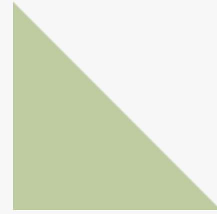

THE CAPITAL CONSERVATION BUFFER (CCB) UNDER THE BASEL III CAPITAL ADEQUACY FRAMEWORK

FREQUENTLY ASKED QUESTIONS

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INTRODUCTION

1. Bank of Jamaica ("the Bank") issued a consultation Paper ("CP") in June 2023, inviting feedback from the industry on the proposals for implementing the Capital Conservation Buffer under the Bank's Basel III Capital Adequacy Framework[1].

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

CONSULTATION FEEDBACK

3. Key and frequently asked questions received from the industry, as well as the responses to those questions, are summarized below.

4. Following this consultative process, the Bank will finalize the Basel III Pillar I Omnibus Capital Adequacy Regulations, including the capital buffers, that will eventually replace the Banking Services Act (Deposit Taking Institutions) (Capital Adequacy) Regulations, 2015.

5. The period until the draft Regulations are sent for promulgation will act as an extension of the consultation process. Interested stakeholders may provide further questions and/or proposals regarding the information provided in this document or otherwise, promptly, by email, to fisdmailbox@boj.org.jm.

These frequently asked questions will be made available on the BOJ's Website. © Bank of Jamaica, 2024. All rights reserved.

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[1] Consultation Paper on the Capital Conservation Buffer

CCB Composition, Minimum Requirements

Question 1. Will the BOJ consider increasing the CCB minimum requirement above 2.5%?

Upon implementation, the CCB minimum requirement will be set at 2.5%. However, Bank of Jamaica maintains the authority to vary the CCB minimum requirement between 0% and 2.5%. Notwithstanding this, decisions to vary any of the capital buffers will be preceded by an official notice. This approach will allow institutions sufficient time to adjust institutional capacity and strategy in order to meet the updated requirement.

Question 2. The capital adequacy requirement of 10% under the Pillar I capital adequacy framework is already above the current Basel III requirement of 8%, and has proven to be very effective during times of stress (e.g., the 2008 financial crisis as well as the recent covid-19 pandemic). Why is the capital conservation buffer necessary given that this will likely place additional pressure on a DTI's capacity to expand credit and achieve ongoing growth objectives?

Bank of Jamaica is cognizant of the additional capital requirements that will be imposed by the introduction of the CCB under Pillar I of the Basel III framework. However, note that the Bank has calibrated the CCB whilst considering conglomeration and interconnectedness in the Jamaican financial system. In the context of ever evolving risks and since the minimum capital requirements represent a floor on the capital levels that an institution should maintain during normal times, institutions should embrace risk-centric approaches by maintaining additional buffers above the capital adequacy ratio ("CAR") to absorb losses while continuing to conduct business as normal. Furthermore, while the minimum CAR will be higher than the Basel III minimum, the overall total capital adequacy ratio ("TCAR") is comparable to the total minimum capital requirements, which include capital buffers, across jurisdictions.

Question 3. When will the CCB become effective?

In order to facilitate a smooth transition to the full minimum CCB requirement, the Bank is utilizing a five (5) year plus one (1) year phase-in arrangement for transitioning to the minimum ratio of 2.5%. Under this arrangement, the CCB will be set at 0% for one year. Thereafter, the CCB minimum requirement will be increased by 0.5% each year, for 5 years, up to the full minimum of 2.5%. The transition period will commence after the completion of the legislative process, through which the CCB will become binding regulations. Institutions are therefore encouraged to proactively align regulatory capital with the forthcoming minimum capital adequacy requirements while maintaining balance with business objectives.

Question 4. Can the CCB be comprised of other forms of capital other than CET1 Capital?

No. The purpose of the CCB is to absorb losses immediately as they occur while allowing the institution to continue normal operations. Therefore, the CCB is solely comprised of CET1 Capital, which is designated for this purpose. In contrast, ATI and Tier 2 Capital must undergo some process of conversion or write-down in order to be loss absorbing.

Question 5. Being a small banking jurisdiction, the 2.5% CCB minimum requirement could have significant financial impact on DTIs given the time and cost needed to source capital to meet the buffer requirement. Impact on the country's economy could be far reaching. Can the implementation period for the CCB be extended to allow DTIs more time to obtain more regulatory capital?

The Bank is confident that institutions will be able to meet the CCB requirements during and after the transition period based on the general compliance of the industry with the current CAR, as well as quantitative assessments which projected the amount of capital DTIs would need to raise, if any, to fully meet the CCB minimum requirement.

Notwithstanding the above, the Bank will maintain flexibility in the phase-in schedule if material changes in market conditions impact capital accumulation.

Question 6. What are the specific criteria and processes for determining when reporting institutions can draw on the CCB?

It is the Bank's expectation that institutions will undergo active and prudent management of capital risk. Institutions will be entrusted with the flexibility to draw on the CCB at any time to absorb losses, subject to the proposed restrictions on distributions when the TCAR falls within the CCB range (see Table 4 of the CP). In the event that the

regulatory capital of an institution falls below the minimum CAR+ systemic risk buffer ('SyRB") requirement, then section 52 of the BSA will apply.

There is no contemplation of a supervisory approval process for an institution intending to initiate drawdowns on the CCB. Instead, the Bank requests that institutions notify the Bank of any such intention to draw on the buffer and provide an explanation for the intended action.

Nonetheless, the Bank reserves the authority to disapprove requests for drawdowns on the buffer if such action poses a threat to financial stability.

Distributions under the CCB Framework

Question 7. Distributions are defined in the Capital SSP as including dividend payments, share buybacks, discretionary payments on other Tier 1 Capital instruments, and discretionary employee bonuses. What categories of bonuses will be included in the definition of distributions that can be restricted under the CCB framework?

Under the CCB framework, there will be restrictions on discretionary distributions for institutions falling within the CCB range. Discretionary distributions are those made at the sole discretion of the employer, including bonuses. The categories of bonuses that may be restricted under the CCB framework include distributions of profit, whether in cash or kind, to executives or managers. One benefit of reducing discretionary distributions of earnings for institutions within the CCB range is that these restrictions provide an opportunity to rebuild capital buffers. For completeness, non-discretionary bonuses are those that are pre-emptively linked to meeting predetermined targets or requirements, such as sales, attendance, and production targets.

Question 8. Will institutions reporting a loss for the most recent financial year be allowed to make distributions?

Institutions reporting a loss for the most recent financial year will be allowed to make distributions from existing retained earnings, provided that the institution's capital levels are above the TCAR and any such payment does not cause the institution to fall within the buffer range (i.e. the institution must be meeting buffer requirements).

Question 9. When will the limits on distributions be effective?

Limits on distributions will be applicable at the effective date of the CCB, that is, upon the completion of the legislative process for the Basel III Pillar I Omnibus Capital Adequacy Regulations.

Question 10. Why are eligible distributions being restricted to net income over the last four (4) quarters?

The limits imposed by the Bank on eligible distributable items to the last four quarters of earnings is motivated by the safety and soundness principle that (discretionary) distributions to shareholders should not be funded by a reduction in regulatory capital through accumulated retained earnings. There is an exception to this rule when an institution's capital level exceeds the TCAR, and any such distributions would not cause an institution to fall below the buffer requirements.

Question 11. Will institutions be required to ask for supervisory approval to monetize portions of the CCB in order to absorb losses?

Institutions will not be required to ask for supervisory approval prior to monetizing portions of the CCB. However, institutions must notify the Bank of any intention to monetize portions of the CCB to absorb losses and provide an explanation for any such usage of the buffer.

Outside periods of idiosyncratic, financial, or economic stress, it is the Bank's expectation that institutions will operate above the CCB range. Institutions are not prohibited from operating within the CCB range, but must be cognizant of the attendant restrictions on distributions set out in table 4 of the CP.

Notwithstanding the above, the Bank will provide sufficient notice to the relevant institutions when idiosyncratic or systemic stress is determined. In such scenarios, institutions will be advised of accompanying forbearance, if any, regarding operating within the CCB range.

Early Warning Threshold

Question 12. Will the early warning threshold specified in section 110 of the Banking Services Act, 2014, be changed by the implementation of the CCB?

No, the early warning threshold of 1 percentage point above any of the prescribed capital levels or any other amount prescribed by the Bank will remain unchanged. The CCB is a protective layer of capital above the minimum capital adequacy requirement, rather than an increase in the capital adequacy requirement.

Question 13. When will an institution be considered to be experiencing statutory impairment of capital?

The introduction of the CCB will not change the early warning thresholds applied to any institution. At the effective date of the CCB, the Bank will consider regulatory capital levels below the CAR + SyRB in normal times to be statutory impairment of capital. The provisions currently under section 52 of the BSA will therefore apply when an institution's regulatory capital falls below the early warning threshold (i.e., CAR +SyRB).

Normal Times & High Credit Growth

Question 14. What do you mean by high credit growth?

High credit growth is defined in the Standard of Sound Practice on Minimum Capital Requirements as referring to both excess and excessive credit growth. Excess and excessive credit growth are measured through the credit to GDP gap indicator. The credit-to-GDP gap measures the extent of deviations of credit relative to GDP from its long-term trend and is used to assess credit cycles within an economy. Generally, large positive values can indicate excessive growth in credit relative to the growth in the economy. Periods of sustained excessive asset price growth that are not aligned with fundamentals have typically preceded sharp asset price declines.

Quantitatively, excess and excessive credit growth are defined as scenarios where when the credit to GDP gap is between 2% and 10%, and where the credit to GDP gap is higher than 10%, respectively.

Question 15. What does 'normal times' mean?

The current approach is to apply the CCB minimum requirement of 2.5% uniformly to reporting institutions in normal times. As outlined in the SSP on Minimum Capital Requirements, "normal times" is defined as periods or conditions where there is no high credit growth (i.e. credit to GDP gap below 2%). It should also be noted that, under paragraph 11 of the consultation paper, the Bank reserves the authority to prescribe differentiated minimum CCB requirements in accordance with the risk profile of a reporting institution.

Other Capital Requirements

Question 16. Will the primary ratio as defined in the Banking Services (Deposit Taking Institutions) (Capital Adequacy) Regulations, 2015, be maintained?

Yes, the primary ratio will be maintained at 6%, calculated as the capital base divided by total assets. The Bank retains the authority to vary this ratio as deemed necessary.

Question 17. How does the CCB factor into the Twin Peaks framework that has been proposed? Will this eventually be a requirement for all financial entities?

The scope of application for the CCB is set out in section 1c of the consultation paper, and includes DTIs (and FHCs upon the operationalisation of the FHC prudential framework). The prudential frameworks for institutions that will be brought under the direct supervision of Bank of Jamaica will be determined at the appropriate time. Institutions can be assured that the forthcoming prudential framework for each type of institution will be subject to periods of consultation. During each consultation process, institutions will be able to provide feedback so that each framework accounts for particular nuances within each type/category of regulated institutions, as well as the broader Jamaican financial system.