DECEMBER 2021

# BASEL III CAPITAL ADEQUACY FRAMEWORK

## FREQUENTLY ASKED QUESTIONS

BANK OF JAMAICA

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## Introduction

1. Bank of Jamaica ("the Bank") issued a Consultation Paper ("CP") 28 December 2020[1] inviting proposals for implementing the Basel III Capital Adequacy Framework, including the capital charge methodologies for credit risk, market risk, and operational risk, as well as a revised definition of regulatory capital.

2. This document captures the most frequently asked questions and substantive feedback on the proposals submitted in the CP, as well as the Bank's responses to the feedback.

## Consultation Feedback

3. The three-month consultation period for the Capital Adequacy Framework ended 31 March 2021. A total of eleven (11) submissions were received from stakeholders in relation to the revised definition of regulatory capital component of the CP.

4. Respondents to the consultation paper sent out to stakeholders on 28 December 2020 raised hundreds of questions around various operational, logistical, and quantifiable aspects of the Capital Adequacy Framework. The Bank has given careful consideration to the issues raised, provided responses, and brought the feedback and responses through a rigorous internal review process.

5. Accordingly, this condensed version of that document, which focuses on key and frequently asked questions, as well as the responses to those questions, are summarized below under the appropriate headings and sub-headings.

6. Following from this consultative process, the Bank will finalize a Standard of Sound Practice on the Capital Adequacy Framework. The Bank has set out proposed implementation timelines for this framework in an Appendix at the end of this document, on which stakeholders may submit feedback and suggestions during the one year period of transition described in the Appendix.

7. Interested stakeholders may provide further questions and/or proposals regarding the information provided in this document or otherwise promptly, by email, to fisdfeedback@boj.org.jm.



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[1] https://www.boj.org.jm/uploads/news/consultation_paper_on_the_implementation_of_basel_iii_capital_adequacy_framework_-_28_december_2020.pdf

# DEFINITION OF REGULATORY CAPITAL

## GENERAL QUESTIONS

**Question 1. How frequently will licensees be required to report their capital positions?**

Financial institutions ("FIs") will be required to report their capital positions on a monthly basis under the Capital Adequacy Framework.

**Question 2. Will there be a transitional arrangement for the implementation of the framework, to assist licensees who do not meet the capital requirements to do so?**

Bank of Jamaica ("the Bank") acknowledges that financial institutions may be at differing states of readiness for the proposed capital adequacy requirements. The Bank will therefore allow for a transitional period of one year (12 months) after the publication of a Standard of Sound Practice on the Capital Adequacy Framework, and a further phase-in arrangement for the imposition of the full capital requirements as set out in paragraph 17 of the consultation paper (CP). Licensees will be able to build up their operational capacity to meet the prescribed capital requirements, including the capital buffers or any other capital requirement.

**Question 3. How long will the transitional period last for?**

The 12-month transition period is tentatively projected to run from 1 July 2022 to 30 June 2023. Financial institutions will be afforded the opportunity to provide feedback to the Bank during the one year transitional period as concerns arise to fisdfeedback@boj.org.jm. Thereafter, the revised standards will be phased in according to an agreed schedule.

**Question 4. What is the scope of application for the Capital Adequacy Framework and will the framework be applicable to credit unions once the *Credit Unions – The Bill, Credit Unions (Special Provisions) Act (CUSPA)* is promulgated?**

The Capital Adequacy Framework will apply to deposit taking institutions (DTIs) on a standalone basis and to financial holding companies (FHCs) that include at least one deposit taking institution, on a consolidated basis. While the Bank has supervisory responsibilities for licensed DTIs and FHCs, the Capital Adequacy Framework will not be applicable to non-DTI members of a financial group. Therefore, the framework will not be applicable to the credit union and insurance sectors at the solo level.

**Question 5. What is the intended treatment for insurance companies?**

The scope of regulatory consolidation is outlined in paragraph 19 of the CP and does not include insurance companies. Under the Capital Adequacy Framework, the sectoral regulatory capital requirements that govern insurance companies in the financial group will remain applicable.

Insurance companies will be expected to meet the minimum solvency requirements for life insurance and general insurance companies in Jamaica, the Minimum Continuing Capital & Surplus Requirement ("MCCSR") and the Minimum Capital Test ("MCT"), respectively, or any other capital requirement as prescribed by the Financial Services Commission.

**Question 6. Will the increase in capital requirements impact connected party limits?**

Under section 57 (1) of the BSA, licensees are prohibited from incurring counterparty exposures to any connected DTI on a solo basis or FHC on a consolidated basis of more than 10% and 20% of the licensee's capital base, respectively. These requirements are intended to mitigate against potential losses from large counterparty exposures.

Therefore, in order to be consistent with prudent capital management practices for the treatment of large counterparty exposures, these limits will be maintained under the Capital Adequacy Framework until further advised.

**Question 7. Will the Financial Services Commission ("FSC") align its capital regime with the Basel III Capital Adequacy Framework?**

There is ongoing dialogue between the Bank, the FSC, and technical advisers on the alignment of the capital requirements for securities dealers. Nonetheless, feedback was invited on an approach outlined in Box 1-A on Page 8 of the CP that requires securities dealers to be subjected to the FSC requirements on a solo basis, and to the requirements in the CP on a consolidated basis.

**Question 8. Using the FHC consolidated basis, will/can additional capital at the holding company level be used to offset capital inadequacies on the financial institution side?**

Yes, FHCs should ensure that there is prudent and active capital management on a group wide basis. Therefore, FHCs will be expected to use available capital to offset any shortfall identified at any one or more FIs within the financial group.

**Question 9. Will there be early warning indicators for all three (3) ratios, and if so, when will these be shared with the industry?**

Section 110 of the BSA specifies the circumstances under which Bank of Jamaica must issue an early warning notice in relation to a licensee's capital levels falling to one percentage point above any of the prescribed minimum regulatory capital requirements. Furthermore, the Bank is currently developing an operational and logistical framework from the financial stability perspective, which will outline policies and procedures on early warning indicators related to the capital buffers.

**Question 10. What is the legal framework and strategies/mechanisms that will be implemented to mitigate Jamaica's lack of access to supervisory colleges given the importance of cross-border cooperation and coordination to supervising financial institutions under the Capital Adequacy Framework? What, if any, is the legal framework to also avoid impact of and/or potential inconsistencies in national initiatives across borders?**

The Caribbean Group of Banking Supervisors (CGBS) is an important avenue for information sharing, cooperation, and capacity building among regional supervisory authorities, and, together, with international counterparts. The CGBS interfaces with the BCBS on important technical issues, as well as with international regulatory agencies on various matters, including training courses.

Furthermore, given the Bank's working relationship with foreign supervisory authorities, as evidenced by invitations to participate on regional and international panels, access to training seminars, as well as assistance in implementing the Basel III Accords, the Bank is confident that such cooperation, coordination, and information sharing with other supervisory authorities will continue.

## THE CAPITAL REQUIREMENTS

**Question 11. How are non- cumulative, non-redeemable preference shares to be treated in the regulatory capital calculation (CET1, AT1, or Tier 2)?**

Under the Capital Adequacy Framework, non-cumulative, non-redeemable preference shares may qualify as AT1 capital, subject to non-violation of the criteria specified in paragraph 51 of the consultation paper.

**Question 12. Will there be restrictions on dividend distributions? Will DTIs be required to seek approval for removal of any statutory funds from the BOJ once applied to CET1?**

The conditions for distributions on CET1 capital are set out between Criteria (e) and (g) in paragraph 49 of the CP. Based on these criteria, the limitations on paying out dividends on CET1 capital instruments are as follows:

a) Distributions must be paid out of distributable items. That is, those profits, as at the end of the financial year plus those brought forward, and reserves that the licensee has available at any time for disbursement to its shareholders at that time.
b) Distributions must only be paid after all legal and contractual obligations have been met and payments on more senior capital instruments have been made, which means there are to be no preferential distributions.

With respect to retained earnings, under the Capital Adequacy Framework, retained earnings will qualify as CET1 capital through two mechanisms: (i) retained earnings as under paragraph 45(d) and (ii) retained earnings reserve fund. The "retained earnings reserve fund" will be subject to the same treatment as currently obtains under the BSA, which includes at section 42(2), the irreducibility of the fund without prior approval of the Supervisor. However, "retained earnings" on the other hand will not be subject to any such restriction.

**Question 13. Will Systemically Important Financial Institutions be required to hold a greater amount of CET1 compared to smaller financial institutions?**

The Bank of Jamaica has given careful consideration to the imposition of differential capital requirements for financial institutions based on characteristics such as size and systemic importance. However, there is currently no such treatment ascribed to financial institutions that may be deemed to be systemically important financial institutions ("SIFI") in Jamaica. Nevertheless, the Bank reserves the authority to require institutions to vary their minimum regulatory capital ratios based on factors including size and systemic importance once Bank of Jamaica's framework for SIFIs has been finalised.

**Question 14. Is the intention of paragraph 38 in the CP to restrict FHCs from raising capital, potentially AT1 and Tier 2, and injecting this as Tier 1 in a banking subsidiary?**

Paragraph 38 of the CP is intended to ensure consistency in the definition and subsequent classification of capital instruments at both the individual and consolidated levels. As such, the intention of paragraph 38 is not to restrict FHCs from raising capital.

**Question 15. Do all the criteria mentioned in paragraph 38 of the CP have to be met in order for retained earnings to be counted towards current year profit?**

The Capital Adequacy Framework permits the use of retained earnings that have been verified by quarterly financial statements, subject to FIs meeting the conditions specified in paragraph 46 of the CP.

Each criterion stipulated in paragraph 46 of the CP must be treated as necessary conditions, without exclusion, to provide adequate independent verification of the accurate reporting of retained earnings.

**Question 16. Will the Tier 1 to Total Assets ratio requirement remain?**

Yes, the Tier 1/total assets ratio requirement will still remain. Part III (5) of the Banking Services (Deposit Taking Institutions) (Capital Adequacy) Regulations, 2015, prescribes that licensees maintain Tier 1 capital of no less than 50% of total regulatory capital. The minimum capital requirements under the Capital Adequacy Framework exceeds, where applicable, the requirements under the aforementioned regulations.

Furthermore, under the Capital Adequacy Framework, licensees will be required to meet the minimum capital requirements set out in Table DC-1, including the effective minimum requirement that Tier 1 capital be at least 8% of total risk-weighted assets.

**Question 17. Will the earnings of associated companies and joint ventures be eligible for inclusion in the Common Equity Tier 1 capital of the group?**

Retained earnings satisfying the criteria set out in paragraph 46 of the CP may be included in CET1 Capital at the consolidated level on the condition that the profits were earned by a member treated as part of the regulatory group. With respect to joint ventures, their operations are outside the scope of consolidation for the FHC, as outlined in the CP. As such, the earnings of joint ventures are ineligible for inclusion in CET1 Capital of the financial group.

## The Capital Buffers

**Question 18. Will the capital buffers take cognisance of the trigger requirements under section 110 of the Banking Services Act?**

The trigger requirement set out at section 110 of the BSA will consider the capital buffers. In addition to the prescribed minimum capital adequacy ratio requirement of 10% under the Capital Adequacy Framework, licensees must hold a maximum Capital Conservation Buffer ("CCB") of 2.5% at all times, unless advised otherwise by Bank of Jamaica ("the Bank"), and a Countercyclical Capital Buffer ("CCyB") between 0% and 2.5%, as deemed necessary. Therefore, the trigger point will be one percentage point above the applicable capital adequacy ratio minimum requirement, plus the prescribed capital buffers.

In cases where the trigger point has been breached, the Bank will act in accordance with the prescriptions outlined in section 110 of the BSA. Notwithstanding the above, the Bank reserves the authority to vary the prescribed capital adequacy minimum ratio and the capital buffers.

**Question 19. Why is the capital buffer a set number? Could there be a range applied based on certain risk factors inherent within a particular bank's internal control environment?**

The Basel III Capital Adequacy Framework provides for the CCyB to vary between 0% and 2.5%, and the CCB to be a fixed amount of 2.5%. The rationale for the differing requirements are as follows: (i) the appropriate levels of CCyB will be partly determined by the levels of excess credit growth, both at the system and individual levels, and therefore be risk sensitive, whereas (ii) the CCB will be set at 2.5% to ensure that FIs build up enough capital outside of periods of stress to be drawn down as losses are incurred without breaching minimum capital requirements.

Further, the Bank will be guided by general principles in the determination of the appropriate CCyB and pre-announce any decision to increase the level of the CCyB by up to 12 months to allow FIs a sufficient period of planning and adjustment.

**Question 20. In calculating the CCyB at the financial holding company level, should the computations be made using standalone or consolidated numbers?**

Under the Capital Adequacy Framework, the CCyB will be calculated at the FHC level in accordance with paragraph 19(b) of the CP using consolidated figures for the financial group upon the introduction of the consolidated Capital Adequacy Framework.

The Bank will also require that the countercyclical capital buffer be maintained at the level of deposit taking institutions within financial groups, as deemed necessary.

**Question 21. How will normal times and excessive credit growth be defined under the framework?**

A definition/description as it pertains to "normal times" and "excessive credit growth" will be provided in the Standard of Sound Practice for the Capital Adequacy Framework. However, for the purposes of the Capital Adequacy Framework, "normal times" will mean periods in which there is determined to be no "excess credit growth", or there is a credit to GDP gap of less than 2 percentage points above the long term trend, "where excessive credit growth" is defined as a credit to GDP gap of between 2 percentage points and 10 percentage points above the long term trend.

For completeness, the Bank will continuously assess this metric to assess for (i) periods of excessive credit growth, and (ii) periods of rapid increases in the credit to GDP gap.

**Question 22. Will the Capital Conservation Buffer be standard across financial groups?**

The Bank intends to implement the CCB requirements in a uniform manner across FIs under the Capital Adequacy Framework. However, Bank of Jamaica reserves the authority to vary any capital requirements under this framework as deemed necessary.

**Question 23. Will the credit cycles that will be used to calibrate the levels for the countercyclical capital buffer be determined at the micro- or macro-level, or both?**

The Counter Cyclical Capital Buffer (CCyB) is a macroprudential tool. As such, the credit cycles in addition to the applicable levels of the CCyB will determined at the macro level. Consequently, the CCyB will be applied uniformly across DTIs on a solo level and FHCs on a consolidated basis.

**Question 24. Will financial institutions with different levels of connectedness and complexity be held to the same standards with respect to the capital conservation buffer?**

Though the Bank appreciates that some FIs may have higher levels of direct connectedness, and may be more adversely affected at the outset of any period of financial stress, there will be a uniform application of the minimum capital requirements upon the introduction of the Capital Adequacy Framework. There may be instances, however, where domestically systemically important financial institutions (D-SIFIs) may be subject to additional capital requirements in cognisance of their overall potential impact on the Jamaican financial system.

Bank of Jamaica further reserves the authority to vary the minimum capital requirements for any licensee or group of licensees under the Capital Adequacy Framework based on factors including those set out at paragraph 33 of the CP.

**Question 25. Does the stress that occasions the relaxation of the capital conservation buffer also relate to idiosyncratic stress events?**

By design, the CCB is constructed to respond to idiosyncratic events, while reducing the risk of a financial institution's capital adequacy ratio breaching the regulatory minimum. This is in contrast to the CCyB which is more responsive to systemic build-ups in risk. Nevertheless, decisions on the macro-prudential tools deployed by the Bank are made on a case-by-case basis, and will be considered based on prevailing conditions at the system-wide or individual levels and other contextual factors. Accordingly, the Bank may allow for the relaxation of capital buffers in response to idiosyncratic stress events.

**Question 26. Given the intention for capital to be released during a recession, how would the release work in a scenario where the market moves from normal (not excessive loan growth, where presumably no CCyB buffer would apply) to recession?**

The procedures governing the release of capital during recessions and other periods of stress will be explained in a Standard of Sound Practice on the Capital Adequacy Framework. It is expected that FIs will extend a sufficient amount of loans during normal times to prompt the Bank to require that FIs hold positive amounts of a CCyB. The release of capital from the CCyB would therefore be initiated in the event that the market moves from normal times to recession.

Also, recall that licensees will be able to count retained earnings as regulatory capital without transferal into the retained earnings reserve fund, potentially replacing the retained earnings reserve amounts repurposed as capital buffers in the specified scenario.

## Resolution of Financial Institutions

**Question 27. Is TLAC an additional capital requirement?**

TLAC is an additional capital requirement. As illustrated in Box DC1-C of the CP, the proposed minimum TLAC requirement is a capital requirement additional to the proposed minimum capital adequacy ratio of 10%.

However, under the Bank's Capital Adequacy Framework, capital that counts towards satisfying the minimum capital adequacy ratio may also count as TLAC, subject to conditions to be detailed in the forthcoming consultation on the TLAC framework.

**Question 28. Is the TLAC requirement specific to domestic SIFIs?**

At present, the TLAC requirement is intended to be applicable for all financial institutions outlined under section IV of the CP. As such, TLAC will be applicable to DTIs on a solo basis and FHCs on a consolidated basis.

The forthcoming Special Resolution Regime will establish the Bank as Jamaica's resolution authority and outline the centrality of TLAC to the effective resolution of FIs under this regime. Though the concept of TLAC will be introduced in the SRR, key proposals on the operational aspects of the TLAC framework will be made in a separate consultation paper.

**Question 29. What is the timeline for implementing the Resolution Authority under the Special Resolution Regime? Will there be an opportunity for the industry to provide feedback?**

Bank of Jamaica notes that a Consultation Paper on the proposed Special Resolution Regime ("SRR") in Jamaica was disseminated to the industry in 2017.

Currently, draft legislation for the SRR, which will establish Bank of Jamaica as the Resolution Authority, is currently at a mature stage of review. The timeline target date will be provided for implementing the Resolution Authority upon completion of the review process, which is tentatively scheduled for 30 June, 2022. Nonetheless, the Bank intends to consult the industry on other important aspects of the framework, consistent with its practice of transparency.

**Question 30. Is the proposal to facilitate the effective bail-in of financial institutions asking financial institutions to issue convertible debt securities? Can the Jamaican financial market facilitate these types of securities?**

The Bank's proposal to facilitate the effective bail-in of financial institutions describes an approach that considers recalibrating gone concern capital to include debt instruments that may be converted into equity. Bank of Jamaica notes the current level of development in Jamaica's capital markets.

However, the proposal in Box DC2-A contemplates that several instruments may qualify as TLAC, including Common Equity, Additional Tier 1 Capital, subordinated debt, and some senior debt, which would allow financial institutions considerable flexibility in meeting the requirements.

Notwithstanding the above, the Bank notes recent progress made by a Bank of Jamaica-led Financial Deepening Implementation Group in facilitating improvements in Jamaica's capital market infrastructure

**Question 31. Why are creditors and shareholders being expected to absorb losses in the event of bank insolvency?**

Bank of Jamaica has carefully considered the experiences from the global financial crisis, featuring government bailouts that were ultimately funded by taxpayers.

The global financial crisis has shown that bailouts may encourage a moral hazard by increasing the likelihood of financial institutions engaging in riskier behaviour than normal under the assumption that the consequences of such behaviour will be deferred to taxpayers, regardless of their direct involvement in the financial institution.

# Credit Risk

## General Questions

**Question 32. What approach will be used to determine the capital charges for credit risk?**

The approach that will be used to determine the capital charges for credit risk is the standardized or 'external ratings based' approach captured under the Basel III framework.

**Question 33. Will the Supervisor issue standards of best practice on minimum expectations of due diligence as referenced in the Standard?**

Licensees are to be guided by the due diligence requirements described under paragraphs 133-134 of the CP. On this basis, licensees are mandated to perform due diligence to understand and assess the risk profile of their counterparties. In all instances, the sophistication of due diligence measures should be proportionate to the size and complexity of its activities.

## Classification of Entities Under The Credit Risk Framework

**Question 34. What is a non-central government public sector entity?**

Non-central government public sector entity (PSE) refers to all publicly controlled or publicly funded agencies, enterprises, and other entities operating in the domestic economy that deliver public programmes, goods or services. This includes: (i) Local Government; (ii) Selected Public Entities, and refers to public organizations that are a part of the government and deliver public programmes, goods or services, but that exist as separate organizations in their own right, possibly as legal entities and operate with a partial degree of operational independence; and (iii) Other Public Entities as designated by the Supervisor from time to time.

**Question 35. What is a multilateral development bank (MDB)?**

MDBs have large sovereign memberships and may include both developed countries and/or developing countries. Each MDB has its own independent legal and operational status, but with a similar mandate and a considerable number of joint owners.

**Question 36. What is the distinction between "corporate SMEs" and "Regulatory MSME"?**

Corporate SMEs are corporate exposures where the reported annual sales for the consolidated group to which the corporate counterparty belongs is less than or equal to JMD 425 million (or USD equivalent) for the financial year. Regulatory retail SMEs on the other hand are a type of corporate SME that satisfies the product, granularity, and low value of individual exposures criteria as described by the BCBS.

**Question 37. What is the definition of residential real estate?**

Residential real estate refers to property that is zoned for single-family homes, multi-family apartments, townhouses and condominiums. As per the Basel framework, it may include those under construction, provided they satisfy all applicable laws and regulations enabling the property to be occupied for housing purposes.

**Question 38. Is there a definition or criteria for what is 'not materially dependent'?**

It is the Bank's view that the term materiality is relative and should therefore be consistent with licensees' internal policies already developed on the subject. As guided by Basel, regulatory real estate exposures (both residential and commercial) are classified as exposures that are 'materially dependent', when the prospects for servicing the loan materially depends on the cash flows generated by the property securing the loan, rather than on the underlying capacity of the borrower to service the debt from other sources.

## Credit Assessment

**Question 39. Who are the eligible external credit assessment institutions?**

The credit risk framework will recognize the ratings of Standard & Poor's Ratings Services, Moody's Investors Service, Fitch Ratings and the Caribbean Information and Credit Rating Services Limited (CariCRIS) as eligible ECAIs for the purpose of allocating risk-weights to claims on counterparties and exposures.

**Question 40. Are there any circumstances under which licensees are allowed to apply their own internal risk ratings as the basis of credit risk measurement?**

Under the standardized approach, licensees are not allowed to use their own internal ratings for credit risk exposures. Therefore, if there are no assigned ECAI ratings, the exposures are to be treated as unrated. Exposures treated as unrated will attract the attendant risk weights assigned to them from the corresponding risk weight categories.

**Question 41. Does the licensee have the freedom to designate all external credit assessment institutions that are recognized by the licensee or only a subset?**

Licensees may designate one, or up to all four recognizable ECAIs as declared eligible by the Supervisor. Licensees are reminded that these designations come at a cost. As a reminder, licensees are to be consistent in their usage of ECAIs and avoid cherry picking to obtain positions that are more favourable at a particular point in time.

**Question 42. In a scenario where the chosen external credit assessment institution does not have a current rating for all exposure with the category, can licensees use another ECAI's rating?**

A licensee should treat all relevant exposures as 'unrated' for risk weighting purposes if those exposures do not have ratings assigned to them by the chosen ECAI(s).

**Question 43. Please clarify and explain what is deemed as "Finished Property"**

As per the Basel Capital framework and the CP, to apply the risk weights, the exposure must be fully secured by either:

1. Finished property, which means a fully completed immovable property; or
2. Residential property under construction or land upon which residential property would be constructed, provided that:
   - (i) The property is a one-to-four family residential housing unit (unit(s) that can house up to four families maximum) that will be the primary residence of the borrower and the lending to the individual is not, in effect, indirectly financing land acquisition, development and construction exposures; or
   - (ii) Sovereign or PSEs involved have the legal powers and ability to ensure that the property under construction will be finished.

**Question 44. Can allowances be made for second mortgages where it is demonstrated that there is adequate value/equity for the second mortgagee?**

The Basel framework allows national discretion in this regard. Therefore, where junior liens provide a holder with a claim for collateral that is legally enforceable and constitutes to an effective credit risk mitigant, junior liens held by a different FI than the one holding the senior lien may also be recognized. This would apply to junior liens held by the same FI that holds the senior lien in case there is an intermediate lien from another FI (i.e. the senior and junior liens held by the FI are not in sequential ranking order.)

In order to meet the above requirements:

- (i) each bank holding a lien on a property can initiate the sale of the property independently from other entities holding a lien on the property; and
- (ii) where the sale of the property is not carried out by means of a public auction, entities holding a senior lien take reasonable steps to obtain a fair market value or the best price that may be obtained in the circumstances

when exercising any power of sale on their own. That is, it is not possible for the entity holding the senior lien to sell the property on its own at a discounted value in detriment of the junior lien.

## Determining Risk Weights

**Question 45. Where there is inadequate rating, the proposed risk weight is up to 150%. Why is a risk weight above 100% being applied?**

In keeping with the Basel standards, the approach for a 150% risk weight for certain claims is based on the credit quality steps (CQS) that indicates either substantial credit risk, likely impairment or impairment. As such, some entities, depending on their classification, may attract a risk weight of up to 150%.

**Question 46. Will financial institutions be allowed to apply a preferential rating to foreign sovereigns and their central banks in the domestic currency of that sovereign?**

Guided by Basel, under the standardized approach, no preferential treatments are accorded to sovereigns and central banks' exposures irrespective of the exposure's currency type. That is, this treatment is no longer allowed under the Basel framework.

**Question 47. Can additional guidance be provided on assigning "base" risk weights to ensure uniformity in the industry?**

The base risk weights are as prescribed by international standards. These buckets (bases) are the floor for each credit quality step. The assignment of a particular risk weight will depend on the due diligence performed by each entity. If the due diligence analysis reflects higher risk characteristics than that implied by the external rating bucket of the exposure, licensees must assign a risk weight at least one bucket higher than the 'base' risk weight determined by the external rating. Licensees' due diligence analysis must never result in the application of a lower risk weight than that determined by the external rating.

**Question 48. What risk weight should be applied in cases where licensees do not have current property valuations available to calculate the LTV on these mortgages?**

The Basel framework guides the Bank's implementation plan. Following on this principle, the Bank will require that licensees apply the Basel prescribed risk weights in this scenario. Accordingly, current property valuations should be sourced where they can. In the event that they cannot be sourced, they will be treated as follows (i) where repayment is not materially dependent on cash flows generated by property: where LTVs are unavailable, the applicable risk weight will be that of the counterparty and (ii) where repayment is materially dependent on cash flows generated by property: where the LTVs are unavailable, the applicable risk weight is 150%.

**Question 49. Kindly clarify the rationale for using a dollar value threshold (for low value of individual exposures) as opposed to a threshold based on the DTI's risk profile**

As per the Basel III guidelines, Bank of Jamaica does not have national discretion to use percentages or a threshold based on the DTI's risk profile. Licensees will therefore be required to comply with the proposed dollar value.

# Market Risk

## General Questions

**Question 50. What is the scope of application for capital charges for market risk under the proposed framework?**

The capital charges for market risk will apply to any risk relating to any interest rate related instruments and equities in the trading book, in addition to any foreign exchange risk, and commodities risk, whether arising from positions in the trading book or otherwise.

**Question 51. How will trading books be treated under the market risk framework?**

The capital requirements for trading book activities under the proposed Capital Adequacy Framework are intended to be applied on a consolidated basis. Therefore, only financial holding companies licensed under the Banking Services Act will be required to calculate and report relevant market risk capital charges that are applicable to a financial group's positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book.

**Question 52. How will market risk requirements specific to the trading book be treated?**

Market risk requirements specific to the trading book will not be applicable to DTIs, as DTIs are prohibited from engaging in trading book activities as per section 54 of the BSA, which states that DTIs shall not manage or invest funds on behalf of its customers unless the investment is carried out under a trust operated within the parameters specified by the Supervisor; or engage in proprietary trading in securities of its own account.

## Other Questions

**Question 53. Under the market risk framework, do FIs need supervisory approval to reclassify an unlisted equity as "listed"?**

An unlisted equity that is subsequently listed will be covered by the presumptive list of trading book instruments included in paragraph 377. Therefore, no explicit supervisory approval is required for a licensee to reclassify an unlisted equity that is subsequently listed to its trading book.

**Question 54. The risk factor for equity implies a 350% risk weight. This places an unfair burden on domestic banks and FHCs that invest in equity. Can this approach be reconsidered?**

The Bank has re-evaluated the proposed scaling factor requirements to reflect the nuances in the local equity market, which all things considered, should not compromise the conservativism inherent in the framework. In accordance with the Basel Committee's requirements, financial institutions must calculate their equity risk exposures for each national market in which the institution holds equity. Against that backdrop, it is proposed that equity exposures in the local equity market must assign a scaling factor of 2 or 200%, whilst the scaling factor for equity exposures in other national markets will be maintained at 3.5 or 350% in line with the Basel Committee's Standard.

**Question 55. Should assets at fair value categorised under other comprehensive income "OCI" be included in the market risk capital requirement for interest rate risk given that their fair value is affected by interest rates?**

As per paragraph 397 of the CP, assets at fair value through OCI are included under market risk capital requirements as movements in the interest rate affect the value of these assets.

**Question 56. Should the charge for financial assets that are classified and measured at fair value through other comprehensive income be based on the guidelines for credit risk or market risk?**

Financial assets that are classified and measured at fair value through other comprehensive income are those assets that are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. Since these assets are not primarily held for any of the purposes listed under paragraph 374 or 375, they must be classified as a banking book asset and the required capital requirement under the credit risk framework would apply. On the other hand, instruments that meet the trading book requirements must be treated in accordance with the market risk framework.

**Question 57. Clarity is required as to the reason behind the increase in the specific market risk charge for GOJ foreign currency instruments**

The decision to not apply a discretionary zero percent rate to GOJ foreign currency securities is based on the concept that securities denominated in a foreign currency are inherently riskier than instruments that are denominated in the domestic currency because of the added foreign exchange risk. Additionally, pursuant to the Banking Services (Deposit Taking Institutions) (Capital Adequacy) Regulations, 2015, as well as the proposed credit risk framework, GOJ exposures denominated in foreign currencies are risk weighted at 100%, which is the treatment accorded under this framework.

**Question 58. Will licensees be required to assign a specific risk weighting factor to GOJ Global Bonds and locally issued GOJ USD bonds?**

GOJ Global Bonds and locally issued GOJ USD bonds would fall under paragraph 406 of the CP. Accordingly, a specific risk factor would be assigned based on the external credit rating of Jamaica and/ or the residual time to maturity of the security. As such, licensees will only be required to apply a 0% specific risk-weighting factor to GOJ exposures which are fully guaranteed by the GOJ and denominated and funded in the local currency (i.e., JMD), as well as BOJ exposures that are denominated and funded in the local currency. In that regard, GOJ exposures that are denominated in foreign currencies will not be subjected to the 0% specific risk-weighting factor. Instead, such exposures will be based on the external credit rating risk-weighting factor as depicted in table MR-1 of the CP.

**Question 59. What approach should be taken in the application of a rating if there is a large disparity in the ratings received from separate external credit assessment institutions (ECAIs)?**

The Bank recommends that licensees use the approach detailed in "Part V" of the CP to resolve issues of discrepancies between different external rating agencies. In this regard, licensees will map eligible ECAIs' ratings to the credit quality steps (CQS) under the standardized approach to credit risk. A CQS is a simplified and standardized scale of credit quality, which is represented by whole numbers from 1 to 6 for rated exposures, and 7 for unrated exposures. The approach will provide consistency across ECAI ratings.

**Question 60. The risk weighting factors for Sovereign Debt Capital Charges could be onerous depending on a DTI's portfolio mix. Are these rates cast in stone?**

The treatment of a sovereign asset under the simplified standardized approach to specific risk is based on its rating and the residual maturity of the instrument. The capital requirement 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, in this case a sovereign. The capital charge for GOJ foreign currency exposures rated BB+ to B- are in line with the Banking Services (Deposit Taking Institutions) (Capital Adequacy) Regulations, 2015, in which such exposures are risk weighted at 100% with a minimum capital requirement of 10%. On the other hand, such exposures that are rated below B- are in line with the proposed credit risk framework in which such exposures are risk weighted at 150% with the minimum capital requirement of 10%.

**Question 61. Is the IDB included in categories of 0% risk weighted multilaterals thereby being exempted from the specific risk weight outlined in the table?**

The Inter-American Development Bank (IADB) is one of the multilateral development banks that are included in the qualifying category and would be assigned a specific risk charge of 0% outlined in Table MR 2 of the CP.

**Question 62. How should long and short positions be treated in the derivation of capital charges for general market risk?**

One of the preliminary steps that must be performed when calculating the general market risk capital requirement is to multiply the summed long and summed short positions in each time band by risk weights to generate the weighted positions. These risk weights are designed to reflect the price sensitivity of those positions to assumed changes in interest rates. The risk-weighted long and risk weighted short positions in each maturity band therefore forms the basis of calculating the general market risk capital charge.

**Question 63. Is there an illustrative example of the disallowance calculations for interest rate risk in the trading book?**

***Vertical disallowances – Illustrative example***

The offsetting of long and short risk-weighted positions within any particular time band results in a net open position, considering the fact that a given time band may include short and long positions whose maturities are not the same. A 10% vertical disallowance capital charge will be applied to the smaller of either the short or long positions within each time band.

To illustrate, consider a financial institution which held the following positions in the 3 to 6 month maturity band on 1 April 2021. Notably, the risk-weighted positions of financial securities within the 3 to 6 month maturity band are calculated as 0.4% of the security's market value. This represents the product of the duration weight of 0.4 and the assumed change in the security's yield of 100 basis points.

| Name of Security | Coupon % | Maturity | Market Value $bn<br>A | Risk Weight %<br>B | Risk Weighted Position $bn<br>A * B |
|---|---|---|---|---|---|
| GOJ Treasury Bill | 9 | 16 July 2021 | -400 | 0.4 | -1.6 |
| Bank T Bill | 16 | 16 July 2021 | 600 | 0.4 | 2.4 |
| GOJ Treasury Bill | 10 | 16 October 2021 | 700 | 0.4 | 2.8 |

*Negative represents short position or liability

| Long (Asset) $ | Short (Liability) $ |
|---|---|
| 1.6 | 1.6 |
| (5.2-1.6) = 3.6 | Net Open Positions |

Based on the above scenario, the sum of the weighted long positions within the 3 to 6 month time band is $5.2 billion and the sum of the weighted shorts is $1.6 billion. The net open position is therefore a long position of $3.6 billion. The net open position will be used in the calculation of the horizontal disallowances, which cover yield curve risk. The amount which has been offset attracts a capital charge of 10%. In that regard, $1.6 billion of long and short positions have been offset against each other. Ordinarily, the capital charge against general market risk would be $3.6 billion. However, based on the Bank's capital adequacy ratio requirement of 10%, the capital charge against general market risk for vertical disallowances in this scenario is $4.5 billion (i.e., $3.6 billion *(10/8).

Importantly, if a licensee does not have both long and short positions in the same maturity band, there is no need for the computation of vertical disallowance.

***Horizontal disallowances – Illustrative example***

In order to cover yield curve risk, the 13 maturity bands are aggregated into three maturity zones (namely zone 1, 2, and 3) and then horizontal disallowances are applied to cover short and long positions in different maturity bands and zones. The concept of capital charges based on offsetting positions in different maturity bands is similar to vertical disallowances for offsetting positions within the same maturity bands. In the event that a financial institution has a net short position in the third maturity band of Table MR 5 of the CP (i.e., 3 to 6 months) and a net long risk-weighted position in the first maturity band (i.e., 0 to 1 month), the two positions may not be offset without taking into consideration the lack of price correlation between positions in the two maturity bands as the differences in maturity are greater between maturity bands than within maturity bands. Therefore, the disallowance factors applied are correspondingly higher.

| Name | Maturity Band | Market Value $bn A | Risk Weight % B | Risk Weighted Position $bn A*B | Net position in zone $bn |
|---|---|---|---|---|---|
| Zone 1 | 0 - 1 month | -400 | 0.0 | 0 | 3.5 |
| | 1 - 3 months | 500 | 0.2 | 1.0 | |
| | 3 - 6 months | -600 | 0.4 | -2.4 | |
| | 6 - 12 months | 700 | 0.7 | 4.9 | |
| Zone 2 | 1 - 2 years | 800 | 1.25 | 10 | 16.75 |
| | 2 - 3 years | -900 | 1.75 | -15.75 | |
| | 3 - 4 years | 1000 | 2.25 | 22.5 | |
| Zone 3 | 4 - 5 years | 1100 | 2.75 | 30.25 | -40.25 |
| | 5 - 7 years | -1200 | 3.25 | -39.0 | |
| | 7 - 10 years | 1300 | 3.75 | 48.75 | |
| | 10 - 15 years | -1400 | 4.50 | -63.0 | |
| | 15 - 20 years | 1500 | 5.25 | 78.75 | |
| | over 20 years | -1600 | 6.00 | -96 | |
| **Total** | | | | | **Abs(-20) (a)** |

**Within maturity zones capital charge:**

| | | |
|---|---|---|
| Zone 1 | Abs(-2.4*0.4) | 0.96 |
| Zone 2 | Abs(-15.75*0.3) | 4.73 |
| Zone 3 | Abs(157.75*0.3) | 47.33 |
| **Total** | | **Abs(53.02) (b)** |

**Capital charge between maturity zones**

| | | |
|---|---|---|
| Zone 1 & 2 | Abs(0.4*0) | 0 |
| Zone 1 & 3 | Abs(1*3.5) | 3.5 |
| Zone 2 & 3 | Abs(0.4*16.75) | 6.7 |
| **Total** | | **Abs(10.2) (c)** |

*An off-setting position will be either the lower of the sum of long positions and or the short positions within a zone. With respect to between zones, there must be a net short and net long position for horizontal disallowances, for which a licensee must select the lower of the netted positions.

Importantly, if a licensee does not have both long and short positions in different time zones, there is no need for the computation of horizontal disallowance.

Ordinarily, the capital charge against general market risk would be $83.22 billion ($20 billion + $53.02 billion + $10.2 billion). However, based on the Bank's capital adequacy ratio requirement of 10%, the capital charge against general market risk for vertical disallowances in this scenario is $104.03 billion (i.e., $83.22 billion *(10/8).

**Question 64. For specific risk related to derivatives, does the specific risk relate only to the underlying instrument, and would the risk of the counterparty, in the case of forwards and other OTC derivatives, be captured by the applicable credit risk capital charge?**

All derivatives would attract the applicable specific and general market risk charges as outlined in sections MR4- A3 and MR4. F and paragraphs 458 to 461 of the Consultation Paper. The derivatives should be converted into positions in the relevant underlying instrument and become subject to specific and general market risk charges. For the avoidance of doubt, separate counterparty risk charges will be applicable to relevant derivatives.

**Question 65. Based on the proposed framework, capital requirements will be 10% of the overall net open position. BOJ now allows DTIs to hold 25% of regulatory capital in a short position and 15% of regulatory capital in a long position. Will this be changed to 10%?**

The net open position limit to regulatory capital will be varied from time to time by Bank of Jamaica. However, on a separate but related matter, on a micro-prudential level, the foreign exchange risk charge for net open positions will remain at 10% on all foreign currency exposures.

**Question 66. The imposition of a specific market risk charge for equities, in addition to the applicable scaling factor has resulted in onerous requirements for long only equity positions. Will this be adjusted?**

Specific risk is defined as the financial institution's gross equity positions, which is the sum of all the long and short equity positions. A financial institution must sum the market value of its net open positions for each national market in which the financial institution holds equities. Notably, the summation of the positions does not depend on whether the positions are long or short; the result of the summation produces the overall gross position for the respective markets. In congruence with international standards, the capital charge for specific risk needs to reflect the diversification of financial institutions' portfolio and the extent to which financial institutions' portfolio comprises of liquid and marketable equities. Owing to such, the Bank is of the view that an appropriate capital charge in the absence of a diversified portfolio, as well as liquid and marketable equities, is 10%.

**Question 67. Is it accurate to say that the imposition of a specific and general market risk charge for equities, in addition to the applicable scaling factor, appears to result in an effective capital requirement of 70% for long only equity positions?**

General market risk is defined as the difference between the sum of a financial institution's long positions and the sum of its short positions, which is the financial institution's overall net position in each national equity market. The capital charge of 10% for general market risk has been ascribed in consideration of the price volatility of the main equity indices at both the local and international level. The effective capital charge for long and short, as well as netted equity positions, is 70%. Notwithstanding this effective capital charge for equity exposures, the proposed simplified standards provide specified scalars to ensure a sufficiently conservative methodology for computing the capital charge for market risk for relatively small or non-complex trading book portfolios.

# Operational Risk

## General Questions

**Question 68. What is the chosen approach that will be used to determine the capital charges for operational risk?**

Bank of Jamaica has adopted the Basel III framework recommended by the Basel Committee on Banking Supervision (BCBS) for calculating operational risk capital charges ("ORC"). As such, all licensees are required to use the Standardized Approach for determining ORC as outlined under section OR1-B of the consultation paper.

**Question 69. Will there be a standardized list of operational risk events?**

In line with international standards, there will be an Operational Risk Taxonomy. The Taxonomy will categorize and classify all operational loss events that must be included in the loss data set.

**Question 70. What is the threshold for the recognition of operational losses?**

The threshold for the recognition of operational losses is JMD $ 1,000,000.00. Of note, there are no threshold requirements for low frequency, high impact operational loss events such as internal fraud, forgeries, and robberies.

**Question 71. How should high frequency, low impact operational loss events be treated?**

Instead of using each individual high frequency, low impact operational loss event, FIs will be required to aggregate these events before incorporating them into operational loss calculations. The Bank has recently issued a revised reporting form for banking fraud which FIs will be able to report certain operational losses from banking fraud.

**Question 72. When can a deposit taking institution incorporate internal loss data into its capital charges for operational risk?**

A deposit taking institution will be able to incorporate internal loss data for its operational risk charges when it has at least three (3) consecutive financial years of good-quality loss data. This will be subject to the Bank's approval as the initial requirement set out under the Basel III framework is for at least ten (10) consecutive financial years of good-quality loss data. If a deposit taking institution does not have internal loss data for at least the past three (3) consecutive financial years, the deposit taking institution must exclude its operational loss data in the calculation of its operational risk charges (ORC).

**Question 73. Can the ILM requirement reduce the overall capital charge for operational risk?**

The ILM serves as a scaling factor that adjusts the business indicator component (BIC) depending on the operational loss experience of a licensee. Given such, if an FI reduces its operational losses, its capital charges will also fall due to the operational setup of the ILM.

**Question 74. Will there be a transitional period for the implementation of the operational risk framework, to assist licensees who do not meet operational risk reporting requirements?**

Bank of Jamaica ("the Bank") acknowledges that financial institutions may be at differing states of readiness for implementing the proposed requirement for capital charges related to operational risk. As such, licensees will be given a 12-month transitional period beginning on 1 July 2022 or any other effective date for the beginning of the transitional period for the Capital Adequacy Framework.

**Question 75. Who will the capital charges for operational risk apply to?**

The capital charges for operational risk will apply to DTIs on a standalone basis, and FHCs that include at least one deposit taking institution, on a consolidated basis.

## The Business Indicator Component

**Question 76. How is the business indicator component (BIC) calculated?**

To calculate the BIC, the business indicator value will have to be derived and then multiplied by the applicable marginal coefficient ($\alpha_i$). The marginal coefficients increase with the size of the BI and are either 12%, 15%, or 18% depending on the particular BI range under which a licensee is categorised.

**Question 77. Will the BI be recalibrated from that which exists under the Basel framework?**

The BI ranges will be recalibrated in order to increase the framework's risk sensitivity. The proposed Basel treatment would require all financial institutions to be placed in bucket 1 if adopted as is for the Jamaican context. This would be disadvantageous for financial institutions with minimal losses.

## The Internal Loss Multiplier

**Question 78. What is the Internal Loss Multiplier (ILM)**

The ILM serves as a scaling factor that adjusts the BIC depending on the operational loss experience of a licensee. It gives a value larger than 1 when the Loss Component is larger than the BIC, and vice versa.

**Question 79. Will operational loss events at the group or consolidated level have an affect the internal loss multiplier (ILM) at the solo or deposit taking institution (DTI) level?**

Regardless of the degree of materiality, loss events at the consolidated level will not impact the calculation of operational risk charges at the solo level. Owing to such, DTIs operating in a financial group will not be subjected to the ILM of the wider financial group.

**Question 80. Who will be impacted by ILM add-ons?**

Financial institutions that do not have at least three consecutive financial years of good-quality loss data must apply an additional ILM add-on to calculate their operational risk capital requirements.

**Question 81. What happens after three years if an institution does not have three consecutive financial years of good-quality data?**

If a financial institution does not have three consecutive financial years of good-quality data after 3 years, the ILM add-on will increase gradually until the data requirement is met. Upon satisfying the data requirement, the ILM add-on(s) will be removed, and the financial institution will thereafter be allowed to use its internal loss in the calculation of its capital charge for operational risk.

## Operational Loss Data

**Question 82. At what point should operational losses of a merger or acquisition be included in the loss data set?**

In the event of a merger or acquisition, the associated losses and BI items resulting from the FI's new scope of operation must be immediately incorporated into the calculation for operational risk capital charges. Losses and BI items from merged entities or acquired businesses should be included in the calculation of the ORC immediately after the merger/acquisition and should be reported in the first update of the licensee's total risk-weighted assets that comes after the merger/acquisition.

**Question 83. Should operational loss events stemming from outsourced activities be included in the operational loss calculations?**

The financial impacts of operational loss events that are incurred by the outsourcer, rather than by the financial institution, should not be recognised as operational losses, and should not be included in the loss dataset. However, the financial effects of outsourcing related events that the FI is responsible for should be treated as operational losses, and hence be included in the loss dataset.

**Question 84. How long can an operational loss event be considered as pending loss?**

The timeline for pending losses should depend on the level of materiality of the loss event, the internal policies of the financial institution, and the applicable accounting standards that apply to the operational loss event. However, if the accounting standard provides for the recognition of such losses, the financial institution must be guided by the accounting standard and not its internal policies.

**Question 85. How should operational losses denominated in foreign currencies be treated?**

An FI must convert its operational losses denominated in a foreign currency into Jamaican dollars using the same exchange rate that the FI used to convert these losses in the FI's financial statements as at the period the loss impacts were accounted for by the FI.

**Question 86. Do you include the net loss or gross loss in the operational loss events data set?**

For the purposes of calculating the Loss Component (LC), an FI must calculate the net loss of an operational loss event by summing the gross losses of all operational loss events that coincide with the applicable calculation window of the past three or ten consecutive financial years depending on the availability of high quality loss data net of all recoveries, including insurance recoveries for the same calculation window. To avoid doubt, an FI must use the date of accounting of the gross losses and recoveries to determine whether they are inside the calculation window of the past three or ten consecutive financial years, whichever is applicable. Recoveries can be used to reduce losses only after the FI receives payment. Therefore, verification of payments received to reduce losses must be provided to the Central Bank upon request.

**Question 87. Can a financial institution exclude loss events from the data set at their own convenience?**

FIs may exclude operational loss events that are no longer relevant to their risk profile from their internal loss dataset with immediate effect after obtaining the written approval of the Bank.