

BANK OF JAMAICA

DISCUSSION PAPER

**INSTITUTIONAL ARRANGEMENTS FOR SAFEGUARDING
FINANCIAL STABILITY**

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INTRODUCTION

1. In December 2010 Cabinet approved the decision for the institutional responsibility for stability of Jamaica's financial system to be assigned to the Bank of Jamaica (BOJ). This reform also comprises the set of legislative reforms that underpin the current 27-month Stand-By Arrangement with the International Monetary Fund (IMF).

2. This Paper outlines proposed amendments to the BOJ Act to vest the BOJ with overall responsibility for financial stability. Comments received from the Attorney General's Chambers, Ministry of Finance, the Financial Services Commission, the Jamaica Deposit Insurance Corporation, the Jamaica Securities Dealers Association as well as individual financial institutions have been incorporated in the amendments.

BACKGROUND

3. One of the important lessons emanating from the global financial crisis is that institutional responsibility for the stability of the financial system as a whole needs to be clearly defined, codified and assigned. Full responsibility for financial stability is unclear where there are multiple supervisory agencies, with none having the authority or mandate to oversee the links among different kinds of activities and to recognize and address systemic risks.

4. To address this deficiency, the route taken by most jurisdictions has been to locate this function within their central banks. Adding financial stability oversight to the role of central banks has been a logical choice in light of their existing supervisory role over banking institutions, in most cases, their core mandate to influence conditions in money and credit markets and their essential function as store of liquidity in the economy.

As part of the set of reforms that underpin the Stand-By Arrangement with the IMF, it has been determined that the BOJ should bear the institutional responsibility for financial stability in Jamaica.

5. The main requirement to effect this change is the definition of a set of amendments to the BOJ Act that would facilitate a more macro-prudential approach to oversight of the financial system as a whole. This would complement the BOJ's traditional direct prudential approach to supervision of the deposit-taking system and expand both the focus and scope of the consultative process currently conducted through the Financial Regulatory Council.

6. Many other jurisdictions around the globe are concurrently pursuing a similar process of financial architecture reform to formalize the financial stability role. Based on a survey of their experiences, Jamaica's own experience and regulatory architecture as well as other considerations, the following has been approved by Cabinet and endorsed by the IMF as the essential amendments to the BOJ Act to meet the objective of assigning formal responsibility to the BOJ and ensuring its ability to discharge the function.

PROPOSED AMENDMENTS

Mandate the Financial Stability Objective of the BOJ

7. Without prejudice to its primary objective of price stability, amend the BOJ Act to include the specific objective of ensuring the stability of the financial system (that is, macro-prudential oversight of financial institutions in addition to the current mandate for the direct prudential supervision of individual institutions and sub-sectors within the deposit-taking system). For this purpose, financial institutions would include those institutions that currently fall under the regulatory oversight of the BOJ or Financial Services Commission (including deposit-taking institutions, securities dealers, insurance companies, cooperatives, collective investment schemes and pension funds). Provisions would also be necessary to allow for the BOJ to designate any other type of financial institution to be subject to this type of oversight.

8. Macro-prudential oversight involves the detection of risks to financial stability and taking effective measures to mitigate and control these risks. This oversight will be effected by the BOJ principally through the exchange of information amongst Financial Regulatory

Authorities as well as forward-looking assessments of vulnerabilities in the financial system and its macro-financial inter-linkages with the real economy and abroad. However, it will be critical that the BOJ is provided with powers to directly access critical information from systemically important financial institutions (SIFIs) or class thereof that may not be readily available from another regulatory agency.

9. Risks to financial stability include shocks that could disrupt the orderly functioning of the financial intermediation process, financial markets and payment and settlement infrastructures and could significantly impair the allocation of economic resources. The power to take effective measures to mitigate and control risks to financial stability will be provided to the BOJ.

Mandate the Establishment, Composition and Tasks of a Financial Stability Committee of the BOJ

10. Amend the BOJ Act to establish a Financial Stability Committee (hereafter, the Committee) which will be responsible for coordinating the activities pursuant to the objective of financial system stability.

11. The tasks of the Committee should be set out in the BOJ Act and would include:

- i. Macro-prudential analysis, i.e. producing forward-looking financial stability assessments in relation to developments in the financial system as well as international markets and the regular exchange of information between members of the Committee regarding monitoring risks to stability of the financial system and assessing the macro-financial inter-linkages with the real economy and abroad;
- ii. Oversight of the design and conduct of periodic stress test scenarios in regard to plausible systemic threats to the stability of the financial system;
- iii. Periodic consultation with representatives from financial sector stakeholders in order to seek their views and obtain their input in assisting the

Committee's understanding of developments that may impact on financial stability;

- iv. Determination of an institution's risk to financial stability;
- v. Determination of criteria for a SIFI designation;
- vi. Determination of parameters which trigger action in respect of a financial institution as required under the BOJ's financial stability mandate;
- vii. Co-ordination of crisis prevention, crisis management and crisis resolution mechanisms and procedures;
- viii. International cooperation in support of financial stability objectives;
- ix. Preparation and provision of periodic and exceptional reports to the Minister of Finance assessing the performance of the financial system; and
- x. Any other activity as determined by the Committee in support of its financial stability objective.

12. A determination by the Committee that a situation of risk to financial stability exists means that corrective measures can be invoked and that process cannot be suspended or reversed without a similar determination that the process should be suspended or reversed.

13. Where any action is being proposed by the BOJ to the Committee in respect of a financial institution under the supervision of another regulatory authority, the head of that regulatory authority shall be notified.

14. The composition of the Committee, which is expected to include non-BOJ staff, will be specified by regulations made under the BOJ Act.

15. The rules of procedure of the Committee with respect to the frequency and conduct of meetings, appointment of support staff, recording of proceedings, etc. shall be determined by the Committee.

16. The law should also contain appropriate provisions to ensure that all members of the Committee are subject to confidentiality requirements relating to the work of the Committee similar to those that bind supervisory staff of BOJ and should also be indemnified with respect to their activities as Committee members.

Discretionary Powers to Provide Liquidity

17. Expand the powers of the BOJ to allow expressly for the provision of emergency liquidity assistance to financial institutions in the event of a threat to systemic stability and in accordance with criteria of systemic importance, solvency and collateral sufficiency. Accordingly,

- i. The BOJ should have the power, in the event of or in the anticipation of severe or unusual disruption in the normal operation of a financial market or the financial system, to issue its own securities or buy and sell securities, obligations, bills of exchange or promissory notes to the extent determined necessary by the BOJ for the purpose of promoting system-wide stability;
- ii. The BOJ should have the power, in the event of or in anticipation of severe or unusual stress on a financial market or the financial system, to:
 - a. Make secured loans, guarantees or other credit facilities to financial institutions upon such terms and conditions as the BOJ sees fit and to the extent determined necessary by the BOJ for the purpose of promoting system-wide stability;
 - b. Enter into cross-border institutional arrangements to ensure co-ordination of actions that may be taken with regard to financial

institutions situated overseas that may be the parent, subsidiary or a branch of a Jamaican financial institution;

- c. To accept upon such terms and conditions as the BOJ sees fit, collateral denominated in a foreign currency or located in a foreign jurisdiction with regard to the provision of emergency liquidity assistance to Jamaican financial institutions.

Power to Initiate Inspection

18. The BOJ should have the power, in consultation with the relevant Regulatory Authority that has jurisdiction over any financial institution, to co-opt that Regulatory Authority to perform, for a specified purpose, an inspection of any financial institution under the jurisdiction of that supervisory body. Inspections in this regard would be undertaken if the BOJ determines that the institution's financial condition or conduct poses or could come to pose a significant risk to the stability of the financial system.

Power to Request Information Pertinent to Macro-Prudential Oversight

19. The BOJ should have the power, after consultation with the relevant Regulatory Authority or Government Agency, to require any Regulatory Authority or Government Agency to provide any information in the possession of or accessible to that Regulatory Authority or Government Agency, where such information is necessary in the discharge of its financial stability function. Special arrangements may need to be made with the Statistical Institute of Jamaica to facilitate the collection and organization of information over which it may have primary responsibility for compiling.

20. All financial institutions should be required to provide the BOJ (through the relevant Regulatory Authority or Government Agency) with macro-prudential and other statistical information not typically collected by such Regulatory Authority or Government Agency which are pertinent to the BOJ's financial stability function. Information required in this regard should be specified by the BOJ in consultation with the Committee. For example, depending on an institution's risk profile and systemic importance, the BOJ may require

detailed evidence of, and periodic results from, an appropriate internal stress-testing programme that covers all material risks. In addition, as a central tool for assessing the financial sector's resilience to potential adverse shocks, the BOJ may prescribe the incorporation of specific alternative macroeconomic scenarios across a set of institutions based on emerging risks. (A stress-testing programme refers to a set of forward-looking quantitative techniques or risk models employed to assess an institution's vulnerability to significant financial and economic shocks. Stress-testing should be actively integrated in an institution's overall risk management framework, subject to oversight by the Board of Directors, to ensure that appropriate policies and procedures are used to manage and mitigate the adverse effects of all material risk factors).

21. The BOJ should have the power to require legal entities who carry out international transactions to provide information which the BOJ determines relevant to establish Jamaica's international investment position (IIP), without these entities being entitled to invoke bank or other secrecy privileges. The IIP, which records the stock of external financial assets and liabilities of residents of an economy, is necessary to provide an accurate assessment of the country's vulnerability and exposure to external creditors.

Power to Issue Prescriptive Rules, Standards and Codes Pertinent to Macro-Prudential Oversight

22. The BOJ should have the power, in consultation with the Committee, to instruct the relevant Regulatory Authority to issue prescriptive rules, standards and codes (applicable to any financial institution or class thereof) pertinent to macro-prudential oversight and the maintenance of financial stability. Such rules, standards or codes would specifically address gaps and imbalances in the financial system that could threaten stability. The setting of rules, standards and codes by the BOJ may include, for example: countercyclical capital buffers and loan loss provisioning; liquidity requirements; time varying loan-to-value (LTV) or loan-to-income limits; collateral valuation rules; foreign currency mismatch limits; more stringent risk weightings; leverage ratio ceilings; corporate governance and risk management guidelines; and restrictions on activities of payment and settlement systems.

23. In advance of issuing rules, standards and codes by a Regulatory Authority under the financial stability mandate, the concerned institution or group of institutions should be given an opportunity to make representation to the Financial Stability Committee unless delay would intensify any threat to financial stability.

24. The BOJ may impose administrative penalties on any institution for any delay in complying with any directives, rules, standards and codes issued by the BOJ in respect of carrying out its financial stability function.

Mandate to Establish and Update Central Financial System Database

25. The BOJ should have the mandate to establish and update a central database containing micro-prudential and macro-prudential information to be available for the relevant Financial Regulatory Authorities represented on the Committee.

Public Accountability of the BOJ's Financial Stability Mandate

26. The BOJ should be required to publish a financial stability report within three months after the end of its financial year to support its accountability on matters relating to the stability of the financial system as a whole.

27. A reasonable timeframe will be allowed before a sensitive or confidential financial stability action by the BOJ may be announced or discussed in public.

28. The BOJ will be prohibited from disclosing any information obtained in carrying out its financial stability mandate except in aggregate form, such that the person or legal entity to which the information refers cannot be identified.

CALL FOR COMMENTS

29. The Bank of Jamaica calls for interested parties to comment on the discussion paper.

Comments should be received by December 2011.

Comments should be sent to:

Governor,

Bank of Jamaica

Nethersole Place

Fax: 876 967 4265

Email: financialstabilitycomments@boj.org.jm,