodology for transferring balances from a dealer's retained earnings account into a retained earnings reserve.</p> <p>(ii) Once the methodology in (i) has been determined, the FSC will seek to introduce the requirement on a phased basis.</p>	Regulation 2 – "Tier 1 capital means the aggregate of...(d) retained earnings reserve, where the structure and composition of the reserve is prescribed or approved by the Commission....."	April 30, 2016	April 1, 2019
1c	Strengthen the liquidity management of licensees.	<p>(i) Licensees shall ensure that they develop and monitor liquidity risk management programmes along the lines of the requirements of Regulation 15 of the Securities (Prudential) Regulations, 2014.</p> <p>(ii) The FSC will collect and review the liquidity management plans of securities dealers.</p> <p>(iii) Testing of licensee liquidity risk management practices will be included as a routine component of the FSC's on-site and off-site examinations.</p>	<p>Regulation 15 (1) (a) – "Every licensee shall develop and monitor liquidity risk management programmes taking into consideration a broad range of adverse circumstances, including extraordinary credit events"</p> <p>Regulation 15 (1) (b) – "Every licensee shall demonstrate to the Commission that it is conducting liquidity risk management in a sound manner"</p>	April 30, 2016	April 1, 2017
1d	Gradually introduce a liquidity ratio	(i) The FSC will suspend the use of the 1 year liquidity gap ratio as outlined in the	Regulation 16 – "The Commission may, from time to	April 1, 2016	April 1, 2017

	KEY DELIVERABLES	DETAILED STEPS	REFERENCE IN SECURITIES (PRUDENTIAL) REGULATIONS, 2014	IMPLEMENTATION START DATE	TARGET DATE FOR FULL IMPLEMENTATION
		<p>Securities (Early Warning Tests) Bulletin – SR-ADVI-05/03-0001.</p> <p>(ii) The FSC will hold consultations with the Bank of Jamaica, securities dealers and other stakeholders with the objective of developing a suitable liquidity ratio for the securities industry.</p> <p>(iii) Once a suitable liquidity ratio has been determined, steps will be taken to monitor licensee levels in the proposed ratio, after which a target benchmark will be established and phased-in over time.</p>	<p><i>time, establish such liquidity ratio as it may deem fit to measure a licensee’s ability to meet its short-term financial obligations on time.”</i></p>		
1e	Implement liquidity controls through appropriate restriction on the early encashment of retail repurchase agreements	<p>(i) The FSC will examine the value and volume of early encashments relating to retail repurchase agreements over a specified time period in order to determine the extent to which early encashments impact the liquidity management ability of licensees. The FSC will take into consideration steps that have been implemented by licensees to discourage early encashments.</p> <p>(ii) Dependent on the outcome in (i) and the results of industry consultation on the matter, the FSC may introduce early encashment restrictions on retail repurchase agreements. To guide the deliberation, the FSC will explore variables such as the value of</p>	<p>Regulation 19 (1) – <i>“The Commission may, by way of guidelines, specify the early encashment restrictions for repurchase agreements and the time frame for the early encashment restrictions on repurchase agreements”</i></p>	April 30, 2016	April 1, 2017

	KEY DELIVERABLES	DETAILED STEPS	REFERENCE IN SECURITIES (PRUDENTIAL) REGULATIONS, 2014	IMPLEMENTATION START DATE	TARGET DATE FOR FULL IMPLEMENTATION
		encashments as a percentage of the total retail repo portfolio or of regulatory capital.			
1f	Manage risk related to large exposures	<ul style="list-style-type: none"> (i) The FSC will enforce the requirement for all licensees to submit an interdealer exposure report within 45 days of the end of each financial quarter. (ii) The FSC will use data obtained from the Interdealer Exposure report to assess the levels of large exposures by its licensees. (iii) Revisions will be made to the Interdealer Exposure template to better capture data which enhances the assessment of the large exposures of licensees. (iv) The FSC will establish the large exposure benchmark at 25%¹ i.e. licensees, except in the case of exemptions, will be prohibited from incurring exposures to any counterparty or group of affiliated counterparties which exceeds 25% of its capital base. (v) The FSC will determine a suitable phasing-in period for the large exposure benchmark based on careful assessment of data obtained from Interdealer Exposure reports. 	Regulation 14(2) (b) – “A licensee shall not incur exposures to any counterparty or group of affiliated counterparties which exceeds the percentage of its capital base as specified by the Commission by notice, in writing”;	June 30, 2016	April 1, 2019

¹ This target benchmark was adopted from the Basel Committee on Banking Supervision’s paper entitled “Supervisory framework for measuring and controlling large exposures”, dated April 2014.

	KEY DELIVERABLES	DETAILED STEPS	REFERENCE IN SECURITIES (PRUDENTIAL) REGULATIONS, 2014	IMPLEMENTATION START DATE	TARGET DATE FOR FULL IMPLEMENTATION
1g	Development of licensee stress testing functions	<p>(i) The FSC will outline the basic steps that should be included in any stress testing conducted by its licensees.</p> <p>(ii) Licensees will be required to conduct stress tests and share results with the FSC on a periodic basis.</p> <p>(iii) The FSC will discuss with each licensee the results obtained from their stress tests, may compare them with the results of the FSC's internal stress tests, and determine if any risk mitigating action is necessary.</p>	Regulation 21 (1) – <i>“The Commission shall prescribe the guidelines related to stress testing.”</i>	April 30, 2016	December 31, 2016
2	Introduce a new prudential tool and monitor dealer levels	<p>(i) The FSC will introduce the Retail Repo Leverage Ratio (RRLR) as a new prudential measure. The RRLR will be computed by dividing a dealer's regulatory capital (aggregate tier 1 & tier 2 capital) by its total retail repo obligations. Expressed as a percentage, the RRLR effectively measures the ability of a firm's regulatory capital to absorb a large fall in the value of the assets which underlie its retail repo obligations.</p> <p>(ii) The FSC will monitor the trend in values of this ratio for securities dealers without establishing a prudential benchmark at the outset.</p> <p>(iii) Once the relationship between the ratio</p>	Regulation 18 (1) – <i>“A licensee shall maintain at all times all ratios specified by the Commission by way of written notice”.</i>	April 30, 2016	April 1, 2019

	KEY DELIVERABLES	DETAILED STEPS	REFERENCE IN SECURITIES (PRUDENTIAL) REGULATIONS, 2014	IMPLEMENTATION START DATE	TARGET DATE FOR FULL IMPLEMENTATION
		<p>and the financial condition of a dealer is better understood, this will form the basis for establishing an appropriate supervisory benchmark and determining whether enhancements to the computation of the ratio are needed.</p> <p>(iv) Once a suitable benchmark is determined, the FSC will commence the process of phasing in the target benchmark.</p>			
3	Routinely assess the market impact of the Strategy for Prudential Tightening and determine if the strategy needs to be enhanced	<p>Assess the market impact of the Strategy for Prudential Tightening by looking at factors, inclusive of:</p> <p>(i) dealer levels of capital adequacy and liquidity;</p> <p>(ii) the extent to which dealers access the BOJ's Emergency Liquidity Facility²;</p> <p>(iii) the results of stress tests conducted on dealer financial data; and</p> <p>(iv) trends in prudential ratios.</p>		April 30, 2016	On-going

² The Emergency Liquidity Facility may not be extended to dealers which have excessive exposures to liquidity and interest rate risks relative to their capital.