



GUIDELINES

LARGE EXPOSURE FRAMEWORK FOR SECURITIES LICENSEES

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FINANCIAL SERVICES COMMISSION

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1.0 BACKGROUND

- 1.01 **The Securities (Prudential) Regulations, 2014**, (Prudential Regulations) were enacted on December 30, 2014 and serve to further enhance the prudential supervision of the securities industry by strengthening the industry's ability to withstand future shocks to the financial system.
- 1.02 Regulation 14 of the Prudential Regulations introduced a regulatory requirement for securities licensees to effectively identify, monitor, manage and report the risks related to large exposures. This large exposure framework complements the Financial Services Commission's (FSC) risk-based capital adequacy requirement and is intended to allow for better protection of licensees from large losses that could result from the sudden default of a single counter-party or group of connected counter-parties and, to remain as a going concern.
- 1.03 Material losses in one entity could potentially trigger concerns about the solvency of another entity, especially if the exposure between the two entities is significantly large. It is also quite possible that financial stability could be threatened as a result. The effective management of large exposures should therefore form an important component of every licensee's risk management framework. Management of large exposures across the financial system will significantly contribute to the maintenance of stability in Jamaica's financial sector.

2.0 DEFINITIONS

- 2.01 For the purposes of these Guidelines, the following terms are defined:

Capital base means the aggregate of Tier 1 capital and Tier 2 capital minus prescribed deductions.

Connected counterparties mean a group of counter-parties with specific control relationships or financial or economic interdependencies such that, were one of the counter-parties to fail, all of the counter-parties would very likely fail.

Counterparty means any party with whom a licensee has a contractual agreement and includes investors, borrowers, secured creditors, issuers of securities and collective investment schemes.

Exposure means the maximum loss that a licensee may incur if a counterparty or a group of connected counterparties fails to meet its obligation to the licensee.

Large exposure means the total exposure of a licensee to counterparty or a group of connected counterparties, which in aggregate is not less than ten per cent (10%) of the licensee's capital base.

Large Exposure Limit means the regulatory prescribed limit for the sum of all exposure values of a securities licensee to a counterparty or to a group of connected counterparties, as a percentage of the licensee's eligible capital base.

Risk Concentrations mean the collective amounts invested in a corporate instrument or loaned to a counterparty that is either the same issuer of the corporate instrument or is connected to the issuer of the corporate instrument.

3.0 SCOPE

- 3.01 These Guidelines are applicable to all licensees under the **Securities Act** with the exception of insurance companies that are licenced securities dealers which are also registered under the **Insurance Act**. Insurance companies licenced as securities dealers will continue to comply with the provisions as stipulated in Regulations 42 and 82 of the Insurance Regulations, which set limits of five per cent (5%) of total assets for counterparty and related party transactions.

4.0 THE ROLE OF THE BOARD OF DIRECTORS

- 4.01 Every licensee shall establish and maintain written policies and procedures, approved by its Board of Directors, which govern the management of the licensee's risks related to large exposures. The Board must ensure that these policies and procedures are reviewed regularly to make sure that they remain adequate and appropriate for the licensee's risk appetite and capital resources.
- 4.02 The Board approved policies and procedures on large exposures should form a part of the licensee's risk management framework and at a minimum, cover:
- (i) The definitions and limits for each type of exposure to individual counterparties and group of connected counterparties, (inclusive of related parties) considered acceptable to the Board;
 - (ii) Procedures and mechanisms for conducting assessments of financial or economic interdependence in order to identify and monitor exposure to groups of connected parties.
 - (iii) Procedures for identifying, measuring, monitoring, controlling and reporting various exposures in relation to their approved limits;
 - (iv) The circumstances for which limits may be exceeded for each type of exposure and the authorisation process for approving these exceptions; and
 - (v) The allocation of duties in relation to large exposure monitoring, reporting and pre-notification and/or request for waivers to the FSC.

- 4.03 The Board should ensure that the licensees have adequate systems and controls in place to identify, measure, monitor and report large exposures to the FSC so that licensees remain in compliance with the phased-down implementation and transitional arrangements for the large exposure framework as set out in paragraph 11.02 of these Guidelines.

5.0 IDENTIFYING LARGE EXPOSURES

- 5.01 A large exposure is an exposure to a single counterparty or a group of connected counterparties which is greater than, or equal to ten per cent (10%) of a licensee's capital base.
- 5.02 For the purpose of the large exposure framework, a group of connected counterparties shall be treated as a single exposure. In this case, the sum of the licensees exposures to all the individual entities included within a group of connected counterparties is subject to the large exposure limit and to the regulatory reporting requirements as prescribed below.

5.1 *Identifying Groups of Connected Counterparties*

- 5.10 A group of connected counterparties is deemed to exist where two or more single counterparties are linked by at least one of the following criteria:
- (a) a control relationship
 - (b) a financial or economic interdependence relationship,
 - (c) Any other connection or relationship which according to the FSC's assessment identifies the counterparties as constituting a single risk to the licensee.
- 5.11 A control relationship exists between two counterparties if one of the counterparties directly or indirectly has control over the other counterparty. A control relationship is deemed to exist if a counterparty owns more than fifty per cent (50%) of the voting rights of the other counterparty. In addition, licensees must assess connectedness between counterparties based on control using the following criteria:
- A. Voting agreements (e.g. control of a majority of voting rights pursuant to an agreement with other shareholders);
 - B. Significant influence on the appointment or dismissal of an entity's administrative, management or supervisory body, such as the right to appoint or remove a majority of members in those bodies, or the fact that a majority of members have been appointed solely as a result of the exercise of an individual entity's voting rights;
 - C. Significant influence on senior management, e.g. an entity has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of another entity (e.g. through consent rights over key decisions).
- 5.12 In determining whether a control relationship exists, licensees are also expected to refer to criteria specified in appropriate internationally recognized accounting standards from time to time for further qualitative guidance.
- 5.13 Where control has been established based on any of the criteria outlined in paragraph 5.11, licensees may still in exceptional cases demonstrate to the FSC that such control does not necessarily result in the entities concerned constituting a group of connected counterparties.

- 5.14 A financial or economic interdependence relationship exists between two counterparties where, if one of the counterparties was to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter similar funding or repayment difficulties. In establishing connectedness based on a financial or economic interdependence relationship, licensees must consider, at a minimum, the following qualitative criteria:
- a. Where fifty per cent (50%) or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty (e.g. the owner of a residential/commercial property and the tenant who pays a significant part of the rent);
 - b. Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs;
 - c. Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers;
 - d. When the expected source of funds to repay each loan one counterparty makes to another is the same and the counterparty does not have another source of income from which the loan may be fully repaid;
 - e. Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities;
 - f. Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s);
 - g. When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found. In this case, the funding problems of one counterparty is likely to spread to another due to a one-way or two-way dependence on the same main funding source.
- 5.15 There may, however, be circumstances where some of the criteria highlighted in paragraph 5.14 do not automatically imply a financial or economic interdependence that results in two or more counterparties being connected. Provided that a licensee can demonstrate to the FSC that a counterparty which is economically closely related to another counterparty may overcome financial difficulties, or even the second counterparty's default, by finding alternative business partners or funding sources within an appropriate time period, the licensee does not need to combine these counterparties to form a group of connected counterparties.
- 5.16 There may be cases where a thorough investigation of economic interdependencies will not be proportionate to the size of the exposures. Therefore, licensees are expected to identify possible connected counterparties on the basis of economic interdependence in all cases where the sum of all exposures to one individual counterparty exceeds five per cent (5%) of the eligible capital base.

6.0 LARGE EXPOSURE LIMITS

- 6.01 Except in relation to "exempt counterparty exposures", a licensee shall not, directly or indirectly, incur exposures, on an aggregate basis to a single counterparty or a group of connected counterparties which must not exceed twenty five per cent (25%) of the licensees capital base.
- 6.02 The limits for intragroup exposures will be specified in writing by the FSC at a later date once the relevant assessments have been conducted on this source of concentration risk.

- 6.04 Notwithstanding paragraph 6.01, the FSC may, in writing, set specific limits on a licensee's exposure to particular counterparties, and groups of counterparties, on a case-by-case basis, having regard to the licensee's individual circumstances.

7.0 EXEMPT EXPOSURES

In paragraph 6.01, "exempt counterparty exposures" mean :

- (a) Exposures considered as prescribed deductions by regulation 2 of the Prudential Regulations. These include:
- i. equity investments in unconsolidated subsidiaries;
 - ii. any substantial investment, whether held directly or indirectly, in any other unconsolidated entities or companies;
 - iii. the proportionate share of the amount of accumulated losses of any unconsolidated subsidiary or any other unconsolidated entity or company in which the licensee has a substantial investment;
 - iv. other facilities provided by the licensee that are treated as capital by unconsolidated subsidiaries and by any other unconsolidated entities or companies in which the licensee has a substantial investment;
 - v. new and existing capital issues between two or more companies that represent, either directly or indirectly, back to back securities.
 - vi. any other deduction designated by the FSC as a "prescribed deduction" by way of Notice.
- (b) Exposures secured by a fully and unconditional guarantee or securities issued by:
- i. the Government of Jamaica (GOJ), the Bank of Jamaica and agencies of the GOJ, statutory bodies and companies owned or controlled by the GOJ, as exempted, in writing, by the FSC.
 - ii. governments and government agencies of CARICOM countries, exempted, in writing, by the FSC;
 - iii. governments and government agencies of the United States of America, Canada and the United Kingdom;
 - iv. governments and government agencies of other G-10 countries (Belgium, France, Germany, Italy, Japan, the Netherlands, Sweden and Switzerland), exempted, in writing, by the FSC;
 - v. governments and government agencies of other sovereign countries that are rated as investment grade by an internationally recognized credit rating agency and the guarantee is explicit, unconditional, legally enforceable and irrevocable over the life of the credit exposure in question and if exempted, in writing, by the FSC.
- (c) Exposures arising from intra-day liquidity and other special circumstances including:
- (i) exposures fully secured or collateralized by cash;
 - (ii) exposures arising from intra-day liquidity support facilities utilized for payment and settlement processes; and

- (iii) exposures that have been written off or specifically provided for.
- (d) exposures arising from reverse repurchase agreements where the underlying securities are exempt as per paragraph 7.0 (a), and for which the reporting licensee has obtained physical control of said securities.

8.0 MEASURING LARGE EXPOSURE LIMITS

- 8.01 In determining large exposures, a licensee must consider all balance sheet exposures and the amounts should be calculated using the sum of nominal amounts for the application of any risk weightings for on balance sheet items.
- 8.02 Where an exposure amount is deducted from the capital base in accordance with the prescribed deductions, it is not required to be added to other exposures for that counterparty for the purpose of applying a large exposure limit.
- 8.03 The ratio to calculate the large exposure limit is calculated by dividing a licensee's exposure to a single counterparty or group of connected counterparties by its capital base.

9.0 SPECIAL APPROVALS AND NOTIFICATION REQUIREMENTS

- 9.01 Licensees shall comply at all times with the exposure limits established in the implementation timetable below unless the FSC has granted an exemption to a licensee as per paragraph 6.04.
- 9.02 A licensee must obtain approval from the FSC prior to undertaking exposures which will be in excess of the large exposure limits. The FSC will grant such approval, in writing, on an exceptions basis, based on the assessments undertaken by the licensee, the specific circumstances of the licensee and:
 - (i) the licensee must assess the risks involved with exceeding the large exposure limits, demonstrate why the proposed exposure will not unreasonably expose the licensee to excessive risk and provide the assessment to the FSC as part of its approval request which must be made in writing; and
 - (ii) the licensee must be able to demonstrate that the proposed exposures are consistent with the risk management policies approved by the Board of Directors.
- 9.03 However, if there are instances where breaches are identified after the undertaking of the exposure, a licensee must notify the FSC in writing no later than 2 working days after the breach of the large exposure limit has occurred. The notification must include the nature of the breach, how the breach occurred and remedial actions taken or planned to be taken inclusive of practicable timelines to address the breach.
- 9.04 A licensee must notify the FSC immediately where it has concerns that its large exposures (inclusive of exempt exposures) have the potential to have a material impact on its capital adequacy and outline its proposed measures to address the concerns.

- 9.05 Depending on the circumstances of a licensee and where the FSC is of the view that the licensee is exposed to a significant level of risk concentration, the FSC may direct the licensee to take measures to reduce its level of risk concentrations so that the licensee is in compliance with the specified limits or increase its capital requirements so as to eliminate the excess exposure.

10.0 REPORTING REQUIREMENTS

- 10.01 Every licensee shall file a report with the FSC in a specified format (**see form attached**) indicating all instances of large exposures with single counterparties or groups of connected counterparties whether exempt or not on a quarterly basis.
- 10.02 Effective December 31, 2018, every licensee is required to file with the FSC no later than forty-five (45) days after the end of each of the licensee's financial quarters, a report in a specified format disclosing all exposures which are equal to or greater than 10% of its capital base as at the reporting date.
- 10.03 Licensees should report exposures on a gross basis (i.e. no set offs). However, debit balances maintained by the reporting licensee on account for counterparties may be offset against credit balances on other accounts with the licensee provided that the following conditions are satisfied:
- a) A legally enforceable right to set off exists in all cases;
 - b) The debit and credit balances relate to the same counterparty or group of connected counterparties; and
 - c) The licensee intends to settle on a net basis or to realize the debit balances and settle the credit balances simultaneously.

11.0 IMPLEMENTATION AND TRANSITIONAL ARRANGEMENTS

- 11.01 The FSC recognizes the need for a pragmatic approach to the implementation of the large exposure framework which allows for an adequate period of adjustment to the new prudential requirements. The implementation timetable sets out a phased approach for the implementation of the large exposure limits as specified in paragraph 6.01 above with full implementation expected to take effect on December 31, 2021. This timetable was drafted in recognition that securities dealers will require time to implement the relevant systems and procedures to identify, measure, monitor and report on their large exposures in order to ensure compliance.
- 11.02 The large exposure limits requirement shall commence on December 31, 2018 and vary in accordance with the table below which outlines the implementation schedule.

Implementation Date	Single/ Group Counterparty Limit
December 31, 2018	175%
June 30, 2019	135%
December 31, 2019	95%
June 30, 2021	55%
December 31, 2021	25%

- 11.03 During the phased implementation period, the limits and the timelines specified in the table above will be reassessed on an on-going basis, taking into consideration other changes in the prudential framework.

