Proposals for the Implementation of the Capital Conservation Buffer

(FOR LICENSEES UNDER THE BANKING SERVICES ACT, 2014)

BANK OF JAMAICA

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Consultation Paper on the Capital Conservation Buffer

(For licensees under the Banking Services Act, 2014)

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TABLE OF CONTENTS

GLOSSARY 5

SECTION 1: INTRODUCTION 6

A. Background and Motivation 6

B. Legal Requirement 7

C. Scope of Application 7

SECTION 2: OVERVIEW OF THE CCB 7

A. Minimum Capital Conservation Buffer Requirement 7

B. Proposal: Calculation of the CET1 Capital eligible as part of a Banking Institution's CCB 9

I) Example: Calculation of the CET1 Capital eligible as part of a Banking Institution's CCB 10

SECTION 3: OPERATION OF THE CCB 11

A. Proposal: Phase-in Schedule 11

B. Limits on Distributions 12

C. Notification Requirements 13

D. Rebuilding the CCB 14

GLOSSARY

“Reporting institution”, means an institution subject to prudential reporting under the Pillar I Capital Adequacy Framework, including a financial holding company which holds at least one (1) deposit-taking institution, or a deposit-taking institution, or any other financial institution that is subject to similar prudential requirements for capital adequacy as deposit-taking institutions, as determined by Bank of Jamaica.

“Capital adequacy ratio”, means regulatory capital as a percentage of risk-weighted assets.

“Deposit-taking institution”, has the meaning assigned to it under the Banking Services Act 2014 (BSA)

“Financial holding company”, has the meaning assigned to it under the BSA.

“Financial institution”, means a person who undertakes or engages in financial services.

“Licensee”, is a licensee under the BSA.

“Eligible distributions”, means the percentage that may be paid out by a reporting institution from net income over the previous four quarters, net of any distributions and associated taxes not already reflected in net income.

“High credit growth”, refers to both excess credit growth and excessive credit growth.

“Normal times”, means any period in which there is no high credit growth.

“Regulatory capital”, in relation to a licensee, means Common Equity Tier 1 Capital, Additional Tier 1 Capital, and Tier 2 Capital less any regulatory deductions as defined under the Standard of Sound Practice on the Minimum Capital Requirements.

“Total regulatory capital ratio”, means the sum of a reporting institution’s regulatory capital plus the reporting institution’s combined capital buffer, as a percentage of risk-weighted assets.

“Total regulatory capital ratio requirement”, means the sum of the minimum capital adequacy ratio (CAR) requirement plus the combined capital buffer minimum requirement, as a percentage of risk-weighted assets (RWA).

SECTION 1: INTRODUCTION

A. BACKGROUND AND MOTIVATION

1. The Basel Committee on Banking Supervision (BCBS) introduced a package of reforms in order to strengthen the resilience of banks to shocks, in efforts to prevent a recurrence of the conditions that precipitated the global financial crisis beginning in 2008. One of these reforms was the Basel III Capital Adequacy Framework, which improves the global capital framework. Bank of Jamaica ("the Bank") is in the process of implementing similar reforms to improve the framework for capital adequacy for licensees and to maintain alignment with international best practice. Accordingly, the Bank has published a Standard of Sound Practice on Pillar I of the Basel III reforms, which sets out the Minimum Capital Requirements for reporting institutions under the scope of application of the framework. The Pillar I Minimum Capital Requirements will enhance the capital framework for reporting institutions, taking the teachings from the global financial crisis by focusing on the highest forms of regulatory capital and expanding the risk coverage of the framework through the capital charges for credit risk, market risk, and operational risk.

2. Another lesson from the global financial crisis beginning in 2008 was that banks should hold additional capital above regulatory minima that can be drawn down to absorb losses. It was observed in other jurisdictions that a number of banks continued to make large distributions in the form of dividends, share buy backs and huge bonuses even as the financial condition of these banks and the global financial system worsened. One motivation for the continued payment of distributions during the crisis was that banks believed that any reductions in distributions would be viewed by markets as a signal of weakness. Even as many of these banks returned to profitability, there was insufficient corresponding build-up of capital buffers to support new lending. This dynamic lead to increased procyclicality in the financial system.

3. The capital conservation buffer (CCB) was introduced by the BCBS in 2019 to ensure that banks have an additional layer of usable capital that can be drawn down when losses are incurred. Banks holding additional capital above regulatory minima benefit from an additional layer of protection and increased operational resilience to insulate the bank during financial crises or idiosyncratic stress events.

4. The recent COVID-19 pandemic demonstrated the importance of capital buffers that offered protection against increasing credit, market, and operational risk and enabled reporting institutions to continue to make distributions subject to certain restrictions. Locally, Bank of Jamaica proactively issued guidance on the payment of dividends, in order to ensure that licensees were acting prudently to manage capital risk during this unprecedented period. Licensees were further encouraged to actively manage downside risks to capital and liquidity, whilst continuing to conduct business as normal.

5. The introduction of the CCB will bolster the Bank's micro-prudential toolkit. Under the proposed CCB, local reporting institutions will be required to hold additional regulatory capital that can be drawn down to absorb losses without breaching the minimum regulatory capital ratio specified in the Standard of Sound Practice (SSP) on the Minimum Capital Requirements. This framework is also intended to increase the effectiveness of the Bank's mandate to maintain financial system stability by ensuring that there are adequate levels of loss absorbing regulatory capital in the system.

B. LEGAL REQUIREMENT

6. The proposed CCB framework will be implemented pursuant to section 34FL(b)(ii) of the Bank of Jamaica Act, 2020, which accords the Financial Policy Committee with the authority to make determinations on Standards of Sound Practice for the operation of licensees in relation to capital adequacy.

C. SCOPE OF APPLICATION

7. The proposals for the CCB framework outlined in this document will be applied to licensees on the following bases:
   a) For each deposit-taking institution (DTI) licensed under the BSA, on a standalone basis, and any other licensee subject to similar prudential requirements for capital adequacy, as determined by the Supervisor; and
   b) For each financial holding company (FHC) licensed under the BSA, on a consolidated basis, at a date to be determined, where the entities within the scope for consolidation are the FHC and other members of the financial group that are within the scope of regulatory consolidation.

8. A DTI that is also licensed as an FHC under sections 74(2)-(3) of the BSA will be required to comply with these proposed CCB requirements at both the standalone level and the consolidated group level[1].

9. The sectoral regulatory capital requirements that govern other types of individual entities in financial groups remain applicable. Therefore, securities dealers, insurance companies and other institutions within financial groups containing a DTI that are not subject to the prudential requirements set out in the Minimum Capital Requirements will not be required to hold a capital conservation buffer in accordance with the proposed CCB framework.

10. Notwithstanding, the Bank will reserve the authority to make determinations, on a case-by-case basis, on the members of financial groups that should be included or excluded from the scope of consolidation for the purposes of this capital adequacy framework.

SECTION 2: OVERVIEW OF THE CCB

A. MINIMUM CAPITAL CONSERVATION BUFFER REQUIREMENT

11. Under the proposed CCB framework, reporting institutions will be required to maintain a capital conservation buffer of 2.5% of RWA in normal times, unless otherwise specified by the Supervisor. However, the Bank will reserve the authority to vary the CCB requirements in accordance with the risk profile of a reporting institution or to protect the safety and stability of the financial system, as deemed necessary.

[1] The requirements will not be applied cumulatively.

Explanatory Note: Calibration of Minimum Capital Conservation Buffer Ratio

12. The proposed requirement for reporting institutions to maintain a minimum CCB ratio of 2.5% of RWA is based on the following factors:
    (a) The calibration is in line with international best practice regarding capital buffers; and
    (b) The high degree of conglomeration and interconnectedness in the Jamaican financial system, which can amplify the impact of financial or economic stress.

13. The introduction of the CCB will increase the applicable capital adequacy ratio requirement for deposit taking reporting institutions subject to the SSP on the Minimum Capital Requirements. Reporting institutions will be required to satisfy the minimum CAR requirement, as well as any additional capital buffer[2] (BR) minimum requirements prescribed by the Supervisor. Upon the introduction of the CCB, the sum of these two requirements will hereafter be referred to as the total capital adequacy ratio (TCAR)[3] requirement. Expressed as a formula, the minimum TCAR requirement will be expressed by:

$$TCAR = CAR + BR$$

where

CAR = the (total) regulatory capital ratio as defined in the SSP on the Minimum Capital Requirements
BR = the combined capital buffer minimum requirement

14. The proposed CCB will solely be comprised of Common Equity Tier 1 (CET1) Capital[4], the highest form of capital. Under the proposed CCB framework, reporting institutions must first use holdings of CET1 Capital to meet the minimum capital adequacy requirements set out in the SSP on the Minimum Capital Requirements, after which any remaining CET1 Capital can be used to meet the applicable CCB minimum requirement. Table 1 sets out the proposed changes to the TCAR for reporting institutions under the SSP on the Minimum Capital Requirements after the implementation of the CCB:

[2] The additional capital buffer requirement above the prescribed minimum CAR may include the CCB, countercyclical capital buffer ("CCyB"), and any other capital buffer prescribed by the Supervisor for any licensee or group of licensees under the scope of the capital adequacy framework.

[3] For the purposes of the capital adequacy framework, the total minimum capital adequacy requirement for an institution will be the sum of the minimum capital adequacy requirement plus any additional buffer requirements imposed on the institution.

[4] Reporting institutions will not be allowed to use any Additional Tier 1 (AT1) Capital, Tier 2 Capital, or any other non-CET1 instrument as part of the CCB.

Table 1: Minimum Capital Requirements before and after full CCB Implementation

Category of Regulatory Capital	Prescribed Minima pre-CCB (as % of risk weighted assets)	Prescribed Minima after full CCB Implementation (as % of risk weighted assets)
Common Equity Tier 1	6.5%	9%
Of which, capital conservation buffer	0%	2.5%
Tier 1 Capital	8%	10.5%
Total Regulatory Capital Ratio	10%	12.5%
Early Warning Threshold (EWT) (section 110 of the BSA)[5]	11%	11%

15. Under the proposed CCB, reporting institutions will be allowed to draw on the CCB at any time to absorb losses, after providing the Bank with an explanation of the reasons for drawing on the buffer. However, reporting institutions should not operate within the CCB range outside of periods of idiosyncratic or systemic financial or economic stress. Further, the Bank will reserve the authority to determine the period for which a reporting institution can operate within the CCB range.

16. Reporting institutions should act prudently and proactively in the management of capital risk[6]. Therefore, reporting institutions are encouraged to hold additional capital above the prescribed levels, in accordance with the risk profile of the institution.

B. PROPOSAL: CALCULATION OF THE CET1 CAPITAL ELIGIBLE AS PART OF A BANKING INSTITUTION'S CCB

17. Reporting institutions will need to meet minimum capital ratios for CET1 Capital, Tier 1 Capital, and Total Regulatory Capital of 6.5%, 8%, and 10% of RWA, respectively, under the SSP on the Minimum Capital Requirements.

18. Under the proposed CCB framework, the maximum CET1 Capital amounts that are eligible for use by an institution as part of the CCB will be calculated by determining the lowest percentage surplus above the prescribed minimum capital ratios of CET1 Capital, Tier 1 Capital, and Total Regulatory Capital[7]. Therefore, the maximum, CET1 Capital amounts that are eligible for use as the CCB will be calculated using the formula:

$$Maximum\ CET1\ counting\ towards\ CCB$$
$$=$$
$$Min\ ((surplus\ CET1\ Capital, surplus\ Tier\ 1\ Capital, surplus\ Total\ Regulatory\ Capital)\%$$

[5] Under section 110 of the BSA, if a licensee's capital levels fall to one percentage point above the prescribed minimum capital levels, or CAR, or above any of the minimum capital levels otherwise set by the Supervisory Committee, the licensee will be subject to prompt corrective action.

[6] Institutions should have a procedure in place to assess their capital adequacy in relation to their risk profile and a strategy for maintaining adequate levels of capital, including capital buffers.

7 The prescribed minimum capital ratios for CET Capital, Tier 1 Capital, and Total Regulatory Capital are 6.5%, 8%, and 10%, as specified in the SSP on the Minimum Capital Requirements.

I) EXAMPLE: CALCULATION OF THE CET1 CAPITAL ELIGIBLE AS PART OF A BANKING INSTITUTION'S CCB

19. Under the proposed CCB framework, the CCB of a reporting institution will be calculated as follows:

i) Subtract minimum capital ratio requirements under the SSP for CET1 Capital, Tier 1 Capital, and Total Regulatory Capital on the Minimum Capital Requirements from risk weighted capital ratios reported by an institution for CET1 Capital, Tier 1 Capital, and Total Regulatory Capital, respectively.

ii) Compare the differences between the prescribed minimum capital ratio requirements under the SSP for CET1 Capital, Tier 1 Capital, and Total Regulatory Capital and the risk weighted capital ratios for CET1 Capital, Tier 1 Capital, and total regulatory capital, respectively.

iii) The applicable capital buffer for an institution is the lowest percentage of the three results.

<u>Table 2: CET1 Capital Eligible as part of the Capital Conservation Buffer Calculation for a Banking Institution</u>

Category of Regulatory Capital	FI's reported capital ratios (as % of RWA) (Column A)	Prescribed Minima (as % of RWA) (Column B)	Results (%) (Column C) = (Column A) less (Column B)
Common Equity Tier 1	9.5%	6.5%	9.5% – 6.5% = 3%
Tier 1 Capital	10%	8%	**10% – 8% = 2%**
Total Regulatory Capital	12.5%	10%	12.5% – 10% = 2.5%

20. In the example set out in Table 2, the institution reports surplus CET1 Capital[8] above the prescribed minima of 3% (i.e. 9.5% - 6.5%). However, only amounts translating to 2% of RWA as highlighted in Table 2 may be used by the reporting institution as a CCB buffer under the proposed CCB framework since the institution would need to use the remaining 1% to satisfy the Tier 1 Capital requirement. Therefore, this reporting institution would fall within the CCB range, despite holding surplus CET1 Capital equal to 3% of RWA above the prescribed minimum CAR. In this example, the reporting institution would need an additional amount of capital equal to 0.5% of RWA to be able to meet the CCB requirement.

21. Under the Bank's proposed approach to calculating the eligible CCB amounts, surplus CET1 Capital above the minimum CET1 Capital requirement must first be used to satisfy the minimum requirements for Tier 1 Capital and Total Regulatory Capital[9], if necessary. Thereafter, a reporting institution may use any remaining CET1 Capital to satisfy capital buffer requirements.

[8] For the purposes of the proposed CCB framework, surplus CET1 Capital refers to holdings of CET1 Capital above the minimum requirement of 6.5% as set out in the SSP on the Minimum Capital Requirements.

[9] Therefore, if an institution has insufficient holdings of ATI or Tier 2 Capital to meet the minimum requirements for Tier 1 Capital or Total Regulatory Capital, respectively, any surplus CET1 Capital must first be used to cover the shortfall prior to CET1 Capital being eligible for use as part of the CCB.

SECTION 3: OPERATION OF THE CCB

A. PROPOSAL: PHASE-IN SCHEDULE

22. Bank of Jamaica recognises that reporting institutions will require time to build the institutional capacity necessary to meet the full CCB minimum requirement of 2.5%. Furthermore, the implementation of the proposed CCB framework will consider the super-equivalency in the current CAR, which affords the Bank flexibility in setting additional capital requirements. The proposed phase-in schedule for implementing the full CCB requirement recognises the period of economic stress precipitated by the COVID-19 pandemic and the attendant downward pressure on bank lending and retained earnings while the global economy undergoes recovery. Accordingly, the Bank proposes that the CCB will be effective on 1 January 2024.

23. The Bank proposes to phase in the CCB over a five-year period in a uniformly increasing manner. This means that the minimum CCB will be increased in annual increments of 0.4% one year after implementation of the CCB, 0.45% after the second year, 0.5% after the third year, 0.55% after the fourth year, and 0.6% after the fifth year. However, the Bank will reserve the authority to accelerate the phase-in period for the CCB as deemed necessary based on developments within the local and global financial systems. Reporting institutions will be afforded sufficient notice prior to any acceleration in the phase-in period for the CCB requirements. Accordingly, the proposed CCB minimum requirement will be phased in over a five-year period as follows:

Table 3: Proposed Phase-in Schedule for the full CCB minimum requirements

Capital Conservation Buffer	Proposed Date	CCB/RWA	CET1/RWA	Tier 1/RWA	CAR/RWA
At implementation	1 Jan 2024	0%	6.5%	8%	10%
+ 1 year	1 Jan 2025	0.4%	6.9%	8.4%	10.4%
+ 2 years	1 Jan 2026	0.85%	7.35%	8.85%	10.85%
+ 3 years	1 Jan 2027	1.35%	7.85%	9.35%	11.35%
+ 4 years	1 Jan 2028	1.9%	8.4%	9.9%	11.9%
+ 5 years	1 Jan 2029	2.5%	9%	10.5%	12.5%

24. Reporting institutions will be required to submit a detailed plan that indicates the steps that will be taken to ensure compliance with the CCB requirements, at last three months prior to the minimum CCB being increased from 0% in accordance with the proposed schedule in Table 2.

25. Notwithstanding the phase-in schedule set out in this section, the implementing of the CCB will not vary the obligation of licensees under section 110 of the BSA regarding the EWT.

B. LIMITS ON DISTRIBUTIONS

26. Reporting institutions must use available CET1 Capital to meet the minimum capital requirements for CET1 Capital, Tier 1 Capital, and Total Regulatory Capital before any remaining amounts can be used to contribute to the CCB. Upon the introduction of the CCB framework[10], reporting institutions meeting the TCAR requirement will be able to make distributions[11] as usual during normal times.

27. There will be restrictions on distributable amounts once a reporting institution begins drawing on the buffer. Consistent with the intended purpose of the CCB, the reporting institution will be able to draw down on the capital conservation buffer in order to continue normal business.

Explanatory Note: Limits on Distributions and Section 52 of the BSA

28. The proposed CCB framework imposes restrictions on distributions in a way that interacts with section 52 of the BSA, which sets out the conditions under which a licensee under the BSA will be subject to restrictions on distributions. In particular, section 52(1)(b) stipulates that licensees will not be allowed to pay dividends on shares if there is statutory impairment of capital, until such impairment has been corrected.

29. Under the CCB framework, any reporting institution reporting regulatory capital levels that fall below the TCAR will be considered to be experiencing statutory impairment of capital. Notwithstanding, a reporting institution may be restricted from paying dividends based on other circumstances in accordance with section 52 of the BSA, as obtained before the introduction of the CCB.

30. Under the CCB framework, restrictions on distributions will increase as the CCB of an institution decreases. Bank of Jamaica will reserve the authority to vary the restrictions on distributions for reporting institutions that have drawn on the CCB, in accordance with an institution's risk profile or to protect the safety and stability of the financial system as deemed necessary.

31. Distributions will be allowed as follows, and as described in Table 3, subject to approval by the Supervisor:

    (i) Reporting institutions may make full distributions if the Total Regulatory Capital levels of the institution exceeds the TCAR, if the institution reports a profit for the most recent financial year;

    (ii) Distributions for institutions reporting a profit for the most recent financial year will be subject to the restrictions outlined in Table 4 if the Total Regulatory Capital level of the institution exceeds the CAR, but not the TCAR;

    (iii) Institutions reporting a profit for the most recent financial year will not be allowed to make distributions if the Total Regulatory Capital level of the reporting institution is lower than the CAR.

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[10] The introduction of the CCB will increase the amounts by which regulatory capital must exceed the minimum capital adequacy requirement of 10% before there are restrictions on the discretionary distribution of earnings, in comparison to the existing capital regime under the Banking Services Act, 2014, and the Banking Services (Deposit Taking Reporting institutions) (Capital Adequacy) Regulations, 2015.

[11] Under the Pillar I Minimum Capital Requirements, distributions include dividend payments, share buybacks, discretionary payments on other Tier 1 Capital instruments, and discretionary employee bonuses.

(iv) Institutions reporting a loss for the most recent financial year will not be allowed to make distributions; and

(v) In the event that an institution makes a financial year loss that results in the reporting institution's capital levels falling below the minimum CCB level, then the constraints as outlined in Table 4 will apply to subsequent distributions.

Table 4: Limits on Distributions based on level of CCB

Size of CCB	Eligible Distributions (% of total)
Above the top of the buffer	No limit
Within fourth quartile of buffer	60%
Within third quartile of buffer	40%
Within second quartile of buffer	20%
Within first quartile of buffer	0%
Below the buffer	0%

32. Under the proposed CCB, an institution reporting a profit for the most recent financial year will be allowed to raise additional capital in order to reduce the constraints on eligible distributions outlined in Table 4, subject to the approval of the Bank. The additional allowable distributions will be equal to the amount of additional capital raised by the reporting institution.

33. Reporting institutions intending to make distributions will be required to perform a full assessment of their CET1 Capital and Total Regulatory Capital levels in order to uncover the impact of the proposed distributions. In the event that the proposed distribution will have an adverse impact on the institution's ability to meet the minimum CAR, then the institution should not make any such declaration on distributions.

34. Under the proposed CCB framework, reporting institutions will be expected to submit a summary of all assessments of CET1 Capital and Total Regulatory Capital levels as referenced above to Bank of Jamaica.

C. NOTIFICATION REQUIREMENTS

35. Under the proposed CCB framework, reporting institutions will be required to immediately notify the Supervisor of any intention to draw on the CCB for the purposes of absorbing losses in response to any idiosyncratic or systemic financial or economic stress.

36. Reporting institutions will be expected to perform the necessary due diligence to ensure that distributions do not harm the financial condition of the entity under the proposed CCB framework. In addition, reporting institutions should inform the Supervisor of any intention to make distributions if the TCAR of the institution falls within the CCB range.

D. REBUILDING THE CCB

37. Under the proposed CCB framework, reporting institutions will need to present a detailed plan within 90 days for rebuilding the buffer after falling within the CCB range during normal times. Reporting institutions will have the burden of proof for satisfying the Supervisor of the viability of the plan and the appropriateness of the timeframe specified.

38. The Bank will allow for flexibility in the timeframe for rebuilding the CCB during periods of idiosyncratic or systemic financial and economic stress which precipitate the drawing down of capital buffers. Under such conditions, reporting institutions will be required to rebuild the CCB within a reasonable timeframe as determined by the Supervisor.

39. In the event that the regulatory capital level of a reporting institution falls within the CCB range, the institutions will be required to provide the Supervisor with a full assessment of its capital adequacy position, the actions taken and will be taken to rebuild the CCB, and the length of time required to implement such measures.

40. Bank of Jamaica will reserve the authority to impose limits on the timeframe for rebuilding the CCB in the event of either a planned draw down on the buffer or an unplanned fall into the CCB range, as deemed necessary.