UWI Mona Banking League 5th Anniversary Celebrations Meeting

Issues facing the financial sector

Address by

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Good afternoon, ladies and gentlemen.

I am pleased to participate in UWI Mona Banking League's 5th Anniversary Celebrations. I am aware that the League was formed under the guidance of my good friend, Professor Claremont Kirton, who also had a hand in starting the banking and finance degree programme six years earlier. I congratulate the Professor and all the faculty and students involved in the continued success of both initiatives.

I also wish to thank the League for inviting me to speak on issues facing the financial sector as well as the role of university students and graduates in a dynamic financial landscape. This is the second time in a few months that I am speaking to a UWI Mona student organisation and so I am starting to feel more at home. I am especially pleased at your interest in these matters as it helps to keep us relevant.

Before sharing my thoughts, I ought to remind you that Bank of Jamaica's website contains useful information on a range of issues facing the financial sector. It includes speeches, the Bank's annual reports, financial stability reports and quarterly monetary policy reports and, along with other publications, it publishes a wealth of data that can be of use to students and researchers on issues relating to the financial sector. I would also like to encourage you to look at the Bank's research papers and consider how you can participate in advancing our research agenda.

Today, I want to focus on the risks associated with insufficient structural liquidity or excessive maturity transformation in the financial sector and to highlight some of the initiatives by Bank of Jamaica and the Financial Services Commission to address the issue.

Maturity transformation is a core business for deposit-taking institutions ("DTIs"). This is the business of accepting deposits, which can be claimed at short or no notice, and lending to individuals and firms for a period much longer than the average tenor of the deposits. This function is important because it delivers credit to consumers and producers which in turn delivers economic growth and job creation. Clearly this is a good thing, but it comes with a vulnerability:

it leaves financial institutions exposed to the risk that depositors demand their money back before the loans are due for repayment thus creating a squeeze on liquidity. An extreme example of this is the classic run on deposits that can occur during a banking crisis.

In order to mitigate this risk, deposit-takers in most countries have traditionally been required by central banks to hold a portion of deposits in reserve (cash reserves held at the central bank and liquid asset reserves held in risk-free short-term securities) and meet specific liquidity risk management standards. However, as was seen in the advanced economies during the global financial crisis, in certain conditions system liquidity can effectively disappear so suddenly that the traditional regulatory measures will fail. The crisis revealed the need for enhancements to liquidity risk management practices and requirements on the part of both financial institutions and their supervisors.

New Liquidity Risk Standards and Management Tools

New liquidity monitoring tools and requirements have been introduced under the Basel III accord. These include requirements for liquidity coverage ratios and net stable funding ratios. Supplementing these is a renewed focus on the central bank's traditional and unique role as a lender of last resort (LOLR). In this context, central banks have been establishing or enhancing committed liquidity facilities (or CLFs) which move them beyond the traditional role of lender of last resort.

At Bank of Jamaica, we have taken heed of these developments and, driven also by analysis of our own local conditions, last year introduced the Enhanced Liquidity Management Framework. A key element of this was the introduction of committed liquidity facilities for deposit-taking institutions. These facilities were introduced against the background of the reduction in available liquid assets occasioned by the two Government of Jamaica debt restructuring exercises in 2010 and 2013 and the government's shift to modernised treasury management practices with the introduction of a single treasury account and the centralised treasury management system. The committed liquidity facilities presently available from BOJ are a weekly auction of two-week repurchase agreements and a standing overnight liquidity facility (the SLF). Deposit-taking institutions freely bid for two-week funding at the weekly auctions while funding under the SLF is accessed at will by deposit-takers without limit at rates set by the BOJ. Also, longer term liquidity-providing instruments have been made available from time to time for special purposes and at special rates.

Deposit-taking institutions are not the only institutions who are involved in maturity transformation. Securities dealers, who are regulated by the Financial Services Commission, also undertake this type of business where they use repurchase agreements to borrow short-term deposit-like funds from retail investors to buy long maturity government securities. We call this the "retail repo" business.

In order to mitigate against potential systemic vulnerabilities and to safeguard the interest of retail repo clients, the authorities advanced efforts in 2015 to phase down the retail repo business model and to enhance the prudential requirements for securities dealers. All securities backing retail repos were transferred to a single trust arrangement in August 2015. Barriers to the establishment of collective investment schemes (that is, unit trusts and mutual funds), a suitable alternative to the retail repo product for investors, have also been removed.

Bank of Jamaica plays a central role in ensuring the stability of the entire financial system. Last month, parliament passed amendments to the Bank of Jamaica Act which assign this responsibility to the Bank and establish a statutory committee of financial sector regulators and policy-makers called the Financial System Stability Committee (or FSSC) which is chaired by the Governor of the Bank. The amendments also introduce a statutory basis for Bank of Jamaica's macroprudential oversight of the financial system. The Bank's macroprudential role entails monitoring and assessing systemic risks affecting Jamaica's financial system and can involve the use of macroprudential tools, when necessary, such as additional capital adequacy and liquidity requirements for financial system participants.

In strengthening backstop defences against potential threats to financial stability, BOJ recently established the Emergency Liquidity Facility (ELF). This facility is designed to offer resources promptly, at the discretion of the Bank, to temporarily illiquid but solvent deposit-taking institutions and securities dealers. Whereas, under routine committed liquidity facilities, lending is backed only by high-quality securities, lending under the ELF may need to be secured by a broader range of collateral, including securities that are subject to greater credit, market or liquidity risks. As a result of this possibility and because some of the institutions do not fall under the Bank's direct regulatory oversight, Bank of Jamaica will require financial institutions to provide liquidity recovery plans that specify credible measures that they will take to safeguard and strengthen their liquidity positions in a crisis or a period of enhanced vulnerability.

Role of University Students in a Dynamic Financial Sector Landscape

Ladies and gentlemen, the global financial crisis has exposed new and intricate sources of vulnerability within the local and global financial sector. In addition, complexities have grown in the relationships between financial institutions and markets and with the introduction of new types of financial products and institutions.

Against this backdrop, you, the current students of economics and finance, will have a role to play in the future of Jamaica's financial sector so that it can make the maximum contribution to economic growth and development. I encourage the UWI Banking League to forge ever deeper relationships with the industry. Continue to foster the development of experts who are able to apply relevant theories and up to date practices in assessing financial sector challenges and formulating timely and effective solutions. Financial risk management and other quantitative skills and a strong theoretical grounding are needed as much today as they have ever been. University students who combine these skills with a sense of purpose and a strong commitment to integrity in all of their actions will become valuable financial sector executives in the future. I also hope to see some of these future experts coming to Bank of Jamaica and other agencies involved in financial sector oversight to keep us on the leading edge of regulatory practices.

Thank you.