BASEL III IMPLEMENTATION: A CASE STUDY ON PROPORTIONALITY CONSIDERATIONS IN JAMAICA

Presentation by Maurene A Simms- Deputy Governor, Bank of Jamaica
June 6, 2019
IMF-World Bank- 19th Annual International Conference on Policy Challenges for the Financial Sector

Good morning colleagues, I must thank our hosts, the FED, IMF and the World Bank Group for inviting Jamaica to share with this august forum our experience in implementing Basel III.

INTRODUCTION

The late Jamaican reggae artist and icon, Bob Marley said, "It takes a revolution to make a solution." Jamaica is well known for its athletic achievements, music and other cultural accomplishments. However, what is lesser known, outside of the IFI sphere, is what one opinion writer has described as a "silent revolution". This "silent revolution", according to the writer, has resulted in an "extraordinary macroeconomic turnaround" [1]. Jamaica has become a front runner amongst its Caribbean peers in its implementation of some of the most modern international regulatory standards and financial system reforms.

Today, I will be speaking about the Basel III Reforms from a developing country perspective, using Jamaica as my point of reference. In Jamaica, we are in the process of developing

[1] Van Trontsenburg, Axel. "Jamaica has made an 'extraordinary' economic turnaround". Miami Herald, May 14, 2019. https://www.miamiherald.com/opinion/op-ed/article230391419.html

proposals for the implementation of the Basel III framework, so this presentation is quite timely for us.

Today, I will examine three points from Jamaica's national context:

1. How the principle of proportionality is being construed in our supervisory framework as we move to implement Basel III;
2. How we have proposed to address the implementation challenges in relation to the Basel III reforms and;
3. How we are proposing to design a framework that builds on the opportunities inherent in the spirit of the Basel III reforms.

I will begin by describing Jamaica's current macroeconomic landscape.

JAMAICA'S CURRENT MACROECONOMIC LANDSCAPE

Propelled by almost a decade of strong economic and financial sector reforms (supported by a series of IMF Programmes as well as support from other IFIs including the IDB and the World Bank), Jamaica's economy is showing strong signs of spring. Debt to GDP ratio is currently 96.06% down almost 40 percentage points from a high of 135% at the start of the reforms in

2013. Bank of Jamaica's policy rate has been whittled down to 0.75%, and inflation out turn has averaged 3.1% for the last 3 years. The Jamaica Stock Exchange was the best performing exchange in the world in 2015 and 2018, with a near 3.5 times increase in value over the five year period ending 2018. And private sector credit is currently expanding at about 16% per annum. Unemployment at 8%, is at a record low and net international reserves are healthy. The country's latest economic rating using Moody's standard is B3 (as at April 2019), with a stable outlook.

Despite the relatively rosy picture just painted, Jamaica continues to perform below its potential, as private investment has not fully taken advantage of the unprecedented opportunities presented by macroeconomic stability and strong fundamentals. The Government has, in a net-sense, been paying back its debt stock at a rate of about 7% of GDP per annum for the last 4 years and it is projected to continue at this pace for the next 5 years until the target Debt/GDP ratio of 60% is met in FY2025/26. There is much scope however, for

Jamaica to improve its international rankings in private sector credit to GDP[2] (private sector credit to GDP is only 36% well below our peers), access to finance; and financial sector efficiency. Current rankings reflect the limited levels of credit intermediation in the economy as well as outsized intermediation spreads that no longer reflect the well-entrenched economic fundamentals. This economic underperformance has motivated the establishment of a special state commissioned group tasked with finding solutions for institutional and market deepening. I will highlight aspects of this group's work throughout the course of this presentation.

While the current macroeconomic environment presents opportunities for increased intermediation, these opportunities are not without risks for financial institutions. As mentioned earlier, continued fiscal consolidation, has resulted in significantly reduced levels of the most dominant and capital efficient investable asset class in the domestic context – that is, Government Securities. With limited alternatives for investable assets and a low interest

[2] International Monetary Fund, 2018, *Jamaica: Financial System Stability Assessment*. Page 22

rate environment, financial institutions - awash with liquidity – are faced with incentives to search for yield further out on the risk-reward curve. Meanwhile, at the regional level we have observed intensified conglomeration of financial institutions, expanding the channels of regional interconnectedness. These realities warrant heightened supervisory surveillance and creates the rationale for more robust regulatory policy and more dynamic supervisory approaches.

Jamaica is therefore at a crucial stage in its progress towards financial sector development as we seek to implement post-crisis international standards in a way that promotes financial stability while acknowledging the idiosyncrasies of the domestic economy, especially those of the financial sector, which is at the heart of this metamorphosis. In this regard, we acknowledge the FSB's efforts in introducing proportionality to the discourse as the impact of regulatory change can be very different for developing countries. As the Basel Committee transparently states, the Basel III standards were largely designed with internationally active banks in mind, however, as any developing jurisdiction that has undergone an FSAP evaluation can attest, these standards set the benchmark by which they are judged. These reforms may not, in a one size fits all way, be appropriate for developing counties where system dynamics and starting points may be different[3]. For instance, there is empirical evidence to suggest that higher levels of capital and liquidity requirements on banks have a more constraining effect on intermediation and economic growth in developing countries than on that of their more advanced counterparts.[4] Developing countries, like Jamaica, face different challenges than those of the more developed, as we seek sustained growth in a long-term perspective, to develop our financial systems, and at the same time, extend access to financial services to the poorest segments of the population[5].

We welcome the increased attention this topic has been receiving by the regulatory community and look forward to increased dialogue in this area.

[3] B2012. "The Impact of Regulatory Reforms on Emerging Markets". June 2012. Report
[4]Abascal Maria, Carranza Luis, Ledo Mayte and López Marmolejo Arnoldo. "Impact of Financial Regulation on Emerging Countries", BBVA Research Working Paper 11/08, 8 March 2011. Available at http:// www.bbvaresearch.com/ketd/fbin/mult/WP_1108_tcm348-249241.
[5] B2012. "The Impact of Regulatory Reforms on Emerging Markets". June 2012. Report.

Presentation by Maurene A Simms- Deputy Governor, Bank of Jamaica
June 6, 2019
IMF-World Bank- 19th Annual International Conference on Policy Challenges for the Financial Sector

BASEL III IMPLEMENTATION IN JAMAICA – General Considerations

Bank of Jamaica (BOJ) has embarked on a programme to enhance Jamaica's regulatory landscape for deposit-taking-institutions (DTIs)[6] and their financial holding companies by implementing Basel III inspired capital and liquidity standards. The approach to proportionality that has been deemed most appropriate for adoption in Jamaica is the System-Wide- Approach (SWAP)[7] for banks and financial groups that contain a bank. Due to the fairly homogenous business models, the relatively small number of financial institutions, and significant levels of interconnectedness of DTIs in Jamaica, we have determined that Basel III type regulations will be applicable to all DTIs and financial conglomerates which contain a DTI. There is also the recognition that in the Jamaican context, difficulties even in small institutions can lead to problems of systemic proportions.[8] [9]

[6] This includes commercial banks, merchant banks and building societies.
[7] Hohl Stefan, Sison Maria Cynthia, Stastny Tomas and Zamil Raihan. "FSI Insights on policy implementation No 11. The Basel framework in 100 jurisdictions: Implementation Status and Proportionality Practices"- November 2018.
[8] As was evidenced in the US Savings and Loans Crisis in the 1980s.
[9] Adrian Tobias and Narain Aditya, Safe and Sound: "International Financial Regulators Help Ensure The Safety And Soundness Of Diverse Financial Systems" Finance & Development, September 2017: 14

In determining the most appropriate ways to address the need for compliance consistent with the overarching goal of financial stability, our approach was to develop a strategy, path and timeline[10] that would allow the implementation of the standards in a way that is consistent with Jamaica's goal of inclusive and sustainable economic development. And to support this effort, develop legislation and regulations that are properly formulated and sufficiently future-proofed so as to handle the coming complexity and sophistication of our financial system.

I will now turn to discuss some of the specific policy issues with which Jamaica is grappling in implementing these international standards, incorporating proportionality considerations.

CAPITAL FRAMEWORK

By way of background, the current capital adequacy regulations for DTIs in Jamaica were patterned off the Basel I standards in terms of the definition of capital, the type of risks captured (credit risk and foreign exchange risk), and the method of calculation of risk-weighted assets. One notable way in which the capital adequacy regulatory standard for DTIs is more conservative than the Basel Capital Framework, is that retained earnings do not now count

[10] Ibid, 14

towards Tier 1 capital unless transferred to a non-distributable reserve account. Another distinction is that unlike the minimum international risk-weighted capital adequacy requirement of 8%, DTIs in Jamaica are subject to a 10% requirement. However, Jamaican regulatory framework has long required DTIs to maintain and satisfy a leverage ratio requirement of 6% - a concept that Basel introduced with the release of its most recent capital accord.

Additionally, there exists a kind of structural regulation as deposit-taking institutions in Jamaica are prohibited from engaging in trading activity (outside of foreign exchange trading). Accordingly, where a financial group includes a DTI, trading in securities must be carried out by a separate legal entity. DTIs are currently well capitalized and profitable. Banks' business models are largely traditional, with large retail deposit funding and some wholesale funding, excess liquidity reserves at BOJ, significant holdings of sovereign securities, and conservative lending policies– although this has been changing more recently.

Effective implementation of the Basel III capital framework is predicated on well-functioning and deep capital markets that provides for price discovery and liquidity. For most developing countries, their capital markets are at best fledgling and Jamaica is no exception. In this regard, the economic reforms and specifically the fiscal consolidation, which has resulted in significant crowding-in, has provided Jamaica with an opportunity to propel the deepening of its capital market. And we are seizing this opportunity. Jamaica has put together an inter-agency working group, the Financial Deepening Implementation Group, led by the much sought after and eminently qualified, Mr David (Billy) Marston to lead a programme to identify and activate projects that will provide an impetus to capital market development. One such project under-way is seeking to significantly grow the number of corporates that are rated thus facilitating better transparency and their access to the capital markets.

BOJ is going about the implementation of Basel III in a very thoughtful way, recognizing how banks currently fund their operations and the opportunities presented by work being done on the development of the capital markets. We are therefore implementing the framework in phases:

- Phase (1), which has already commenced, focuses on the implementation of the Liquidity Coverage Ratio (LCR) which is scheduled for full implementation by end third quarter of 2019;

- Phase (2), entails the implementation of standardized approaches for minimum capital requirements for credit, market and operational risks under Pillar 1 and will also involve the implementation of the Pillar 2 elements of Basel II/III including, frameworks for Internal Capital Adequacy Assessment Process (ICAAP), the Supervisory Review and Evaluation Process (SREP); and the full implementation of the regulatory framework specifically applicable to D-SIFIs; and
- Phase (3), the final phase, scheduled to commence in 2022, will involve the imposition of additional capital and liquidity measures; that is, the capital conservation buffer, the countercyclical capital buffer and the Net Stable Funding Ratio (NSFR).

I will now turn to address some of the specific policy design considerations in BOJ's Basel implementation work. First, I will discuss some issues pertaining to capital requirements before turning to considerations surrounding the Liquidity Coverage Ratio.

THE DEFINITION OF CAPITAL

Basel III recognizes non-equity capital instruments that can count towards meeting regulatory capital requirements. From a regulatory standpoint, the inclusion of these instruments is desirable not only because of the market discipline exerted by this type of capital, but as a source of loss absorption in a "gone concern" scenario, that can enable the execution of effective and orderly private sector funded resolution of firms that are systemic in failure. This is one element of the Basel framework where the presumption of well-functioning and deep capital markets mentioned earlier, poses a challenge as banks in Jamaica are constrained in the extent to which they can include these instruments in their funding structure due to the limited maturity and depth of the domestic capital markets. This problem is exacerbated by the design features in the current capital regulations[11], which do not comprehensively capture the reformed international standards, in terms of how it defines and treats with non-equity capital instruments, and places limits on the extent to which Tier 2 can count towards regulatory capital.[12] The foregoing needs to be viewed in the context of the current operating environment for banks in Jamaica which I will highlight briefly.

Banks currently meet their capital requirements with what is the equivalent of CET1 under the Basel III framework. Apart from CET1, the dominant source of funding used by these banks are

[11] The Banking Services Act (Deposit Taking Institutions) (Capital Adequacy) Regulations, 2015
[12] Section 6(1) of The Banking Services Act (Deposit Taking Institutions) (Capital Adequacy) Regulations, 2015

deposits. There is limited and infrequent reliance on long-term debt financing. The fledgling nature of the capital markets and the current legal and regulatory framework, all compound to create an environment in which banks are not incentivized to raise long-term debt financing, as their current funding structure enables them to meet regulatory requirements relatively cheaply, while at the same time satisfy the return objectives of equity owners.

I would like to digress for a moment to highlight a related policy challenge with which Jamaica is currently grappling. Jamaica is in the midst of implementing a **Special Resolution Regime** (SRR) for financial institutions.

One of the key success factors underpinning the workability of the SRR, especially for larger more complex banks, is their ability to issue and maintain a stock of “bail-inable” debt instruments with loss absorbing capacity (“LAC”) which is akin to Tier 2 capital. Again, these standards presume sufficiently deep capital markets, which will continue to pose a challenge for Jamaica, for some time yet. Nonetheless, there exists opportunities to coordinate the design of LAC under the SRR, with the design of Tier 2 capital in the capital adequacy framework. This design approach could smooth the path towards the eventual imposition of mandatory LAC requirements aimed at promoting the resolvability of banks and the workability of the SRR.

I will now discuss the BOJ's approach to the implementation of Basel III requirements with regard to the calculations of risk-weighted assets.

RISK-WEIGHTED ASSET REQUIREMENTS

The prudential regulatory framework in Jamaica does not currently acknowledge the use of external ratings by DTIs. Instead, minimum capital requirements for credit risk exposures are determined using prescribed Basel I-based regulatory risk-weights. Aside from liquid assets and cash reserve requirements (under the monetary policy framework), there is currently no prudential liquidity regulatory requirement. However, the implementation of Basel III Risk-Weighted Asset requirement presents an opportunity for the introduction of an external ratings framework, to sit alongside the Basel III non-ratings based regime, for the purposes of determining risk-weightings for credit risk exposures. Allowing DTIs to use external ratings, as an alternative to prescribed regulatory risk-weightings, has the potential to foster the development of a market for externally rated corporate issues.

Basel III presumes markets where there is a profusion of rated issues and issuers. However, in Jamaica there is a dearth of externally rated issues and issuers in the corporate landscape. Basel III also presumes that high quality corporates attract favourable ratings but in Jamaica, like many developing countries, the sovereign ceiling problem presents a challenge, which creates undue and distortive downward pressure on the credit ratings that corporates might otherwise been able to receive from global rating agencies. Furthermore, the fixed costs associated with accessing credit ratings from the top rating agencies will likely be prohibitive for many domestic corporates.

Jamaica has considered the above challenges and as a solution has proposed utilizing a rating framework based on regional or national rating scales as a credible way of differentiating credit riskiness of domestic and regional corporates, of course still subject to creditor due diligence. There is at least one credit rating service provider that produces ratings using regional and national rating scales and that satisfies the BCBS qualifying criteria for External Credit Assessment Institutions (ECAI) at more affordable cost points.

Also, the incentives regime around external ratings extends to corporates (including SMEs) in ways that can benefit financial institutions and the financial system generally. Where corporate entities are incentivised to become rated, they will likely align their finance and accounting operations towards best practice, and invest in relevant supporting infrastructure. In addition to giving these corporates greater access to the capital markets, the resultant maturity in corporate landscape will lead to better quality and more reliable data that DTIs and other financial institutions can utilise to make well-based risk taking decisions. Furthermore, the potential for greater access to finance for corporates along with better capital allocation by financial intermediaries should promote a more vibrant economy, which in in turn supports financial stability.

I will now examine the proposals being put forward in Jamaica for the implementation of the LCR under the first phase of BOJ's Basel III implementation programme.

LIQUIDITY COVERAGE RATIO

The Basel III LCR requires DTIs to hold high quality liquid assets. This presents challenges in implementation for Jamaica as in the absence of more advanced capital markets, more short term sovereign debt securities would be necessary to meet the requirements. As I intimated earlier, the fiscal consolidation efforts has resulted in a reduction in domestic sovereign debt instruments and the alternative of holding highly rated corporate paper is difficult because of scarcity and the challenges with ratings.

In order to tailor the LCR requirements to the Jamaican financial landscape, among the measures being considered is the proposal to recognize a class of high quality externally rated Jamaican corporate debt securities as qualifying for Level 2 HQLA treatment under the LCR. This would widen the pool of liquid resources that banks could draw on in times of liquidity stress events.

The proposed tailoring of the LCR framework aligns with some of the strategies being proposed by the Billy Marston led Financial Deepening Implementation Group. These strategies include, inter alia:

- the promotion of external ratings for corporates aimed at creating an additional class of HQLA*;*
- incentivizing the market-making capability of security dealers*;* and
- the development of trading microstructures that promote price discovery, transparency and most importantly, liquidity in the capital markets.

CONCLUSION

In closing, Jamaica is striving to design proposals to adapt and modernize its prudential regulatory framework, that are aligned to international standards, while recognizing national idiosyncrasies, such as: high levels of financial conglomerates; institutional business models and risk profiles; and a fledgling capital market, as we continuously seek to strike a delicate balance.

We want to use the implementation of international standards such as Basel III, as engines for enhanced financial resilience whilst balancing broader national priorities around sustainable financial development. Whereas in advanced economies regulators can prioritize their efforts on deterrence measures to avoid domestic and global financial crises; regulators in developing countries have a "finer line to walk"; we have to thoughtfully impose prudential regulatory standards in a way that satisfies international regulatory requirements but which does not negatively impact the country's wider developmental goals.[13]

[13] B2012. "The Impact of Regulatory Reforms on Emerging Markets". June 2012. Report.

We therefore welcome the increased level of dialogue on the topic of proportionality within the international regulatory community and hope that this discourse will support greater awareness of the diverse contexts of individual developing countries, with the overall aim of enriching the international policy development process and promoting our common interest in global financial stability.