The Appropriate Levels of Single and Group Counterparty Exposure Limits

Consultation Paper

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Bank of Jamaica
Nethersole Place
Kingston, Jamaica
Telephone 876-922-0750-9; Fax 876-922-2519
or email: fisdfeedback@boj.org.jm

Responding to this Paper

This document is being circulated to financial institutions and other relevant stakeholders to facilitate industry consultation and feedback. Comments are invited on the proposal for the Counterparty Exposures Framework. Comments are most helpful if they:

- indicate the clause and specific point to which a comment relates;
- contain a clear rationale for an amendment or state a specific area of concern;
- provide evidence to support the views expressed; and
- propose alternative regulatory approaches to be considered by BOJ and FSC.

Submission of Responses

Comments on the proposals will be received up to the close of business on November 30, 2017 via

- Email: fisdfeedback@boj.org.jm
  Attention: Jide Lewis (Mr) Ph.D., CFA, FRM

  Or

- Postal Mail:
  Attention: Jide Lewis (Mr) Ph.D., CFA, FRM
  Position: Division Chief, Financial Institutions Supervisory Division
  Institution: Bank of Jamaica
  Mailing Address: Nethersole Place
  Kingston, Jamaica

- Email: Lewis-Jonesa@fscjamaica.org
  Attention: Andrea Lewis-Jones (Mrs)

  Postal Mail:
  Attention: Mrs Andrea Lewis-Jones
  Position: Manager, Securities
  Institution: Financial Services Commission
  Mailing Address: 39-42 Barbados Avenue
  Kingston 5, Jamaica

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ABBREVIATIONS

BCBS	**Basel Committee on Banking Supervision**
BOJ	**Bank of Jamaica**
BOJA	**Bank of Jamaica Act, Amended 2015**
BSA	**Banking Services Act, 2014**
CEF	**Counterparty Exposure Framework**
DTI	**Deposit-taking institution (commercial banks, merchant banks, building societies and credit unions)**
FHC	**Financial Holding Company**
FI	**Financial Institution (securities dealers and insurance companies)**
FINSAC	**Financial Sector Adjustment Company Limited**
FSC	**Financial Services Commission**
FSCA	**Financial Services Commission Act, Amended 2004**
GDP	**Gross Domestic Product**
GOJ	**Government of Jamaica**
IA	**Insurance Act, 2001**
IAIS	**International Association of Insurance Supervisors**
IC	**Insurance Company**
IOSCO	**International Organization of Securities Commission**
SD	**Securities Dealer**

GLOSSARY

Capital base (BOJ)	In relation to a licensee means Tier 1 capital.
Capital base (FSC – SDs & Life ICs)	Means the aggregate of Tier 1 and Tier 2 capital minus prescribed deductions.
Capital base (FSC – General ICs)	Means balance sheet capital less prescribed deductions.
Connected counterparties	A group of counterparties with specific control relationships or financial or economic interdependencies such that, were one of the counterparties to fail, all of the counterparties would very likely fail.
Counterparty	Means any party with whom a regulated financial institution has a contractual agreement and includes investors, borrowers, secured creditors, issuers of securities and collective investment schemes.
Counterparty exposure	In relation to regulated financial institutions, includes any transaction or arrangement that creates an exposure to a counterparty or a group of connected counterparties.
Counterparty limit	The regulatory prescribed limit for the sum of all exposure values of a financial institution to a counterparty or to a group of connected counterparties, as a percentage of the financial institutions' eligible capital base.
Counterparty risk	The risk that either counterparty to a contract will default on its contractual obligation.
Large exposure	The sum of all exposure values of a financial institution to a counterparty or to a group of connected counterparties, equal to or above 10% of the financial institution's eligible capital base.
Large exposure framework	The regulatory framework which establishes counterparty limits.
Risk concentrations	The collective amounts invested in a corporate instrument or loaned to a counterparty that is either the same issuer of the corporate instrument or is connected to the issuer of the corporate instrument.

EXECUTIVE SUMMARY

Common to the Jamaican financial crisis of the mid-1990s and the 2008 global financial meltdown was the existence of large counterparty exposures amongst key financial institutions which, at the demise of one or a few financial entities and non-financial corporations, resulted in contagion-induced financial sector fallout. This reinforced the need for national authorities to bolster, on an ongoing basis, the legal and operational frameworks governing the preservation of financial system stability.

Though domestic regulators have long had established prudential thresholds for counterparty exposure limits for institutions on a solo and consolidated basis, internationally, the threshold is now being extended to financial holding companies. Consequently, in light of prudential and financial stability concerns, regulators are proposing revisions to their prudential requirements for FIs to reflect the internationally agreed framework for the measurement of large exposures. These revisions seek to address important gaps that pre-dispose the financial system to contagion risk, and to allow for the pursuit of timely, efficient and effective mitigation strategies that will avert or limit the possibility of an FI's failure that could extend to the financial group, due to unsustainably large counterparty exposures.

In Jamaica, the existing legal framework governing counterparty credit limits for regulated FIs is contained in three pieces of legislation: the BSA, 2014 for FHCs (Part XII); the Insurance Regulations, 2001 for ICs (Regulation 42); and the Securities (Prudential) Regulations, 2014 for the SD sub-sector (Regulation 14(2)(b)). Currently, existing counterparty regulations indicate that FHCs are subject to aggregate limits of 20% and 40% of capital base for individual and a group of counterparties, respectively. For non-DTIs, the insurance sector is subject to a limit of 5% in terms of the ratio of a single counterparty exposure to total assets, while no limit is in place for securities dealers (although the legislation gives the regulator the power to cap overall leverage that can be employed by SDs).

It is within this context that this consultation paper seeks to review the existing legislation and its application to ascertain whether these are: (i) appropriate to both the scope of activities and level of complexity of FIs; and (ii) broadly consistent with international standards. Further, although the provisions for the counterparty exposure limits will remain in the relevant sector legislation, harmonization of the standard to all FIs, to the extent possible, will reduce the opportunity for regulatory arbitrage.

The need for banks to measure and limit the size of large counterparty exposures in relation to their capital was first recognized by the BCBS's Best Practice Guidance in 1991, followed by the Core Principles for Effective Banking Supervision in 2012 (Core Principle 19), which require local laws and bank regulations to set prudent limits on large exposures to a single borrower or a group of connected borrowers. The IAIS also provides guidance on the limiting of large counterparty exposures, with its own Insurance Core Principles for insurers, with elements spread across Principles 13, 15 and 17. However, IOSCO, standard setters for securities dealers, does not provide specific guidance on the treatment of large exposures.

In 2014, BCBS issued Standards for the Supervisory Framework for Measuring and Controlling Large Exposures. These Standards redefined the large exposure principles to complement risk-based capital requirements, and operate to measure and limit large exposures in relation to an FI's capital. The key aspects of that large exposure framework are:

- a limit of 25% of Tier 1 capital for an FI's large exposures to a counterparty or a group of connected counterparties, with national discretion to impose smaller limits for certain types of exposures;
- criteria for identifying a group of connected counterparties; and

- clear and consistent measurement of large exposure values, including specific treatments to be applied for credit risk mitigation, trading book positions, covered bonds, structured vehicles, non-qualifying central counterparties and clearing activities.

Currently, with the local financial system in Jamaica being highly conglomerated, and the crowding in of the private sector arising from the significant reduction in Government of Jamaica debt issues in the domestic market, coupled with the thrust of local financial institutions to preserve revenue, financial institutions have been increasingly diversifying their lending and investment portfolios across sectors, borders, asset classes and currencies. This development however, could over time, conceivably lead to a net build up in concentrations in single counterparties or groups of connected counterparties.

Accordingly, and given the considerations for what would be best suited for the Jamaican context at this time, the proposed CEF will initially be applicable to FHCs[1] and securities dealers, as well as any associated entities providing critical support services to these FIs. Notably, in relation to the insurance sub-sector, although those provisions prescribe an exposure limit of total adjusted assets for individual counterparties, which is similar in intent to the CEF, there currently exists no provision for group counterparty exposure limits. In this regard, the regulators welcome submissions on (i) the appropriate measure for group counterparty exposure limits for ICs and (ii) a suitable metric to evaluate counterparty exposure limits for ICs that would satisfactorily meet the objectives of the CEF.

Against the background of global practice, in extending the large exposures framework to FHCs, this paper examines the CEF's implications for consolidated supervision, and, further extends the qualifying list of exemptions to the framework.

It is proposed that prescribed counterparty exposure limits be 25% of a regulated, in-scope financial institution's eligible capital base at all times. Further, a temporary increase in this limit may be approved by the relevant regulator however this waiver should not exceed 50% of the financial institution's total capital.

It is further recommended that counterparty exposure limits be applicable to all exposures except for the following specified counterparty exposures:

i. Exposures considered as prescribed deductions by regulation 2 of the Banking Services (Capital Adequacy) Regulations, 2015 and regulation 2 of the Securities (Prudential) Regulations, 2014;
ii. Exposures fully secured by cash;
iii. Intragroup exposures (FHCs);
iv. Exposures secured by a full and unconditional guarantee, or securities issued by:
    a. the Government of Jamaica or the Bank of Jamaica;
    b. governments and government agencies of CARICOM countries, exempted, in writing, by the relevant regulator;
    c. governments and government agencies of the United States of America, Canada and the United Kingdom;
    d. governments and government agencies of other G-10 countries (i.e., Belgium, France, Germany, Italy, Japan, the Netherlands, Sweden and Switzerland), exempted, in writing, by the relevant regulator;
    e. governments and government agencies of other sovereign countries that are rated as investment grade by an internationally recognized credit rating agency, approved by the Supervisory Committee of the Bank of Jamaica, and the guarantee is explicit, unconditional, legally

[1] At a later date, after further discussions with the DTI sub-sector, the CEF will be extended to commercial banks, merchant banks, building societies, cooperative societies that operate as credit unions (to be licensed under the Bank of Jamaica (Credit Union) Regulations).

enforceable and irrevocable over the life of the credit exposure in question, and has been exempted in writing by the relevant regulator;

v. Exposures arising from intra-day liquidity support facilities;
vi. Exposures that have been written off or specifically provided for; and
vii. Exposures arising from reverse repurchase arrangements where the underlying securities are issued by the Government of Jamaica or the Bank of Jamaica for which there is an agreement that the seller will repurchase these securities at the end of the stated period and for which the licensed entity has obtained physical control of said securities.

The transition period for implementation of the CEF will be subject to any cross-sectoral gaps or perceived unintended consequences being addressed *a priori* to ensure consistency and coherence in the imposition of counterparty exposure limits for the local financial sector.

I. INTRODUCTION

1. The fundamental aim of the CEF is to act as a backstop measure, to prevent licensees from incurring disproportionately large losses as a result of the default of an individual counterparty or group of connected counterparties, due to the occurrence of unforeseen events, so as to ensure that licensees manage concentration and contagion risks. In this regard, the CEF complements other regulatory capital and risk management requirements within the prudential and risk-based frameworks of BOJ and the FSC.

2. The CEF is also anticipated to ensure that risk concentrations arising from large exposures to individual counterparties or groups of connected counterparties are kept within acceptable levels, as part of the overarching principles of prudential supervision, which are to ensure safety and soundness of licensees, continued financial stability, maintenance of confidence in FIs and protection of consumers and depositors. The magnitude of these risks is significantly influenced by the existence of correlated risk factors which in times of stress can adversely affect the creditworthiness of each counterparty or group of counterparties that comprise the concentration.

3. In a setting where Jamaica's financial system has become increasingly conglomerated and more complex, there is growing concern that large exposures within the system are also increasing in volume, opaqueness and complexity.

4. BOJ, regulators of FHCs, and FSC, the regulator for non-DTIs, are consequently proposing revisions to their prudential requirements for the aforementioned entities to reflect the internationally agreed framework for the measurement of large exposures, address important gaps that pre-dispose the financial system to contagion risk, and to allow for the pursuit of timely, efficient and effective mitigation strategies that will avert the possibility of an FI's failure due to unsustainably large counterparty exposures.

5. This paper details the implications for consolidated supervision, and, further extends the qualifying list of exemptions to the framework.

6. With the BSA construct already in place, the CEF would sit neatly within the BOJ's supervisory framework, given BOJ's oversight of FHCs. This CEF being implemented for both regulatory regimes is necessary to ensure effective and coherent management by the two regulators, in the context of their respective capital adequacy frameworks and to mitigate regulatory arbitrage.

7. Further, in the context of Jamaica's experience and environment, it is proposed that a CEF, based on international standards, be initially applicable to FHCs and securities dealers, as well as any associated entities providing critical support services to these FIs. The CEF will be implemented in a manner that is proportionate to the structure, interconnectedness and complexity of the Jamaican financial system in order to enhance the counterparty credit risk framework within FIs, and thereby bolster the resilience of the financial group and therefore the financial system to contagion risk. In relation to the proposals for ICs, the authorities are open to submissions setting out in detail suitable alternatives that satisfy the objectives of the CEF, having regard for the need for convergence in the requirements for respective financial industry sub-sectors in order to minimize the potential for regulatory arbitrage

8. At a later date, after further discussions with the DTI sub-sector, the CEF will be extended to commercial banks, merchant banks, building societies, cooperative societies that operate as credit unions (to be licensed under the Bank of Jamaica (Credit Union) Regulations).

II. BACKGROUND

9. The Jamaican financial crisis of the mid-1990s, along with the 2008 global financial meltdown have reinforced the need for national authorities to bolster, on an ongoing basis, the legal and operational frameworks governing the preservation of financial system stability. Common to both these crises was the issue of large counterparty credit exposures amongst FIs, which had the negative effect of contagion-induced financial sector fallout at the demise of one or a few entities.

10. In the case of the Jamaican financial crisis, non-viable FIs whose fate were partly the result of unsustainably large, counterparty credit exposures had to be nationalized and recapitalized at significant costs to the public purse, which some estimates put at 42% of GDP.[2]

11. Given the importance of FIs to the real economy, the public policy response to Jamaica's financial crisis of the mid-1990s was to mitigate the risk to the overall stability of the financial system to protect the real economy from undue fallout and disruptions to critical financial services. One aspect of this thrust, which remains an area of concern is the formalization of a large (counterparty) exposures framework for local FIs. This is in a context of the need for FIs to measure and limit the size of their credit exposures to corporate or institutional counterparties relative to eligible capital base as a means of minimizing the risk of widespread financial fallout arising from the failure of FIs within the local financial system.

12. The need for FIs to measure and limit the size of large counterparty exposures in relation to their capital was recognized by the BCBS in 1991, with the review of supervisory practices and supervisory guidance on large exposures. Similarly, the Core Principles for Effective Banking Supervision, Core Principle 19 (see Box 1), require local laws and bank regulations to set prudent limits on large exposures to a single borrower or a group of connected borrowers. The IAIS provided guidance on the limiting of large counterparty exposures, with its own Insurance Core Principles for insurers, with elements spread across Principles 13, 15 and 17 (Box 3). Standard setters for securities dealers - IOSCO - were less direct in its guiding supervisory principles, not giving specific guidance with regard to the treatment of large exposures.

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[2] World Bank Report No.26088-JM "Jamaica the Road to Sustained Growth", December 2003. According to the WB "…in March 2001 the Government took over the FINSAC bonds issued to Banks and Insurance Companies (valued at J$142.7 billion or 42% of GDP at the time)…".The Report noted that Jamaica's financial crisis was one of the costliest in terms of its resolution.

13. With the advent of consolidated supervision, the pieces of Guidance were found lacking in their detail of, inter alia; how FIs should measure and aggregate counterparty exposures, factors to be considered in the determination of whether separate legal entities can form a group of connected counterparties for the purpose of measuring and aggregating large counterparty exposures, nor the definition of capital on which these limits were based.

14. The BCBS issued standards in April 2014 for member jurisdictions to establish supervisory frameworks for measuring and controlling large exposures, to address weaknesses in the large exposures regulatory framework globally and to equip regulators and supervisors with the tools to prevent or contain the rapid contagion across global markets and amongst FIs with counterparty credit exposures.

15. Accordingly, this consultation paper seeks to review the existing legislation and its application to ascertain whether these are: (i) appropriate to both the scope of activities and level of complexity of FIs; and (ii) broadly consistent with international standards.

OVERVIEW OF THE STRUCTURE OF THE FINANCIAL SYSTEM IN JAMAICA

16. BOJ and FSC have responsibility for financial system stability as stipulated in the BOJA and FSCA, respectively. Where two or more FIs operating in Jamaica are members of a financial group and one of them is a DTI, an FHC must be established, per Section 69(1) of the BSA. In its regulatory and supervisory role, the Governor of the BOJ is the Supervisor of FHCs and other specified FIs.

17. The FSC, headed by the Executive Director, is the regulator for non-DTIs (i.e. SDs, investment advisors, ICs, private pension funds and collective investment schemes) as is established under the FSCA. SDs and investment advisors are licensed under the Securities Act, and ICs are registered under the IA.

18. As at September 2017, there were eleven (11) DTIs consisting of eight (8) commercial banks, two (2) building societies and one (1) merchant bank, and twenty-nine (29) credit unions. The non-DTI sector is comprised of forty-two (42) SDs, eleven (11) general insurance companies, and six (6) life insurance companies. Collectively, the assets of DTIs and non-DTIs account for a little over 160% of GDP.

19. Financial groups account for approximately 90% of system assets, suggesting a high level of interconnectedness arising from the relationships and transactions amongst financial conglomerates in the system. Accordingly, these factors heighten the risk of contagion from the failure of a single entity or group.

20. The services of FIs are necessary to support the effecting of financial transactions, the accumulation of savings as well as borrowing, payment, clearing and settlement services, by significant numbers of individuals and companies within the economy. Should any of these FIs become insolvent or illiquid, depending on the extent and level of counterparty credit exposures with other FIs, there may be significant fallout and/or disruption to the continuity of critical services provided by other FIs, potentially posing a significant threat to the stability and effective performance of the financial system with deleterious implications for the real sector activity.

21. The existing legal framework governing counterparty credit exposure limits for licensees is contained in three key pieces of legislation; the BSA, the Insurance Regulations, and the Securities (Prudential) Regulations. As the regulatory authorities, BOJ and FSC have the powers to intervene under their respective legislation should there be a threat to the financial condition of these licensees, due to, inter alia, excessively and/or unsustainably large counterparty exposures as a percentage of eligible capital base.

MARKET STRUCTURE OF COUNTERPARTY EXPOSURES IN JAMAICA

22. Jamaica's financial system is comprised of five major subsectors which are DTIs, SDs, Life Insurers and General Insurers and Credit Unions. Furthermore, financial groups span across multiple subsectors within the system.

International Standards Box: 1 – Core Principle 19 for Effective Bank Supervision: Concentration Risk & Large Exposure Limits

BCP: PRINCIPLE 19: CONCENTRATION RISK AND LARGE EXPOSURE LIMITS

The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Essential criteria

A. Laws, regulations or the supervisor require banks to have policies and processes that provide a comprehensive bank-wide view of significant sources of concentration risk. Exposures arising from off-balance sheet as well as on-balance sheet items and from contingent liabilities are captured.
B. The supervisor determines that a bank's information systems identify and aggregate on a timely basis, and facilitate active management of, exposures creating risk concentrations and large exposure to single counterparties or groups of connected counterparties.
C. The supervisor determines that a bank's risk management policies and processes establish thresholds for acceptable concentrations of risk, reflecting the bank's risk appetite, risk profile and capital strength, which are understood by, and regularly communicated to, relevant staff. The supervisor also determines that the bank's policies and processes require all material concentrations to be regularly reviewed and reported to the bank's Board.
D. The supervisor regularly obtains information that enables concentrations within a bank's portfolio, including sectoral, geographical and currency exposures, to be reviewed.
E. In respect of credit exposure to single counterparties or groups of connected counterparties, laws or regulations explicitly define, or the supervisor has the power to define, a "group of connected counterparties" to reflect actual risk exposure. The supervisor may exercise discretion in applying this definition on a case by case basis.
F. Laws, regulations or the supervisor set prudent and appropriate requirements to control and constrain large credit exposures to a single counterparty or a group of connected counterparties. "Exposures" for this purpose include all claims and transactions (including those giving rise to counterparty credit risk exposure), on-balance sheet as well as off-balance sheet. The supervisor determines that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.
G. The supervisor requires banks to include the impact of significant risk concentrations into their stress testing programmes for risk management purposes.

Additional criterion

H. In respect of credit exposure to single counterparties or groups of connected counterparties, banks are required to adhere to the following:
    a. ten per cent or more of a bank's capital is defined as a large exposure; and
    b. twenty-five per cent of a bank's capital is the limit for an individual large exposure to a private sector non-bank counterparty or a group of connected counterparties.

Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialized banks.

23. An analysis of SDs' and ICs' exposure to other FIs conducted over the March 2012 to December 2016 period, revealed that the institutions exhibited high levels of gross exposure to capital ratios, spread generally across the respective subsectors, and primarily evident in investments with overseas FIs and credit exposures to the private sector. Though there has been moderation across the financial system over time, for SDs, average gross exposure to capital ratios remained relatively high.

EXISTING LEGAL FRAMEWORK

24. The existing legal framework governing counterparty exposure limits are contained in three pieces of legislation – the BSA for FHCs (Part XII), the Insurance Regulations for ICs (Regulation 42), and the Securities (Prudential) Regulations for the SD subsector (Regulation 14(2)(b)), which allows the FSC to specify exposure limits by notice in writing.

25. Currently, existing regulations indicate that FHCs are subject to aggregate counterparty limits of 20% and 40% of capital base for individual and a group of counterparties, respectively. These provisions apply to FHCs on a consolidated basis. For non-DTIs, the insurance sector is subject to a limit of 5% in terms of single counterparty exposure to total assets, while no counterparty limit is in position for SDs (although the legislation gives the regulator the power to cap overall leverage that can be employed by SDs). Box 2 highlights weaknesses in the existing framework.

Box: 2 – Weaknesses in the Existing Legal Framework

WEAKNESSES IN EXISTING FRAMEWORK

A. The scope of the existing framework is spread across legislation, with guidance for FHCs found within the BSA, and guidance for non-DTIs found within the Insurance Regulations and Securities (Prudential) Regulations. Limits guided by a joint consultative process for the proposed CEF will facilitate harmonization of the framework across sub-sectors.

B. The definition of capital used across financial groups vary. In line with the amended Basel framework, the CEF proposals tighten the definition of capital used to calculate the large exposure limits. Going forward licensees will have to calculate large exposures against eligible capital base and not total capital.

C. Differences in large exposure limits across financial groups may lead to regulatory arbitrage across different financial subsectors within the group. The proposed CEF will update the existing counterparty exposure framework by adopting a 25% large exposure limit.

D. Additionally, non-regulated entities that accept and introduce risk to the financial group could lead to increasing and unsustainably large exposures within the group. The CEF proposed for FHCs will provide for treatment of these entities.

E. There is no identifiable criteria for the classification of a group of connected counterparties. The proposed CEF will provide guidance in this area.

F. Without uniformity, certain categories of credit exposures were subject to more lenient treatments due to increased complexity and opaqueness of these exposures, as well as interconnectedness and consolidation within the financial system.

III. RATIONALE & OBJECTIVES OF THE COUNTERPARTY EXPOSURES FRAMEWORK

26. Globally, regulations of large exposures show considerable homogeneity. However, considerable variation existed in the implementation of important aspects such as: scope of application; the value of large exposure limits; the definition of capital on which limits were based; methods for calculating exposure values; treatment of credit risk mitigation techniques; and whether certain types of exposures were subject to more lenient treatments.

27. With the enhancement of the CEF, local regulators will now complement the risk-based and consolidated capital standards with improved oversight of financial groups' capital management at the solo and consolidated levels. The prescribed CEF will seek to ensure that licensees exposures to a single counterparty and persons connected to it are within prudent limits at all times.

28. When considering or exercising the application of the CEF, regulators must have regard to the following exposure limit objectives:

    a. Protection and enhancement of public confidence and maintenance of stability in the financial system;
    b. Protection of depositors, investors, policyholders and other users of the financial system against undue risks of losses and other damage that may arise from excessive exposures;
    c. Avoid undue costs to taxpayers and minimize overall costs of financial distress;
    d. Strengthening of oversight and regulation of the financial system while minimizing the need for crisis management;
    e. Prevention of situations of regulatory arbitrage across different financial subsectors within the group; and
    f. Mitigation of micro-prudential risk from exposures that are large compared to the capital resources of FIs.

29. The objectives listed above are not in order of priority and will be applied and balanced depending on each circumstance.

IV. SCOPE AND APPLICATION

30. At present, the proposed CEF will be applicable to FHCs and securities dealers, as well as any associated entities providing critical support services to these FIs to the extent that large exposures attributable to these entities can be managed as part of the BOJ's coverage by way of the BSA.

31. In relation to the insurance sub-sector, submissions from industry participants and other relevant stakeholders as to what maybe a suitable alternative threshold whether tied to total assets or the FIs' capital base are welcome.

32. The provisions for the counterparty exposure limits will remain in the relevant sector legislation, however the harmonization of the standard to all FIs falling within the FHC framework and SDs will reduce the opportunity for regulatory arbitrage.

33. In principle, a single regime is more likely to be effective if the administering of large exposure limits for one or more FIs is taken in relation to the group rather than each member of the group being subject exclusively to different regulatory regimes, which could present opportunities to FIs for regulatory arbitrage.

FHC OBLIGATIONS AND CONSOLIDATED SUPERVISION IMPLICATIONS

34. FIs, falling within the scope of the CEF, are required to comply with the prescribed counterparty exposure limits at both the entity and consolidated level. The application of the counterparty exposures framework at the consolidated level implies that FIs must consider all exposures to third parties across the relevant regulatory consolidation group and compare the aggregate of those exposures with the group's eligible capital base.

35. The CEF on a consolidated basis is geared towards addressing counterparty risks which are unique to financial groups such as removing opportunities for regulatory arbitrage, while promoting the prudent maintenance and allocation of capital across the group, in line with the consolidated supervision framework. Regulators will have oversight of financial groups' capital management at the consolidated level as per their respective capital adequacy frameworks.

36. The FHC framework will foster greater regulatory collaboration and cooperation with relevant domestic and overseas regulators to enable effective regulation of the counterparty exposure limits on a consolidated, cross-border basis. This will permit a more efficient and effective assessment of the financial groups' capital and counterparty exposure positions and compliance with minimum requirements, as well as a more coordinated approach to assessing and resolving inadequacies where these may arise.

International Standards Box: 3 – Summary of Insurance Core Principles on Concentration Risk Management

ICP: CONCENTRATION RISK MANAGEMENT

The risk management system is designed and operated at all levels of the insurer to allow for the identification, assessment, monitoring, mitigation and reporting of all risks of the insurer in a timely manner. It takes into account the probability, potential impact and time horizon of risks.

Types of risk to be addressed

– The supervisor should address all relevant and material categories of risk - including as a minimum underwriting risk, credit risk, market risk, operational risk and liquidity risk. This should include any significant risk concentrations, for example, to economic risk factors, market sectors or individual counterparties, taking into account both direct and indirect exposures and the potential for exposures in related areas to become more correlated under stressed circumstances.

– Rules may also be defined to restrict exposure to any single counterparty, group, or homogeneous risk group (such as industry and geographical area) to, for example, a defined percentage of the total assets or capital base. Such rules or restrictions may either be applied directly to the investments or lead to charges to or deductions from available capital which act as a disincentive to investment in risky assets or high concentrations in particular assets, rather than as a prohibition.

Additional guidance for insurance groups

– For insurance groups, the supervisor should specify how investments should be aggregated for the purposes of regulatory investment requirements that apply to the group and consider appropriate restrictions on intra-group transactions, for example, to limit contagion or reputational risk. Issues to be considered may include exposures to related counterparties and the exposures arising from investments in subsidiaries and interests over which the insurer has some influence. In stress situations there will tend to be greater restrictions on movements and realization of investments within the group. The regulatory regime may therefore require contractual evidence of the ability to access assets for solvency purposes before allowing their inclusion for group purposes.

Reinsurance

– A cedant should set prudent limits or guidelines reflecting security and size of the reinsurer, in relation to its maximum aggregate exposure to any one reinsurer or to a group of related reinsurers, which will be complementary to any local regulatory limits or guidelines. The insurer should also have in place procedures for monitoring this aggregate exposure to ensure that these limits or guidelines are not breached, including procedures to see that excess concentrations are brought back within limits or guidelines, or otherwise managed, going forward. At certain times, for acceptable reasons, a cedant might breach a limit, for example facultative placements and capacity issues or the growth of claim reserves. In the event of a limit being breached consideration should be given to additional risk mitigation procedures in place to counterbalance any breaches.

37. Consequently, the sum of all the exposure values of an FI to a group of connected counterparties must not be higher than the prescribed 25% of the FI's eligible capital base at all times.

IDENTIFYING GROUPS OF CONNECTED COUNTERPARTIES

38. For the purpose of the CEF, a group of connected counterparties shall be treated as a single exposure. In this case, the sum of the FI's exposures to all the individual entities included within a group of connected counterparties is subject to the large exposure limit and to the regulatory reporting requirements as prescribed below.

39. Two or more natural or legal persons shall be deemed a group of connected counterparties if at least one of the following criteria is satisfied:

    a. Cross guarantees;
    b. Common collateral, common ownership, management or financial interest, partnerships or joint ventures;
    c. The ability to exercise a control relationship: counterparties are connected through a control relationship when one of the counterparties, directly or indirectly, has control over the other(s) (Box 4);
    d. Financial or economic interdependence: if one of the counterparties were to experience financial problems, in particular funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties (Box 5); and
    e. Any other connection or relationship which, according to the relevant regulator's assessment, identifies the counterparties as constituting a single risk to the licensee.

40. FIs must assess the relationship amongst counterparties with reference to the criteria above in order to establish the existence of a group of connected counterparties.

International Standards Box: 4 – Determination of Connectedness Based on a Control Relationship

DETERMINATION OF A CONTROL RELATIONSHIP

In assessing whether there is a control relationship between counterparties, FIs must automatically consider that one of the counterparties, directly or indirectly, has control over the other(s) if one entity owns more than 50% of the voting rights of the other entity.

In addition, FIs must assess connectedness between counterparties based on control using the following criteria:

A. Voting agreements (e.g. control of a majority of voting rights pursuant to an agreement with other shareholders);
B. Significant influence on the appointment or dismissal of an entity's administrative, management or supervisory body, such as the right to appoint or remove a majority of members in those bodies, or the fact that a majority of members have been appointed solely as a result of the exercise of an individual entity's voting rights; and
C. Significant influence on senior management, e.g. an entity has the power, pursuant to a contract or otherwise, to exercise a controlling influence over the management or policies of another entity (e.g. through consent rights over key decisions).

FIs are also expected to refer to criteria specified in appropriate internationally recognized accounting standards for further qualitative guidance when determining control.

Where control has been established based on any of these criteria, FIs may still demonstrate to its relevant supervisor in exceptional cases that such control does not necessarily result in the entities concerned constituting a group of connected counterparties.

41. Where a single counterparty is connected to more than one group of persons, FIs must aggregate the exposure in each of the groups.

42. A situation described in paragraph 41 may arise where the counterparty-

  a. is jointly controlled by two or more persons that hold equal participation in the counterparty;
  b. is a partner in more than one partnership and exercises control over these partnerships;
  c. is dependent on a sole supplier for its business output and is also solely dependent on its parent for financial assistance; or
  d. is the sole supplier to a group of persons.

43. FIs must have in place procedures and mechanisms for conducting financial or economic interdependence assessments, which shall at least cover its large exposures.

International Standard Box: 5 – Determination of Connectedness based on Economic Interdependence

DETERMINATION OF ECONOMIC INTERPENDENCE

In establishing connectedness based on financial or economic interdependence, FIs must consider, at a minimum, the following qualitative criteria:

A. Where 50% or more of one counterparty's gross receipts or gross expenditures (on an annual basis) is derived from transactions with the other counterparty (e.g. the owner of a residential/commercial property and the tenant who pays a significant part of the rent);
B. Where one counterparty has fully or partly guaranteed the exposure of the other counterparty, or is liable by other means, and the exposure is so significant that the guarantor is likely to default if a claim occurs;
C. Where a significant part of one counterparty's production/output is sold to another counterparty, which cannot easily be replaced by other customers;
D. When the expected source of funds to repay each loan one counterparty makes to another is the same and the counterparty does not have another source of income from which the loan may be fully repaid;
E. Where it is likely that the financial problems of one counterparty would cause difficulties for the other counterparties in terms of full and timely repayment of liabilities;
F. Where the insolvency or default of one counterparty is likely to be associated with the insolvency or default of the other(s); and
G. When two or more counterparties rely on the same source for the majority of their funding and, in the event of the common provider's default, an alternative provider cannot be found - in this Supervisory framework for measuring and controlling large exposures case, the funding problems of one counterparty are likely to spread to another due to a one-way or two-way dependence on the same main funding source.

There may, however, be circumstances where some of these criteria do not automatically imply an economic dependence that results in two or more counterparties being connected. Provided that the FI can demonstrate to its supervisor that a counterparty which is economically closely related to another counterparty may overcome financial difficulties, or even the second counterparty's default, by finding alternative business partners or funding sources within an appropriate time period, the FI does not need to combine these counterparties to form a group of connected counterparties.

There are cases where a thorough investigation of economic interdependencies will not be proportionate to the size of the exposures. Therefore, FIs are expected to identify possible connected counterparties on the basis of economic interdependence in all cases where the sum of all exposures to one individual counterparty exceeds 5% of the eligible capital base.

44. Where applicable, as assessed by the relevant regulator, FIs may be directed to treat entities of which by itself or jointly with another, it has control or financial or economic interdependence, as a single counterparty.

VI. MEASURING LARGE COUNTERPARTY EXPOSURES

45. The exposure values to be considered by the FHC in order to identify large exposures to a counterparty are all those exposures defined under the applicable risk-based capital framework. It must consider on-balance sheet and off-balance sheet exposures included in the banking or trading book and instruments with counterparty credit risk under the enhanced risk-based capital framework.

46. In the case of non-DTIs, the exposure values to be considered by FIs in order to identify large exposures to a counterparty are all those exposures defined under the applicable capital adequacy framework. It must consider all on-balance sheet exposures and instruments with an inherent counterparty credit risk exposures as per the prevailing capital adequacy framework.

VII. PROPOSED COUNTERPARTY EXPOSURE LIMITS

47. In line with international standards (Box 6) and the impact assessment jointly conducted by BOJ and FSC, the following limits for FHCs and SDs are being proposed on a transitory basis:

    i. Twenty-five percent (25%) of an FI's eligible capital base at the entity level and at the consolidated level; and
    ii. A limit as may be approved, which shall not exceed 50% of the FI's total capital.

48. It is the expectation that these FIs will formally develop a framework of policies and processes essential for group oversight, as well as necessary for identifying, measuring, monitoring, controlling and reporting, to ensure compliance with prescribed limits, on an individual and consolidated basis.

49. Notwithstanding paragraph 47, the relevant regulator may, in writing, set specific limits on an FI's exposure to particular counterparties, and groups of counterparties, on a case-by-case basis, having regard to the FI's individual circumstances.

International Standard Box: 6 – Jurisdictional Comparison of Existing Exposure Limits

	Australia	United Kingdom	United States	Singapore	Malaysia	Bahamas
Single & Group Exposures	25%	25%	25%	25%	25%	25%

VIII. EXEMPTIONS

50. Exempt exposures are not taken into account for the purposes of the CEF (although accounted for with regard to risk-weighting). There are a number of exemptions from the CEF and the proposed counterparty exposure limits shall be applied to all exposures except for the following specified counterparty exposures:

PRESCRIBED DEDUCTIONS

51. Exposures considered as prescribed deductions by regulation 2 of the Banking Services (Capital Adequacy) Regulations, 2015 and regulation 2 of the Securities (Prudential) Regulations), 2014. These include the aggregate of:

    a. equity investments in unconsolidated subsidiaries;
    b. any substantial investment, whether held directly or indirectly, in any other unconsolidated entities or companies;
    c. the proportionate share of the amount of accumulated losses of any unconsolidated subsidiary or any other unconsolidated entity or company in which the licensee has a substantial investment;
    d. other facilities provided by the licensee that are treated as capital by unconsolidated subsidiaries and by any other unconsolidated entities or companies in which the licensee has a substantial investment;
    e. new and existing capital issues between the licensee and one or more other licensee(s) that represent, either directly or indirectly, back-to-back placements;
    f. new and existing capital issues between two or more companies that represent, either directly or indirectly, back to back securities; and
    g. any other deduction designated by the relevant regulator as a "prescribed deduction" by way of Notice.

INTRAGROUP EXPOSURES

52. Intragroup exposures for FHCs have not been included in the scope of this framework based on the adjustments that would be made as a result of consolidation in Supervision, although they could be considered as another source of concentration risk.

53. For SDs, intragroup exposures will be included subject to the provisions and guidelines under the respective legislation.

SOVEREIGN EXPOSURES AND ENTITIES CONNECTED WITH SOVEREIGNS

54. FHCs' and SDs' exposures to sovereigns and their central banks are exempted. This exemption also applies to public sector entities treated as sovereigns according to the applicable capital adequacy requirement. Any portion of an exposure guaranteed by, or secured by financial instruments issued by, sovereigns would be similarly excluded from the scope of this framework to the extent that the eligibility criteria for recognition of the credit risk mitigation are met. These include exposures secured by a fully and unconditional guarantee, or securities issued by:

    a. the Government of Jamaica or the Bank of Jamaica;
    b. governments and government agencies of CARICOM countries, exempted, in writing, by the relevant regulator;
    c. governments and government agencies of the United States of America, Canada and the United Kingdom;
    d. governments and government agencies of other G-10 countries (i.e., Belgium, France, Germany, Italy, Japan, the Netherlands, Sweden and Switzerland), exempted, in writing, by the relevant regulator; and
    e. governments and government agencies of other sovereign countries that are rated as investment grade by an internationally recognized credit rating agency, approved by the Supervisory

Committee of the Bank of Jamaica, and the guarantee is explicit, unconditional, legally enforceable and irrevocable over the life of the credit exposure in question, and has been exempted in writing, by the relevant regulator.

CASH, INTRA-DAY AND WRITTEN OFF EXPOSURES

55. Exposures fully secured or collateralized by cash are exempt as no risk is carried.

56. To avoid disturbing the payment and settlement processes, exposures arising from intra-day liquidity support facilities are not subject to the limits of the CEF.

57. Exposures that have been written off or specifically provided for are exempt for the purposes of the CEF.

REVERSE REPURCHASE AGREEMENTS

58. Exposures arising from reverse repurchase arrangements where the underlying securities are issued by the Government of Jamaica or Bank of Jamaica for which there is an agreement that the seller will repurchase these securities at the end of the stated period, and for which the licensed entity has obtained physical control of said securities.

IX. CREDIT RISK MITIGATION TECHNIQUES

59. Eligible credit risk mitigation techniques for large exposures purposes are those which have been allowed under the BSA and the FSCA – that is, the recognition of eligible collateral and guarantees.

COLLATERALIZATION

60. For the purpose of compliance with the CEF, a financial institution may reduce its exposures to a single counterparty to the extent that such exposures are secured by eligible collateral, as follows:

    a. cash deposits;
    b. securities issued or guaranteed by the Government of Jamaica, or the Bank of Jamaica.

61. FIs shall not recognize a commitment to provide collateral as eligible credit risk mitigation for the purpose of compliance with the CEF.

62. When the exposure and collateral are held in different currencies, FIs shall make an adjustment to the collateral to take into account possible future fluctuations in exchange rates.

GUARANTEES

63. Except as otherwise stated by the relevant regulator, FIs may substitute their exposures to the direct counterparty with exposures to guarantors provided that these guarantors are of a better rating than the direct counterparty, or equal rating if the direct counterparty is of the highest rating (e.g. AAA).

64. For the purposes of the CEF, FIs must demonstrate that minimum requirements of risk management practices outlined in the germane policy documents are met. FIs shall at all times comply with any additional risk management requirements as may be specified by the relevant regulator.

X. APPROVALS

65. FHCs and SDs must obtain prior approval from BOJ or FSC as applicable for any proposed exposures in excess of the prescribed limits set out in Part VII. Such approval will only be granted on an exceptions basis. The licensee concerned must be able to satisfy regulators as to why the proposed exposure(s) might reasonably be expected not to expose the FI or the group of which it is a part, to excessive risk.

66. The BOJ or FSC may impose a higher minimum capital ratio on the FI at the solo level and the consolidated level to compensate for the additional risk that may be associated with the proposed exposures.

XI. TRANSITIONAL ARRANGEMENTS AND REPORTING

67. In recognition that FHCs and FIs may require time to fully comply with the requirements in the attendant policy document, to facilitate implementation, these FIs will be given a sufficient period to implement systems to support the aggregation and monitoring of exposures to counterparties and associated persons connected to them.

68. All specified exposures which exceed the prescribed counterparty exposure limits based on requirements specified, will be required to transition into compliance, subject to any explicit provisional arrangements in respect of such exposures as may be approved on a case-by-case basis.

69. In the case of exposures by an FI where an approval for the institution to maintain a higher prescribed counterparty exposure limit has been granted in accordance with paragraph 49, the FI must ensure that all exposures that are in excess of the approved limit are brought into compliance within the timeframe stipulated by the relevant regulator.

70. During the transition period, limits will be reassessed on an on-going basis, taking into consideration other changes in the prudential framework such as changes in the components of regulatory capital.