FINANCIAL SERVICES COMMISSION

CONSULTATION PAPER:

Measures to Enhance the Prudential Regulation of the Securities Industry in Jamaica

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SR-CONSUL-10/09-0021

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2010 September 30

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MEASURES TO ENHANCE THE PRUDENTIAL REGULATION OF THE SECURITIES INDUSTRY IN JAMAICA: CONSULTATION PAPER

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Glossary

BCBS	Basel Committee on Banking Supervision
BIA	Basic Indicator Approach
BoJ	Bank of Jamaica
FLR	Funding Liquidity Risk
FSC	Financial Services Commission of Jamaica
FSC Act	Financial Services Commission Act, 2001
GoJ	Government of Jamaica
IA	Investment adviser
IOSCO	International Organisation of Securities Commissions
JSDA	Jamaica Securities Dealers Association
LAR	Securities (Licensing and Registration) Regulations 1998
LCR	Liquidity Coverage Ratio
NSFR	Net Stable Funding Ratio
OR	Operational Risk
SD	Securities dealer
UCITS	Undertakings for Collective Investments in Transferable Securities

Abstract: *The Financial Services Commission (FSC) is proposing significant changes to existing prudential requirements for securities dealers licensed under the Securities Act. The proposals include recommendations for: changes to the definition of regulatory capital, the determination of capital charges for market and operational risks, the measurement and management of liquidity risks and changes to the determination of initial capital requirements. The proposed changes to initial capital requirements also portend changes to the definition of securities dealers by type of business. This document elaborates the rationale for, and contents of, the FSC's proposals and elicits comments from the public.*

1.0 EXECUTIVE SUMMARY

1.01 The FSC has concluded that its prudential supervision of SDs and Investment Advisers (IAs), incorporating as it does essential elements of the Basel Accord[1], is broadly sound but needs enhancement and updating to meet the unique needs of participants in, and risks inherent in, Jamaica's securities markets. When considering measures to strengthen the sectors ability to withstand future shocks the concentration of the business model, and therefore the revenue stream, of most SDs in one product is a particular challenge for the FSC and the industry. Mechanisms readily available in some other markets, such as a full range of hedging tools or a deep and liquid money market, are either not available or only in very restricted forms. The financial conservatism of Jamaican retail investors provides another hurdle to overcome, though that may respond to greater efforts to educate investors and savers by the industry and the authorities.

1.02 A further challenge is the limited range of permissible products from which the SDs can generate new revenues. To address this issue the Government is taking steps to encourage the development of collective investment schemes. It will do so by amending the Unit Trust Act and by exempting local mutual funds from certain provisions in the Companies Act of Jamaica. The prospects for improved economic growth should also encourage private enterprises in the industrial, agricultural and service sectors to raise capital in the public markets via issues of shares and corporate bonds on the Jamaica Stock Exchange. This will provide greater opportunities for generating fee income from traditional investment banking activities such as advice and underwriting.

1..03 The FSC has also concluded that the legislative and regulatory framework which governs its issuance of licenses to firms and individuals provides for too little differentiation among business activities. It does not, for example, distinguish between agency broking and principal dealing or provide for a license specific to discretionary fund management. Combined with initial capital requirements which are low by the standards of best practice in the Caribbean and elsewhere this may encourage new entrants to seek to engage in high risk activities when they should initially focus on low risk activities and grow their businesses incrementally. The current practice, whereby the FSC imposes restrictions when granting a licence cannot be a complete solution.

1.04 The first step in enhancing the prudential regulation of the SD sector was taken in June 2010 when the risk weighting applied to holdings of the foreign currency bonds issued by the GOJ was raised from zero to 12.5%. Over the next two years this percentage will rise by a further 12.5% each quarter until it reaches 100% in March 2012. This will bring the treatment of these securities held on the books of the SDs into line with the global standard as set out in the Basel Accord. There are no plans to change the zero percent risk weighting applied to GoJ debt issued in Jamaican dollars.

1.05 The rest of this Consultation Paper sets out the additional elements which the FSC considers should form the basis of an enhanced regime for the licensing and capitalisation of SDs. Some elements, such as the operational risk and liquidity risk components, build upon the GOJ's commitment in the 2010 IMF program to change in these areas. Others, such as the leverage ratio proposal consist of clarification and reinforcement of current FSC guidelines. A third category, such as the licensing proposals,

[1] Originally applied only to internationally active banks, the Accord and its subsequent amendments have become the standard for all banks and securities dealers in many jurisdictions including Jamaica. On some estimates, by 2009 over 5000 banks in some 100 countries were subject to the Basel Accord. In many of those countries (e.g. in the member states of the European Union) the Accord applies, with some modifications, to broker dealers and investment banks The FSC implemented the Accord for the SDs in 2004.

consists of measures to update the regulatory framework to take account of current and future developments in the business models of SDs.

1.06 The current intention is that following finalisation of the changes to the prudential regulatory framework, the necessary changes to guidelines will be made, alongside the introduction of changes to regulations and where necessary, proposals to change primary legislation. Changes to supervisory procedures and required enhancements to management and control systems in SDs will be expected to be introduced as soon as practicable, having regard to human and IT resource constraints in the SDs and the. The expectation is that measures with a direct quantitative impact on the capital necessary for SDs to meet regulatory requirements will, on current plans, be imposed in stages commencing in June 2012.

1.07 In order to assess the possible impact of the proposals set out below on the balance sheets and profitability of the SDs the FSC is undertaking its own an impact assessment based on data filed by the SDs as part of their regular reporting to the FSC. It has also had initial discussions with the JSDA and has encouraged the JSDA to provide additional data to better inform its processes of prioritizing and calibration. The FSC recognises that the timetable for data aggregation, analysis and decision making is ambitious and demanding but it is necessary to enable the GOJ to meet policy targets under its medium term economic and financial programme.

1.08 The FSC recognises that all regulatory change has an impact on the commercial decision making of those entities affected by it. Changes in regulatory capital may reduce the risk adjusted return on some business lines and enhance it on others. The FSC is seeking to create an environment in which business decisions can be made in a rational and orderly manner and in a way which avoids causing unnecessary disturbance to markets and to the interests of investors and issuers while also enhancing transparency in its various forms to benefit market players, including retail investors. The implementation timetable (in stages commencing June 2012) will contribute to these goals.

2.0 BACKGROUND

2.01 The Government of Jamaica has announced its intention to continue strengthening the regulatory and supervisory framework of the securities dealers (SD) sector in order to assist in strengthening the sectors ability to withstand future shocks. The Government recognises the major contribution made by the SDs to the development of the Jamaican capital market and economy over the last decade. As a result of their efforts both in conjunction with, and in parallel to, the Jamaica Stock Exchange, they have developed a range of products for investors and savers and have made a major contribution to the ability of the government, its agencies, and the corporate sector to achieve their developmental goals. As a consequence Jamaica has one of the most vibrant financial markets in the region. Oversight by the Financial Services Commission has secured high standards of entry and ongoing business activities for the protection of investors and has helped to preserve and enhance the integrity of the markets.

2.02 An important component of the on-going supervision of securities dealers is the enforcement of minimum capital requirements. The current framework for minimum capital standards may be conveniently disaggregated into three separate but complementary components, namely:

i) A risk-based capital requirement, whereby securities dealers are required to maintain a ratio of regulatory capital to risk-weighted-assets of at least 10%;[2]

ii) A leverage ratio whereby, dealers are required to maintain a ratio of book capital to total assets of at least 6%;[3] and

iii) A "quasi-capital ratio" in the form of initial margin requirements for repurchase ('Repo") transactions, whereby dealers issuing repo contracts are required to ensure that the fair value of the securities to be repurchased is at least 5% greater than the initial purchase price (in dollars) of the security, at the time that the transaction occurs.[4] The required initial margin depends on the type of security underlying the repo contract. These requirements are referred to as "Margin R" requirements.

2.03 The risk weights applied in the existing risk-based capital framework are based on the credit risk-weighting scheme under Basel 1. Table 1 summarizes the current risk weights that are applied. SDs are required to compute the ratio of Tier 1 and Tier 2 capital to their Risk Weighted Assets and to report it, along with substantial supporting data, to the FSC monthly. The 12 largest SDs provide additional information. The minimum ratio is 10% and the level at which advance warning must be given to the FSC is set at 12%. For monitoring purposes the FSC uses an early-warning benchmark of 14%. In the event of problems, the FSC has a graduated range of intervention options.[5]

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[2] See FSC "Guidelines for Interim Capital Standards for Securities Dealers" (SR-GUID-04/07-0011).
[3] See FSC "Securities Bulletin: Early Warning Tests" (SR -ADVI-05/03-0001).
[4] See FSC "Guidelines For Margin Requirements for Repurchase Agreements" (SR-GUID-04/07-0010).
[5] The interventions options will also be reviewed, and where necessary, enhanced as part of the structural reforms for the financial sector which is contemplated under the GOJ's medium-term economic and financial policy programme.

Table 1: Risk-weighting requirements for securities dealers (July 2004 - March 2010)

DESCRIPTION OF ASSETS	RISK WEIGHT
Cash on Hand	0%
BOJ Deposits & Instruments (including BOJ Repos)	0%
GOJ Debt Securities (held outright)	0%
GOJ Debt Securities (backing reverse repos and executable transfer form and security are held by the dealer)	0%
Loans granted to or which are guaranteed by the GOJ	0%
Debt securities issued by statutory bodies or companies owned or controlled by GOJ, or agency of the GOJ and guaranteed by the GOJ	0%
US, UK and Canadian Debt (Govt & Central Bank)	0%
Other G-10 Debt[1] (Govt & Central Bank)	0%
CARICOM Debt [2] (Govt & Central Bank)	0%
Loans (100% cash or GOJ debt secured)	0%
Goodwill	0%
Back to back Securities	0%
Deposits and Other Amounts Due from Local Banks	20%
Deposits and Other Amounts Due from Regulated Foreign Banks in the US, UK and Canada	20%
Deposits and Other Amounts Due from Regulated Foreign Banks in other countries	20%
Amounts due from Local Securities Dealers (secured against cash, GOJ securities or other Government and Central Banks which are weighted at 0%	20%
Due from Other Govts., Other Central Banks and Development Banks	20%
Residential Mortgages (First charge and current or arrears < 3 months)	50%
Other Mortgages and Loans	100%
Equity Investments (Ordinary and Preference)	100%
Other Securities	100%

Table 1: Risk-weighting requirements for securities dealers (July 2004 - March 2010)	
DESCRIPTION OF ASSETS	**RISK WEIGHT**
Fixed Assets	100%
Other Assets	100%
Net Foreign Exchange Exposure [=(Assets - Liabilities) + (Bought-Sold)]	100%

2.04 Since 2005 (modified in 2008) the FSC has employed a leverage ratio of 6% to the balance sheets of SDs as one of a number of ratios that constitute its Early Warning System[6]. In practice, these ratios are among the information set which is used by the FSC to determine the safety and soundness of licensed securities dealers and whether further detailed assessments of the financial condition of a licensee should be undertaken. As such, although the FSC's leverage ratio is not currently mandatory, a persistent failure to meet the minimum requirement may be among the grounds considered by the FSC in determining whether or not regulatory action should be taken on the basis of a licensee engaging in or being about to engage in "unsafe and unsound practices in the conduct of its affairs". Such regulatory action is permitted under section 8 of the FSC Act.

2.05 The initial margin requirement for repo transactions may be viewed as a "quasi-capital requirement" because (a) it does not include a maintenance margin requirement, and (b) it is as for collateral protection for a specific class of the dealers' funding activity.

2.06 The existing framework has served Jamaica well. Financial markets in Jamaica have emerged from the recent global financial and economic turmoil in good health. In no small measure this was the result of collaborative efforts on the part of Government, the Financial Services Commission (FSC), Bank of Jamaica (BOJ), the SDs and the banks, as well as the strictures imposed by the existing prudential framework. However, supervisory authorities have noted lessons from that experience. In particular, the FSC has identified areas of its prudential supervision of licensees that it believes should be improved. A number of these issues were also identified in the 2005 supervisory assessment conducted under the joint International Monetary Fund (IMF)/World Bank Financial Sector Assessment Program (FSAP).

2.07 The FSC has also recognised that some restrictions on the businesses SDs are able to undertake are no longer necessary. Where the FSC has the power to end such restrictions it has begun to do so. However, there may be other complementary financial and economic reforms which are outside the direct influence of the FSC. In this regard the FSC notes the position of the JSDA that reforms of the capital regime for securities dealers should be accompanied by other regulatory changes designed to enhance the ability of securities dealers to engage in endogenous risk mitigation activities. Such initiatives include, in particular, a reform of the regulatory regime for foreign currency transactions, which it is argued is necessary for several reasons, including:

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[6] REF

i) Providing adequate portfolio diversification opportunities;

ii) Providing adequate hedging opportunities; and

iii) Providing adequate opportunities for product development.

2.08 The FSC is committed to developing its prudential supervision in ways which will provide incentives for SDs to broaden the range of products they can offer to the public, and in ensuring that prudential reforms are implemented in a manner that preserves the stability and viability of the securities sector.

2.09 In order to ensure that, to the fullest extent possible, the public interest goals that the FSC is dedicated to pursuing are consistent with enhancing capital market development for the benefit of issuers and investors, the FSC has issued this Consultation Paper.

3.0 THE CALCULATION OF REQUIRED CAPITAL - THE CURRENT POSITION AND PROPOSED ENHANCEMENTS

3.01 As implemented by the FSC, the current requirements for the calculation of regulatory capital are largely consistent with Basel I and appear fundamentally sound. However, it is recognized that there are areas which require enhancement and updating to meet the risks inherent in Jamaica's securities markets.

3.02 Table 2 sets out the components of the computation of Tier I and Tier 2 capital by the SDs. It is illustrated by reference to Form C1, filed with the FSC as required in the FSC's Guidelines for Interim Capital Standards for Securities Dealers 2004. As can be seen the FSC's interpretation of what is acceptable as regulatory capital has expanded since 2004 but this has not been reflected by amendments to the Guideline.

Table 2: Calculation of regulatory capital for existing risk-based capital requirements

	Form C1	**FSC Guideline**
Tier 1	Ordinary shares (paid up)	Ordinary shares issued and fully paid
	Preference shares (perpetual non-cumulative)	Preference shares issued and fully paid (perpetual non-cumulative)
	Share premium	Share premium (ordinary and preference shares) Capital raised from sale of shares to Government of Jamaica

Table 2: Calculation of regulatory capital for existing risk-based capital requirements		
		or its agencies for restructuring
	Retained earnings (accumulated deficit) b/f	
	Current year to date profit	
	Statutory revenue reserve	
	Other eligible reserves	Eligible reserves as approved by the FSC
Less	IAS 39 Fair Value Reserve (negative balance only)	
	Goodwill	Goodwill
	Accumulated losses for previous years	Accumulated losses for previous years + losses for current year
	Start-up expenses	Start-up expenses
	Other intangible assets	Other intangible assets (exc computer software)
Tier 2	Preference shares (perpetual, cumulative)	Preference shares (perpetual, cumulative)
	Preference shares (non-perpetual, original	Term preference shares (original term>5 yrs)

Table 2: Calculation of regulatory capital for existing risk-based capital requirements		
	term>5yrs)	
	Share premium on preference shares	Share premium on preference shares
	Subordinated debts Subordinated debt issued to GoJ or its agencies	Remaining balance on subordinated debts [7] Subordinated debt issued to GoJ or its agencies for financial assistance
	General provisions for loss on assets up to a maximum of 1.25% of a licensee's RWA	General provisions for loss on assets up to a maximum of 1.25% of a licensee's RWA
	Capital reserve	
	Revaluation reserve (including real property)	
	Other eligible reserves	Other eligible reserves as approved by the FSC

3.03 The most significant differences are the operational permissions granted to SDs to include retained earnings and current year to date profits in the Tier 1 computation and a revaluation reserve (including real property) in Tier 2. None of these were specifically identified in the 2004 Guidelines on Interim Capital Standards. However, they have been incorporated in regulatory filings submitted by licensed securities dealers.

[7] This is a distinction of form rather than substance. There is no practical difference between the terms "Subordinated debts" and "Remaining balance on subordinated debts"

3.04 Retained earnings are an important element in the Tier 1 component of many SDs balance sheets and their exclusion would be problematic. Furthermore, the FSC is confident, based on the history of profit retention and dividend payments, that firms will tend to retain most of these amounts (as audited) in keeping with prudent practice. The FSC is also confident that their retention will not necessarily introduce undue subjectivity into the calculation of regulatory capital. The 2004 Guidelines will be amended accordingly to clarify this position. However, in order to further reinforce the permanent nature of Tier 1 capital (a key Basel I objective) the FSC proposes that retained earnings may continue to be included only if they are placed in a special reserve account and are not available for distribution except with the permission of the FSC. Year to date profits on the other hand are unaudited and may in due course be subject to substantial revision. Their continued inclusion is not prudent. The FSC therefore proposes modify the existing calculation of regulatory capital by removing year to date profits from the list of operationally permitted eligible capital components. The 2004 Guidelines will also be clarified accordingly. Further measures to minimise the risk of capital being withdrawn by the owners of an SD with a deteriorating financial position are discussed below at Section 11.

3.05 The third component not in the 2004 Guidelines, namely, revaluation estimates on real property (such as headquarters buildings), are inherently subjective and the underlying asset is intrinsically illiquid. The FSC is considering permitting further changes to revaluation reserves for real property (gains or losses). Revaluation changes on real property will continue to be admitted for the purposes of computing regulatory capital provided that:

i) such property is held as an investment asset; and

ii) there is satisfactory evidence that the revaluation gains or losses were made on the basis of annual valuations conducted by an appropriately qualified and independent third party.

Where a licensee prefers not to revalue annually or the asset is not an investment asset, then the whole revaluation component will be deemed non-admissible for the purpose of computing Tier 2 capital. These amendments will be consistent with current developments in the Basel Accord whereby the instruments acceptable as Tier 1 and Tier 2 capital are being reduced.

4.0 MARKET RISK

4.01 Market risk is defined as the risk of losses in on- and off-balancesheet positions arising from movements in market prices. Market risk is not a factor in the FSC's risk weighted capital regime except for net foreign exchange exposures. The risk weights applied to assets by the FSC are credit risk weights[8]. Although the positions entered on the C1 form are valued at the current market price there is no requirement to take account of the risks of future losses arising from movements in market prices or from the losses that may be incurred if holdings have to be sold. As such the Jamaican regime is significantly deficient when assessed against the full Basel Accord which was first extended to cover market risk in 1996 and again in 2005[9]. A comparison with a traditional securities market approach such as that

[8] Government of Jamaica debt in Jamaican dollars has a risk weighting of zero for the purpose of regulatory capital calculation

[9] Amendment to the Capital Accord to incorporate market risks: updated November 2005.

employed for many years by the US SEC (Rule 15c-3-1 or the Net Capital Rule) reveals similar discrepancies.

4.02 Consistent with its overall treatment of regulatory capital (ie applying the Basel Accord Methodology), the FSC therefore proposes to adopt major elements of the standardized approach of the Basel market risk amendment (the "Trading Book"). This recognises that all securities on an SDs balance sheet are marketable and available for trading should the opportunity occur, or should a sale become necessary, including those used as collateral for repo. It will require an SD to apply separate charges for specific risk and general market risk to the securities held on its balance sheet. The capital charge for specific risk is designed to protect against an adverse movement in the price of an individual security owing to factors related to the individual issuer. It is not an explicit credit risk charge but the factors are credit rating specific; it has limited provisions for offsets. The capital charge for general market risk (for bonds) is designed to capture the risk of loss arising from changes in market interest rates. Broadly the capital charge increases with the tenor of the security since the longer the tenor the greater the price movement for a given change in the interest rate. See Annex 3 for a detailed description of the proposal.

4.03 The capital charges for interest rate related instruments and equities will apply to the current market value of items on SDs balance sheets. In calculating an SD's overall capital ratio, an explicit numerical link between credit and market risk will be created by multiplying the measure of market risk by 10 (i.e., the reciprocal of the minimum capital ratio of 10%) and adding the resulting figure to the sum of risk-weighted assets compiled for credit risk purposes.

4.04 It should be noted that in considering proposals for market risk capital charges, the FSC considered more complex approaches which were also available under the current construction of Basel II. However, these more complex alternative approaches are not being proposed at this time. The approach described above and the detailed metrics set out in Annex 3 represent a simplified form of the Basel Amendment for the treatment of market risk in the trading book. For example, it proposes the adoption of the "maturity" method for calculating market risk rather then offering the option of the more technologically demanding and resource intensive "duration" approach. The FSC believes that this is appropriate given the current stage of development of the securities market in Jamaica. Among the drivers of the Amendment was the growing size and complexity of "internationally active" banks' trading activities including multi-currency exposures, use of advanced hedging structures intended to reduce risk, and the growing use of OTC derivatives and other off balance sheet instruments which have price behavior not necessarily consistent with the price movement of the underlying securities. These internationally active banks had developed a range of modeling techniques to analyze and calculate the risks to their portfolios and sought regulatory recognition of the "VAR" models for the calculation of regulatory capital. Supervisors were given the authority to approve these models, subject to certain constrains, by the Amendment.

4.06 In the view of the FSC, the asset and liability mixes of the SDs does not require advanced modeling techniques for the calculation of market risk capital given the limited range of instruments available and the restrictions on foreign currency investment by SDs. The FSC is also of the view that, for the majority of SDs, the resource cost to develop, maintain and use such advanced techniques and the resource cost of expanding the FSC's own resources to effectively supervise the use of such models, is not warranted at this time. However, the FSC is prepared to consider submissions on these issues, particularly from SDs which believe the complexity of their asset and liability structures would benefit from the recognition of modeling techniques for the calculation of the market risk component of regulatory capital.

4.1 *Interface of Market Risk Requirements with Existing Margin R Requirements*

4.11 In response to comments from the SD industry the FSC has considered whether, in proposing to apply a market risk factor to the calculation of regulatory capital, it should remove the obligation on SDs which conduct retail repo business to ensure that the collateral which supports the repo contracts exceeds the cash placed with SDs by 5%. However, a market risk factor and Margin R have two different purposes. The purpose of Margin R is to protect clients in the event of an SD being obliged to transfer the collateral rather than cash to its clients when repo contracts fall due. The market risk factor is intended to achieve greater resilience in the balance sheet of an SD in the event of volatility in the market price of its assets or the need to sell those assets at prices below those at which it had previously marked them . As part of the reforms to the capital regime being considered here, the FSC is prepared to consider whether the 5% factor under the existing Margin R requirements is too blunt a tool and to implement a more sophisticated risk-based margin framework based on maturity buckets similar to those used in calculating General Market Risk.

4.2 *A Note on the Need for Accurate Pricing*

4.21 The accuracy of calculation of a market risk charge is dependent on the reliability of secondary market prices for securities held by the SDs[10]. The FSC understands that, in the case of GoJ bonds, indicative prices are provided by Bloomberg based on a poll of dealers. The FSC recognises the efforts the JSDA and its members have made in recent years to improve the accuracy of the yield curves used to price GoJ bonds whether international or domestic. However, it is also recognized that a reliance on dealer provided indicative quotes has limitations. Therefore, in order to reduce the risk that the capital allocated to market risk is mis-calculated the FSC is of the view that further improvements to the process of price discovery in secondary markets are required, particularly with regard to securing enhanced transparency of firm quotes and actual traded prices of domestic and international GoJ bonds. This would be consistent with international developments and the IOSCO Principles of Securities Regulation. In this context the FSC notes the initiative of the Jamaica Stock Exchange to increase the secondary market transparency of trading in GoJ bonds. The FSC believes this or other similar initiatives may provide significant enhancement to the accuracy of pricing and therefore to the overall robustness of risk management in the SDs and prudential supervision by the FSC.

5.0 LEVERAGE RISK

5.01 It is internationally recognised that excessive leverage played a crucial role in the global financial and economic crisis. It played a part in triggering the crisis, while the process of de-leveraging has played a major role in amplifying the magnitude of the crisis.[11]

[10] The same point is valid as regards the valuation of positions currently used on the C1 form
[11] See speeches by Mario Draghi, Gerald Corrigan, Philipp Hildebrand and others

5.02 The FSC proposes to make the 6% leverage ratio a mandatory statutory requirement. It should be recognized that, based on current the regulatory practice (see paragraph 4.0 above), this proposal would not represent a radical departure from present practice. The FSC intends that the ratio should be maintained at all times. However, as part of this consultation process, the FSC is also prepared to consider reasoned arguments for an alternative approach For example, this could take the form of the adoption of a leverage ratio range (for example 4-7%) to be applied by the FSC on an SD specific basis. The argument in favour of this approach is that it would give the FSC and each SD the flexibility to match the ratio to the business model, governance and risk management capabilities of the firm.

6.0 LIQUIDITY RISK

6.01 The Government of Jamaica is committed under the IMF's program to including a liquidity risk component in the overall package of reforms for the capitalisation of the SD sector. The FSC identified the importance of liquidity risk in 2004 when it published a paper, for comment, described as providing "*principles and practical guidance for sound liquidity management*"[12]. The guidance stresses that one of the goals of liquidity management within an SD is the establishment of a minimum acceptable level of liquidity. It is a detailed statement of what should be the priorities of an SD's management in this area with examples of the systems, process and judgments that are necessary elements. The paper discusses extensively the role of supervisors in monitoring and forming a judgment on the quality of liquidity management in an SD. It also sets out the FSC's requirement that licensees "*maintain sufficient liquidity to ensure safe and sound operations*".

6.02 However the FSC did not translate the "principles and practical guidance" into formal guidelines This was a departure from its normal approach such as when imposing capital standards on SDs, margin requirements for repurchase agreements and other elements of prudential supervision. Nor did it set seek to quantify its requirement that SDs maintain "*sufficient liquidity to ensure safe and sound operations*".

6.03 The FSC intends to address both of these issues in the current process of strengthening its supervisory framework. As a first step the FSC proposes to reissue its 2004 informal guidance as formal guidance having enforceable effect. It believes that while some well managed SDs should find compliance largely a matter of ensuring that current procedures and processes are fully compliant, others may find it more challenging. The objective of this proposal is to generate an improvement in liquidity management across the sector to the benefit of all participants. At this point the FSC intends that the guidance should provide licensees with a range of options to achieve compliance and provide the FSC with a degree of discretion in what it considers acceptable.

6.04 Furthermore, given that many SDs are part of groups with activities in Jamaica and in several Caribbean jurisdictions and beyond the FSC will take this opportunity to ensure that its efforts in this area are properly coordinated with other regulators and that it properly understands the priorities of those regulators with whom it shares responsibility for the supervision of financial groups.

6.05 In addition, the FSC is proposing to establish quantitative metrics to give effect to its requirement set out in the 2004 paper that SDs maintain sufficient liquidity to ensure safe and sound operations. The

[12] Liquidity management for securities dealers that are not licensed deposit takers: SR-GUID-04/11-0013

objective is to reduce the exposure of SDs to liquidity risk. Reliance solely on management system and controls was appropriate in 2004 but the global financial and economic crisis has demonstrated that this is no longer the case. The BCBS has recently brought forward two quantitative measures intended to address specific stress events which will expose an institution to liquidity risk[13]. One, the Liquidity Coverage Ratio (LCR), is directed at short term liquidity crises; the other, the Net Stable Funding Ratio (NSFR), is intended to promote longer-term structural funding of banks' balance sheets, off-balance sheet exposures and capital markets activities. Both measures encountered significant opposition from the commercial banks particularly the NSFR. In the case of the LCR, the BCBS has made a number of changes. In the case of the NSFR, the BCBS has decided to reassess a number of the elements of the metric and to delay implementation until 2018.

6.06 In proceeding to the consultation phase of its own proposals the FSC has taken these developments into consideration. In general terms, it notes that the BCBS proposals are intended to apply to the complex business models of large internationally active banks although, as observed above, decisions taken by the BCBS are generally implemented by banking and securities regulators in many jurisdictions. That has been the case in Jamaica since 2004 with regard to the SDs. The FSC has also noted that the business of the SDs in Jamaica is not banking as such; their core business is not making loans to individuals and corporate borrowers, nor do they take unsecured deposits from the public as do banks. The liabilities of SDs to their clients consist, instead, primarily of cash placed with them under repurchase agreements. The terms of these agreements can be met by transferring to those clients the assets (GoJ notes and bonds) in which the client funds are invested[14]. Several dealers also act as primary dealers or market makers in the issuance of GOJ and BOJ financial instruments. There are however similarities between the risk profile of many SDs, on the one hand, and deposit-taking institutions (DTIs), on the other. In particular, SDs and DTIs exhibit a common maturity mis-match between the assets and liabilities on their balance sheets. Further, with respect to retail repurchase agreements, the reality of customer expectations is that cash will be returned and not the underlying securities. Therefore, the FSC is of the view that the development of quantitative metrics governing liquidity risk for the SD sector is appropriate and necessary for a comprehensive regulatory treatment of the risks faced by securities dealers. In this regard, the work of the BCBS may be instructive in developing metrics capable of being implemented in the Jamaican market.

6.07 As in any liquidity risk management system the objective is to achieve a situation in which an SD maintains an adequate level of cash, unencumbered, high quality assets, access to irrevocable lines of credit etc that can be converted into cash to meet its liquidity needs in a very short period of time and in circumstances in which the wholesale funding markets are severely restricted or closed. The FSC's current initial capital requirement, which can be mix of cash and GoJ securities, is unlikely to match the liquidity needs of most SDs and in any case the GoJ securities can be of any tenor, most of which are not liquid in the sense of there being an active two way market with committed market makers and with transactions taking place on a regular basis.

6.1 *Liquidity Coverage Ratio*

6.12 To address the issue of meeting increased demand for funds in a period of market stress the FSC is considering the adoption of a version of the liquidity Coverage Ratio (LCR), as recommended for

[13] Consultative proposals to strengthen global capital and liquidity regulations: 17 December 2009

[14] Ownership of loans made by banks for mortgages, car purchases etc cannot be transferred to depositors

implementation by the BCBS, possibly in 2012. The FSC understands that some SDs already manage their liquidity position by the use of cash reserves, credit lines and by seeking to keep the maturity of their marketable securities as short as practical and consistent with maintaining an adequate level of profitability. A formal LCR requirement would become a ratio mandated by the FSC with which an SD would have to be in compliance at all times. The level of cash and near cash assets would have to at least equal to the estimated net cumulative cash outflows over the next 30 days should this period be one of severe liquidity stress. The FSC is considering two issues in this regard on which it seeks the views of respondents.

6.13 First, what would be the likely run-off of client funds in such a 30 day period? The BCBS has determined a range of between 5% and 100% depending on the nature of the client or counterparty, (eg wholesale or retail, small company or large company), and whether, in the case of retail deposits, they are protected by deposit insurance. For uninsured retail deposits it has recommended a floor of 10% but advised regulators to set higher percentages as they deem necessary for local circumstances. The FSC believes that 10% is too low given that (i) most retail repos are for 30 days (although some have automatic rollover facilities which require a positive act by the client to cancel) and (ii) the practice has developed of returning a client's funds on demand (ie breaking the repo) for no penalty. Therefore the FSC proposes that the run-off rate should be set at 35%.

6.14 The second issue is whether, in practice and with what difficulty, the SDs can accumulate sufficient cash and near cash to meet the requirement. The FSC recognises that in the Jamaican market there are significant limits on the availability of high quality, short term liquid assets and market mechanisms to liquefy other marketable securities when needed. In the US dollar market US treasury bills of short maturity are readily available. Although not the FSC's favoured option, it may be that the LCR will initially have to take the form of a periodic stress testing requirement, in a standardized format and with the results reported to the FSC. An SD would have an obligation to take remedial action if the FSC so determines, rather than the LCR being a quantitative requirement to be met at all times. These are matters which the FSC will consider in depth in the course of the consultation period.

6.2 *Net Stable Funding Ratio*

6.21 The FSC is considering the implementation of a Net Stable Funding Ratio (NSFR). This metric is intended to establish a minimum acceptable amount of stable funding based on the liquidity characteristics of an SD's assets and activities over a one year horizon. It is designed to incentivise structural changes in the liquidity risk profiles of SDs away from short-term funding mismatches and toward more stable, longer-term funding of assets and business activities. It is therefore fully consistent with the medium to long term goals of the Government and the FSC. The introduction of a NSFR will, take full account of the continuing dialogue between the BCBS and the banks and non-bank securities firms which will be impacted by its final decisions.

6.22 The NSFR is defined as a ratio of available amount of stable funding (ASF) to a required amount of stable funding (RSF); it must be greater than 100%. "Stable funding" is defined as those types and amounts of equity and liability financing expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress. The amount of such funding required of a specific entity is a function of the liquidity characteristics of various types of assets held, off balance sheet contingent exposures incurred, and/or the activities pursued by the institution.

6.23 Thus, in addition to the inclusion of all Tier 1 and Tier 2 capital in the definition of "available stable funding" credit is given to a substantial majority of liabilities in terms of client cash held by the entity in forms such as deposits and retail repos. Similarly, high quality, short maturity and other unencumbered assets are not required to be fully funded. The "required amount of stable funding" is calculated as the sum of the value of the assets held and funded by the institution, multiplied by a specific required stable funding (RSF) factor assigned to each particular asset type, See Annex 2 for a detailed description of the components of ASF and RSF and their weighting.

7.0 OPERATIONAL RISK

7.01 The Government of Jamaica is committed to including an operational risk component in the overall package of reforms to the capitalisation of the SD sector. Operational Risk ("OR") can be defined in various ways and include various components. In this paper the FSC has adopted the BCBS definition of OR as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events'. Thus it includes legal risk but excludes strategic and reputational risk.[15]

7.02 A failure to properly manage OR can result in a misstatement of a licensee's risk/return profile, and can expose the licensee to significant losses. Hence similar rigour should be applied to the management of OR as is done for the management of other significant risks. A clear understanding by licensees of what is meant by operational risk is critical to the effective management and control of this risk category. It is also important that licensees consider the full range of material operational risks they face and capture the most significant causes of severe operational losses. OR event types which have the potential to result in substantial losses include external and internal fraud, breach of fiduciary duties, misuse of confidential customer information, improper trading activities, money laundering, the sale of unauthorised products, natural disasters, computer hardware and software failures and utility outages.

7.1 *Enhanced Systems and Controls and Supervisory Oversight*

7.11 Within Basel I, as adopted in Jamaica (and globally), the treatment of operational risk has been treated primarily as an issue of systems and internal controls and the supervision thereof. In February 2003 the BCBS codified its policy in a set of Principles that provide a framework for the effective management and supervision of operational risk[16]. The FSC is reviewing the extent to which the Principles are already incorporated in its supervisory monitoring and the risk management and control processes of licensees, and to make enhancements where necessary to match key elements of these principles (see Annex 1). As there are no quantitative or capital elements in this approach, the FSC is proposing that licensees should start work on this element of the operational risk component as soon as its detailed terms are established by the FSC and following an appropriate period of consultation in 2011.

7.12 In practice, licensees will have to review their systems and controls and make changes where deficiencies are identified. The FSC will need to enhance its supervisory practices in order to be able to meet the requirement to be able to satisfy itself that licensees are meeting the standards as set, to identify deficiencies and to assess the adequacy of changes proposed and implemented. This may require additional resources or the development of new skill sets within the current work forces.

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[15] Sound practices for the management and supervision of operational risk: BCBS February 2003
[16] Sound practices for the management and supervision of operation risk*: BCBS* February 2003.

7.2 *Allocation of Capital to Meet OR Exposure*

7.21 A quantitative approach to operational risk is now also in effect under the Basel Accord as modified in Basel II[17]. This quantitative approach was based on the BCBS's response to its discussions with those banks which have been seeking to measure manage and minimise operational risk for many years. The FSC is proposing to adopt a similar approach in its prudential supervision of SDs, relying on the metrics proposed under the BCBS treatment. However, the FSC has sought to adapt the BCBS approach to the circum stances of the Jamaican market, by seeking to extract those elements of the BCBS approach that are more closely aligned with the broad structure of securities operations in Jamaica.

7.22 Therefore, the FSC is seeking comments on the relative benefits of two metrics, known as the Basic Indicator Approach (BIA) and the Standardised Approach (SA). The two methodologies are described briefly below.

7.3 ***Basic Indicator Approach (BIA):*** a SD using the BIA approach must hold capital for OR equal to a percentage of its average gross income[18] over the last three years (excluding any year in which gross net income is negative). The percentage is to be established by the FSC and is the same for all SDs.

7.4 ***Standardised Approach*:** here the calculation is essentially the same except that the SD's activities would be divided into several business lines such as corporate finance, trading as principal, retail/corporate repo, fund management, and retail brokerage. These business lines appear to match, in general, the broad organization of Jamaican securities operations. The rationale for this approach is that gross income within each business line is a broad indicator that serves as a proxy for the scale of business operations and thus the likely scale of operational risk exposure within each of these business lines. Each line is subject to its own risk based capital charge and these amounts are summed to produce the total operational risk capital charge for the SD as a whole. The FSC is currently considering applying the BIA percentage to the highest risk business line with substantial reductions for lower risk activities.

7.41 In order to quality to use the Standardised Approach an SD would have to demonstrate to the satisfaction of the FSC that, at a minimum:

i) Its board of directors and senior management, as appropriate, are actively involved in the oversight of the operational risk management framework;

ii) It has an operational risk management system that is conceptually sound and is implemented with integrity; and

iii) It has sufficient resources in the use of the approach in the major business lines as well as the control and audit areas

[17] International Convergence of Capital Measurement and Capital Standards A Revised Framework: BCBS June 2004

[18] Gross income is to be defined as net interest income plus net non-interest income (As defined by the FSC consistent with IFRS as implemented in Jamaica

7.42 The FSC is proposing to apply the following factors[19]:

Basic Indicator Approach:	18%
Standardised Approach	
Business Line	Factor
Dealing as principal	18%
Retail/corporate repo	18%
Retail/corporate lending	18%
Corporate finance (fee based)	14%
Dealing as agent (brokerage)	12%
Fund management (exc repo)	12%
Investment advice (fee based)	10%

The FSC is seeking the views of respondents, on the impact on balance sheets and profitability, of the BIA and SA as calibrated above.

7.5 *The Role of Insurance*

7.51 It has been suggested to the FSC that insurance to cover all or some of the elements of OR is available. If SDs are able to provide detailed information on this product the FSC is prepared to consider whether such a product, might have a role to play in the mitigation of OR. Its preliminary thoughts are however that there are problems with the use of insurance. First, the intermediation of an insurance company creates a layer of counterparty risk (the insurance company might default); second reliance on insurance may weaken the resolve of the board of directors and management of an SD to minimise and mitigate sources of OR; third, an (non-resident) insurance company is unlikely to have sufficient access to the risk management and control systems of an SD on an ongoing basis to keep its risk assessment up to date; fourth, when an OR loss crystallises , an insurance company may seek to avoid settlement.

8.0 THE TREATMENT OF MARGIN TRADING RISK

8.01 In Jamaica, as elsewhere, the term "margin" has more than one meaning depending on the context. For the purposes of this section of the Consultation Paper margin trading refers to the purchase by SDs of securities on margin, where the SD puts up a percentage of the purchase price and borrows the balance

[19] A simplified version of the Basel factors focussed on securities market aspects of operational risk

from the selling dealer, thereby creating leveraged exposure to changes in the market price of the margined securities from which it hopes to profit.[20]

8.02 The Government of Jamaica is committed to including reforms in the regulation of margin trading as part of the overall package of reforms to the capitalisation of the securities dealers' sector. The goal of the FSC is to improve the resilience of the balance sheets of SDs that engage in this activity.

8.03 The FSC is of the view that the principal risk which needs to be mitigated is Funding Liquidity Risk (FLR). This arises from margin calls issued by the crediting broker which must usually be met within a very short period of time Margin calls can arise from several sources such as losses due to a decline in credit rating of the issuer of the assets bought on margin; losses due to a rise in interest rates – of the "risk-free" rate and/or a rise in the spread between the risk-free rate and that for emerging market debt; and from the crediting broker changing its terms of or exiting the business of margin lending. (The last is a long tail or operational risk but could be significant, for example, an unexpected 100% margin call that is to be met at short notice).

8.04 The current situation is that FLR is not adequately accounted for in computing required risk-based capital ratios. The foreign currency element of GoJ FX bonds will now be subject to a 100% risk weighting, however, the risk charge is on the net foreign exchange exposure and not the gross exposure.

8.05 The FSC proposes to address the FLR issue by developing an appropriate metric within the overall liquidity risk management processes SDs are required to implement. (see section 8 above). For example, the FLR could be addressed within the overall framework of a Net Stable Funding Ratio. In this case the ASF would exclude margin loans as the "call" feature of these loans gives them a risk adjusted maturity of less than one year. The RSF factor for bonds bought on margin would be 100% as they are "encumbered assets." So for every 100 in securities bought on (50%) margin (and added to the denominator) there would be a reduction of 50 in the funds available to support the position (the numerator). At some point as margin positions increase, the ASF/RSF ratio would approach 100% which would cap margin positions unless the SD could obtain additional funding.

8.06 The FSC is also examining the extent to which the increased Credit Risk weightings being applied in stages to GoJ foreign currency bonds and the proposed Market Risk factors to be applied generally deal sufficiently with the credit and market risk in securities bought on margin. The FSC seeks representations from respondents on these issues and the FSC's proposed solutions.

9.0 MINIMIZING THE RISK OF INAPPROPRIATE CAPITAL WITHDRAWALS

9.01 When a company is in a stressed situation, shareholders may have increased incentives to withdraw capital. This is particularly the case if there it appears to management and shareholders (which may be overlapping groups) that there are few if any alternative courses of action which hold a realistic prospect

[20] The other use of the term "margin" in Jamaica refers to the obligation on SDs to provide repo clients with collateral to a value in excess of the cash invested by the client and to maintain that excess at a percentage "margin" determined by the FSC. There are no current plans to amend this arrangement which has as its objective the protection of investors in the repo market

of maintaining shareholder value. The FSC proposes to introduce enforceable guidance to deal with this risk.

9.02 To provide a measure of constraint on such actions it is necessary to impose limitations on the withdrawal of capital in certain pre-determined circumstances. The FSC therefore proposes that if a withdrawal of equity capital from an SD, or a subsidiary or affiliate of an SD, by action of a shareholder or a partner would result in the licensee's net capital falling below a specified percentage (for example 120%) of the regulatory capital required by the rules, the FSC must be notified before the withdrawal is made. Further, the withdrawal cannot be made until the FSC gives permission. This restriction applies to withdrawals by any means including dividend payments or share buybacks. The withdrawal would be subject to the FSC being obliged to respond within a pre-determined time period (for example, 10 days). Permission will not be given if the FSC can demonstrate that it has a reasonable belief that the protection of investors requires such action. It should be noted that such powers would not be inconsistent with powers already available to the FSC under section 8 of the FSC Act. However, the proposal allows for the elimination of ambiguity in the powers of the FSC to affect a licensee's treatment of capital, in furtherance of its investor protection mandate.

10.0 LARGE EXPOSURE PROVISIONS

10.01 The FSC has identified an omission in its capital guidelines related to large exposures. A large exposure regime is necessary to minimize the risk of an SD failing as the result of the failure of a counterparty or another entity (such as an issuer of securities that the SD may have underwritten and has not placed with clients). Internationally, a large exposure is generally defined as the total exposure of an entity to a counterparty, a group of connected counterparties, or a group of connected clients, which in aggregate equals or exceeds 10% of the entity's Tier 1 and Tier 2 capital.

10.02 The FSC proposes to introduce enforceable guidance to require that an exposure in excess of 10% would be notifiable to it and exposures in excess of 25% would be prohibited. The FSC is prepared to consider reasoned proposals from respondents for exemptions from this regime for short dated securities and for government debt with a 0% risk weighting. Currently, GoJ bonds denominated in Jamaican dollars are in this second category. On certain technical matters the FSC's current thinking is that (a) the provision will apply to asset exposures, measured gross, and (b) netting of assets of and liabilities to the same counterparty will not be allowed until appropriate changes are made to the bankruptcy regime.

11.0 LICENSING BASED ON FUNCTION

11.01 The FSC is of the view that the Securities Act 1993 (as amended) and the Securities (Licensing and Registration) Regulations 1996 (LAR) (as amended), have not kept pace with these and other changes to the range of activities which licensees undertake. The FSC is therefore proposing a restructuring of the licensing process to match international good practice. This would include the creation of several new categories of securities firm in addition to the two currently set out in the Securities Act. These would be based on the activities each applicant intends to carry on. They would identify the risks to the applicant and its potential clients inherent in each activity. Initial capital requirements and in some cases ongoing requirements, would match those risks.

11.02 A possible risk based-framework, consistent with international practice, on which to base initial capital requirements, is set out below:

i) Advising on securities;

ii) Managing a client's portfolio of securities on a discretionary basis;

iii) Dealing in securities and arranging deals in securities as agent, but excluding dealing as principal;

iv) All of the above plus dealing as principal; and

v) Additional requirements would apply to licensees which hold or administer clients' money and/or securities or are authorized to do so.

11.03 The initial capital requirement for an IA is J$ 1 million in free assets and for a SD the initial capital requirement is J$ 5 million in free assets[21]. These initial capital requirements have not changed since 1998 and hence there has been a major reduction in the cost of entry to the securities business since that time. While that may have had benefits in lowering the barriers to entry and thereby encouraging competition and innovation, it may also have increased the risks to investors by enabling small, lightly capitalised companies and those without the resources necessary to install and maintain risk management and control mechanisms of the necessary robustness, resilience and independence to properly protect clients to obtain a license.

11.04 The requirements for a full service SD are also low in comparison with some other Caribbean jurisdictions.[22] The minimal differentiation in initial capital requirements may also have encouraged applicant firms to identify higher risk activities as the focus of their proposed business models. The sole distinction between IAs and SDs does not provide an incentive to applicants to enter at a low risk level and increase their risk exposure as they become more experienced, grow, and demonstrate that they are providing a quality of service which enables them to retain clients and attract new clients.

11.05 This hierarchy of risk, where advising on securities is the lowest risk category and dealing as principal is the highest risk category is based on an analysis of exposures faced by the firm and its customers as set out below. The FSC is seeking the views of respondents on whether, and if so how, this analysis should be refined.

11.1 ***Advising on Securities.*** The risk to clients is limited to losses incurred (or failure to maximize returns) as a result of following defective advice. The risks to a firm, are primarily (i) that income from fees charged for advice will be insufficient to cover the expenses of operating the firm (eg office rental, staff salaries, telephones, internet access etc.) and (ii) that the firm will be sued by customers who believe that the advice they received was negligently given or biased by the payment of commissions from product providers.

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[21] The requirement for an individual applying for both licenses is net worth of J$ 2 million or the holding of indemnity insurance to the same amount and net worth is defined as the difference between an individual's assets and liabilities.

[22] Regional comparisons include The Bahamas - 34 million J$ equivalent; Trinidad and Tobago – 70 million J$ equivalent

11.2 ***Advising on and Managing Securities on a Discretionary Basis.*** Clients are exposed to several risks. Losses may arise from defective advice (if this is part of the service); from poor investment decisions in the discretionary management of the client's portfolio, from 'churning' the portfolio to generate excessive commissions or from self interest in the choice of SD to which a client order is transmitted for execution (eg the SD may pay for order flow and provide poor execution quality). The firm is exposed to the risk of having to compensate clients for any of these failures; to the risk of failing to resource and manage its business sufficiently well to minimize the possibility of such claims arising and/or succeeding; the risk that income from fees charged for the services provided will be insufficient to cover the expenses of operating the firm.

11.3 ***Dealing in Securities and Arranging Deals in Securities as Agent, but Excluding Dealing as Principal.*** In addition to the risks to the firm and its clients as set out as regards advising and managing the client is exposed to the risk of poor execution and settlement of his orders.

11.4 ***All of the Above Plus Dealing as Principal and Underwriting New Issues of Securities as Principal.*** Where a firm is registered to carry out all the securities activities for which a license may be granted, in addition to the risks set out above the client is exposed to additional risks from the firm's failure to properly manage the conflicts of interest which arise in dealing as principal with clients (or where the manager of the client's portfolio works in the same firm or group as the trader responsible for the profitability of the dealing as principal activity). Counterparties and clearing houses will be exposed to the risk of the firm not completing transaction it has entered into for its own account and the firm will be exposed to the risk that its own account dealing results in substantial losses which will erode its capital below regulatory minima or force it into insolvency.

11.5 ***Additional Requirements are Necessary for Licensees which hold or Administer Clients' oney and/or securities or are authorized to do so.*** Where a licensee holds or administers client money and/or securities the client is at risk that his funds and/or securities will be mismanaged or misappropriated through incompetence or fraud which in extreme cases will result in all, or substantially all, of the client's funds and securities being irrecoverable. There is therefore a premium on the probity of the owners, managers and employees of the licensee and the necessity for the licensee to install and operate record keeping and systems and controls in the custody and cash management parts of its business of the highest standard. Relative to licensees that do not offer this service this additional business line requires significant additional resources to set up and maintain. A licensee's external auditor will also have additional, important and chargeable functions to perform in assessing its operation. The higher regulatory capital requirements for licensees which hold clients' money and/or securities, or are authorized to do so, reflect these increase resource requirements.

11.51 Based on the LAR's definition of initial capital as free assets (for a company) as the net asset worth of the company held in the form of cash and readily convertible securities, a proposed scale of initial capital requirements is set out in Table 3:

Table 3: Proposed Initial Capital Requirements by Business Type		
Securities Activity	**Initial Capital (free assets)**	**Additional Initial Capital required for managing client funds and/or securities**
Advising on securities	J$ 2, 000,000[23]	Management of client funds or securities not permitted
Advising and discretionary management	J$ 5,500,000	J$ 5,500,000
Dealing and arranging deals as agent	J$ 9,000,000	J$ 7,000,000
Any or all of the above plus dealing as principal	J$ 50,000,000[24]	No add-on required

The FSC is prepared to consider submissions regarding the appropriate level of the initial capital requirements outlined in table 3.

11.52 The FSC is also prepared to consider a complementary approach to the determination of initial capital requirements based on (a) the submission of a detailed business plan, (b) the requirement to hold capital in a specified proportion to projected first year expenses. The requirement would then be structured as the higher of the tabular charges in table 2 or the capital-to-cost ratio. Respondents are asked to express their views on this complementary approach

12.0 A SEPARATE CAPITAL REGIME FOR IAS AND FUND MANAGERS

12.01 For firms carrying on the business solely of advising or discretionary management of portfolios on behalf of clients the FSC is proposing to apply a simple expenditure based rule to ongoing capital requirements. As discussed above the risk to clients in merely receiving advice from a firm is limited to the quality of the advice. Where a client has given a fund manager discretion as to the management of a portfolio of securities the client's risk is limited to the quality of the investment decisions and to the manager dealing outside the agreed mandate as well as risk such as fraud or mis-management of the custody function, (when that is part of the agreement).

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[23] Consideration could be given to providing the option of replacing this capital amount with a requirement to hold professional indemnity insurance (in an approved form) to the same value

[24] Regional comparisons include The Bahamas - 34 million J$ equivalent; Trinidad and Tobago – 70 million J$ equivalent

12.02 As regards fund management the issue of the proper capital requirement was left unresolved in 2004. At that time the FSC was prepared to accept, as an interim measure, the argument that its then proposal of applying a 25% credit conversion factor for discretionary funds under management, on the Basel model for off-balance sheet exposures, was too high.

12.03 In the view of the FSC an expenditure based requirement would create an environment in which a firm would be able to wind down its business over a relatively short period. It would be able to do so without loss to its customers or the customers of other firms and without disrupting the orderly functioning of financial markets. This might be the case where a licensee which was losing advisory customers or was having discretionary mandates withdrawn. It would also provide the FSC with time to intervene, if deemed necessary, to achieve the desired result. It would also be consistent with international standards such as the IOSCO Principles of Securities Regulation[25] and (in its detailed requirements) and the financial resources requirements imposed on firms in the EU which manage collective investment schemes (UCITS) under the relevant Directives.

12.04 In outline, the guideline for the calculation of an expenditure based capital requirement for discretionary fund managers would look as follows: it would consist of a requirement to maintain the higher of the Initial Capital Requirement (free assets) or 3 months annual audited fixed expenditures[26]. In the case of very large fund managers there would be an addition to the annual expenditure amount based on funds under management[27] . As noted in the FSC's 2004 *Guidance for Interim Capital Standards for Securities Dealers,* funds under repo agreements would be excluded. These contracts should not be considered as falling under the definition of traditional funds management for the reasons set out above.

13.0 SUMMARY OF PROPOSALS FOR CHANGE

13.1 ***Capital Ratio*:** retained earnings will be maintained in Tier 1 but subject to a prohibition on withdrawal without the approval of the FSC. Current year to date profits will no longer be treated as eligible capital. Within Tier 2 the FSC is considering permitting further changes to revaluation reserves for real property (gains or losses) held as investment assets subject to satisfactory evidence that the revaluation gains or losses were made on the basis of annual valuations conducted by an appropriately qualified and independent third party. To ensure transparency the FSC will amend its guideline on capital requirements and the reporting form C1 to secure consistency and will maintain that consistency going forward.

13.2 ***Market Risk*:** a market risk element based on the Basel Accord trading book amendment will be added to the capital ratio calculation to provide a capital buffer against changes in market prices and the risk that when securities have to be sold the price received may be at a discount to the current market price.

13.3 ***Leverage Risk*:** the FSC will upgrade its leverage ratio to a mandatory requirement. The objective would be to given additional emphasis to the contributing role of excessive leverage in triggering financial crises

[25] IOSCO: Objectives and Principles of Securities Regulation, February 2008 pages 35,36
[26] The comparable figure for IAs (as defined above) might be half this amount
[27] In the case of the UK FSA an additional amount of 0.02% of the excess applies if if the funds under management (FUM) exceed €250,000,000. A smaller amount of FUM would be appropriate in Jamaica, taking account of the size of the market

and the damage to the real economy that the subsequent process of de-leveraging causes. This will reinforce the current position whereby trading in excess of the ratio is, and has been used as, grounds for the FSC intervening against an SD under Section 8 of the Securities Act. A ratio specific to each SD and determined by the FSC within an overall range remains under consideration.

13.4 ***Liquidity Risk*: the FSC will employ a twin track approach to dealing with liquidity risk. The objective is to formalise best practice as currently carried out by some SDs, to raise standards where deemed necessary by the FSC, and to harmonise the standard across the industry.

i) It will reissue, as enforceable guidance, the informal guidance on liquidity risk management it issued in 2004, updated to take account of recent international policy developments; and

ii) The FSC proposes to impose a Net Stable Funding Ratio and a Liquidity Coverage Ratio, calibrated to the circumstances of the Jamaican market. As regards an LCR, limitations on the supply of liquid high quality assets in the Jamaican market may require this initially to take the form of a periodic stress testing requirement, with an obligation on an SD to take remedial action if the FSC so determines, rather than a quantitative requirement to be met at all times.

The FSC will undertake development of these quantitative measures having full regard to the continuing international debate between the BCBS and the industry on the application and calibration of these metrics.

13.5 ***Operational Risk*:** the FSC will undertake a twin track approach to dealing with OR. For these purposes OR is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

i) The FSC will implement the BCBS 2003 Principles for the effective management and supervision of OR[28] to the extent not already incorporated in supervisory monitoring and the risk management and control processes of the firms and incorporate them in enforceable guidance;

ii) The FSC proposes to adopt a quantitative approach to OR as is now in effect under the Basel Accord as modified in Basel II[29].

Although FSC currently proposes that the Basic Approach and the Standardised Approach will be available to SDs, the FSC's position is that it would prefer SDs to adopt the latter, as it is capable of closer correlation to the risk in particular business lines, and will calibrate this accordingly. The FSC is also open to substantiated proposals for an insurance-based component.

13.6 ***Margin Trading Risk*:** The current position is that the risk inherent in margin trading is not taken into account when computing the capital ratio.[30] In the view of the FSC the principal risk which needs to be mitigated is Funding Liquidity Risk (FLR). This arises from margin calls issued by the crediting broker which must usually be met within a very short period of time. The FSC proposes to address the FLR issue by developing an appropriate metric within the overall liquidity risk management processes SDs are required to implement, possibly within the overall framework of a Net Stable Funding Ratio. The FSC

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[28] *Sound practices for the management and supervision of operation risk*: February 2003.
[29] *International Convergence of Capital Measurement and Capital Standards A Revised Framework*: June 2004
[30] In the case of foreign currency bonds there is a 100% risk weighting on net foreign exchange exposures but not on gross exposures.

is also examining the extent to which the increased Credit Risk weightings being applied in stages to GoJ foreign currency bonds and the proposed Market Risk factors to be applied generally deal sufficiently with the credit and market risk in securities bought on margin.

13.7 ***Withdrawal of Capital Risk*:** The FSC proposes that proposals to withdraw capital (via dividend payments, share buybacks or other means) must be notified to it when that withdrawal would cause an SD's capital ratio to decline below an FSC determined minimum. This will be above the 12% capital ratio at which an SD is currently required to inform the FSC. The FSC believes 20% is the appropriate level. This will be buttressed by a power for the FSC to impose a temporary restriction on a proposed withdrawal if it believes investor protection requires such action. The objective is to minimise the risk of shareholders withdrawing capital from an SD in the face of a deteriorating financial situation.

13.8 ***Large Exposure Risk*:** the FSC is proposing to introduce a large exposure regime to minimize the risk of an SD failing as the result of the failure of a counterparty or another entity (such as an issuer of securities the SD may have underwritten and has not placed with clients). The regime will require that an exposure in excess of 10% of Tier 1 and Tier 2 is notified to the supervisor and exposures in excess of 25% are prohibited. The FSC expects to include exemptions for short dated securities and for government debt with a 0% risk weight.

13.9 ***Greater Differentiation in the Licensing of SDs and IAs*:** The FSC will seek the means to create additional categories of licenses. This will be based on a more clearly articulated hierarchy of risk and will include initial capital requirements set at levels which better reflect those risks than is currently the case. Initial capital requirements for full service SDs will be raised to levels which better reflect best practice in the region. The FSC proposes that IAs, and licensees whose sole business is the discretionary management of portfolios for clients individually and also for unit trusts and mutual funds will be subject to ongoing capital requirements which better reflect the primary regulatory need of ensuring that they can be run down in an orderly manner if they fail, with minimal risk of loss of client funds or securities.

14.0 CONCLUSIONS

14.01 This consultation paper fleshes a package of reforms to enhance prudential standards for securities dealers, pursuant to a commitment from the GOJ to effect policy reforms aimed at reducing vulnerabilities, and enhancing investor protection, within Jamaica's financial sector. The FSC recognizes that, in implementing ant package of policy reforms, the content, pace and sequencing of specific reform measures must adequately balance the twin objectives of enhancing investor protection and preserving financial stability, in particular, avoiding sudden shocks to the market and to the role of securities dealers as market intermediaries for the placement of corporate and government securities. This consultation has highlighted specific questions on which comments are invited and the FSC is also interested in receiving comments regarding the appropriate sequencing and timing of the various elements of the reform package.

14.02 However, notwithstanding these specific concerns, the FSC invites comments on any and all aspects of prudential reform presented in this paper. Comments should be submitted in hard copy or via email, on or before **2010 October 31**. Comments may be submitted in hard copy to:

The Senior Director, Securities

Financial Services Commission

39-43 Barbados Avenue

Kingston 5

Or by email to:

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ANNEX 1

OPERATIONAL RISK PRINCIPLES

Principles for an Effective Risk Management Environment

Principle 1: The board of directors of an SD should be aware of the major aspects of the SD's operational risks as a distinct risk category that should be managed, and it should approve and periodically review the SD's operational risk management framework. The framework should provide a firm-wide definition of operational risk and lay down the principles of how operational risk is to be identified, assessed, monitored, and controlled/mitigated.

Principle 2: The board of directors should ensure that the SD's operational risk management framework is subject to effective and comprehensive internal audit by operationally independent, appropriately trained and competent staff. The internal audit function should not be directly responsible for operational risk management.

Principle 3: Senior management should have responsibility for implementing the operational risk management framework approved by the board of directors. The framework should be consistently implemented throughout the whole organisation, and all levels of staff should understand their responsibilities with respect to operational risk management. Senior management should also have responsibility for developing policies, processes and procedures for managing operational risk in all of the SD's material products, activities, processes and systems.

Risk Management: Identification, Assessment, Monitoring, and Mitigation/Control.

Principle 4: SDs should identify and assess the operational risk inherent in all material products, activities, processes and systems. SDs should also ensure that before new products, activities, processes and systems are introduced or undertaken, the operational risk inherent in them is subject to adequate assessment procedures.

Principle 5: SDs should implement a process to regularly monitor operational risk profiles and material exposures to losses. There should be regular reporting of pertinent information to senior management and the board of directors that supports the proactive management of operational risk.

Principle 6: SDs should have policies, processes and procedures to control and/or mitigate material operational risks. SDs should periodically review their risk limitation and control strategies and should adjust their operational risk profile accordingly using appropriate strategies, in light of their overall risk appetite and **profile.**

Principle 7: SDs s should have in place contingency and business continuity plans to ensure their ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

Role of Supervisors

Principle 8: The FSC should require that all SD, regardless of size, have an effective framework in place to identify, assess, monitor and control/mitigate material operational risks as part of an overall approach to risk management.

Principle 9: The FSC should conduct, directly or indirectly, regular independent evaluation of an SD's policies, procedures and practices related to operational risks. The FSC should ensure that there are appropriate mechanisms in place which allows it to remain apprised of developments at SDs.

Role of Disclosure

Principle 10: SDs should make sufficient public disclosure to allow clients and cpoiunterparties to assess their approach to operational risk management.

ANNEX 2

NET STABLE FUNDING RATIO

The **N**et **S**table **F**unding **R**atio (NSFR) is defined as the ratio of the **A**vailable Amount of **S**table **F**unding (ASF) to the **R**equired Amount of **S**table **F**unding (RSF). The NSFR is expected to be greater than 100%.

Components of ASF and Associated ASF factors

100%	The total amount of capital, including both Tier 1 and Tier 2 as defined by the FSC.
	The total amount of any preferred stock not included in Tier 2 that has an effective maturity of one year or greater taking into account any explicit or embedded options that would reduce the expected maturity to less than one year.
	The total amount of secured and unsecured borrowings and liabilities (including term repo) with effective maturities of one year or more excluding any instruments with formal or informal call features.
80%	Retail and corporate funds secured by repo or otherwise with a term of less than one year but at least 90 days and with no formal or informal call features.
50%	Retail and corporate funds secured by repo or otherwise with a term of less than 90 days but at least 30 days and with no formal or informal call features
0%	All other liabilities.

Composition of Asset Categories and Associated RSF Factors (Note: Encumbered assets include those posted as collateral for repo and securities purchased on margin)

0%	Cash and money market instruments with maturities of <365 days Securities with effective remaining maturities of less than one year
5%	Unencumbered marketable securities issued by sovereigns and other public sector bodies with a maturity of one year or more with a 0% risk weight

assigned by the FSC provided that active and liquid cash and/or repo markets exist for them

20%	Unencumbered corporate bonds rated at least A with a maturity of one year or more which are traded in active and liquid cash and/or repo markets
80%	Loans to corporate and retail clients whether secured or unsecured and with a residual maturity of less than one year
100%	All other assets

ANNEX 3

CALCULATION OF THE MARKET RISK FACTOR

Consistent with the Basel approach the proposal divides Market Risk into two parts, Specific Risk and General Market Risk.[31] These are to be added to produce the overall Market Risk Factor Fixed-rate instruments are allocated according to the residual term to maturity and floating-rate instruments according to the residual term to the next repricing date.

Netting of long and short positions will be treated differently in the calculation of Specific Risk and General Market Risk. In the case of Specific Risk netting will be restricted to matched positions in the identical issue. Even if the issuer is the same, no netting will be permitted between different issues since differences in coupon rates, liquidity, call features, etc. mean that prices may diverge in the short run. In the case of General Market Risk the net long or short position in each maturity band may be used.

Debt

Specific Risk factors

Sovereign debt or equivalent rated AAA- to AA-		0%
Sovereign debt or equivalent A+ to BBB-		
Residual Maturity	0-6 months	0.25%
	6-24 months	1%
	Over 24 months	1.6%
Sovereign debt or equivalent rated BB+ to B-		8%
Sovereign debt or equivalent rated below B-		12%

General Market Risk factors

Maturity Band		Factor
Coupon > 3%	Coupon < 3%	
0- 1 month	0-1 month	0.00%
> 1-3 months	> 1-3 months	0.20%
> 3-6 months	> 3-6 months	0.4%

[31] Specific Risk is the risk of adverse price movements related to the issuer of the security General Market Risk is the risk of loss arising from adverse changes in overall market prices

> 6 - 12 months	> 6 - 12 months	0.7%
> 1-2 years	> 1.0-1.9 years	1.25%
> 2 - 3 years	> 1.9-2.8 years	1.75%
> 3-4 years	> 2.8-3.6 years	2.25%
> 4-5 years	> 3.6-4.3 years	2.75%
> 5-7 years	> 4.3-5.7 years	3.25%
> 7-10 years	> 5.7-7.3 years	3.75%
> 10-15 years	> 7.3-9.3 years	4.5%
> 15-20 years	> 9.3-10.6 years	5.25%
> 20years	> 0.6-12.0 years	6.00%
	> 12.0-20.0 years	8.00%
	> 20 years	12.50%

Equity

Specific Risk factor - 8%, unless the portfolio is both liquid and well-diversified, in which case the charge will be 4%.

General Market Risk factor – 8%