

**SPEAKING NOTES FOR
PRESENTATION BY DR. THE HON. OMAR DAVIES
AT CAIB CONFERENCE
HALF MOON HOTEL AND RESORT
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Introductory Thoughts

1. I am pleased to participate in this function for a number of reasons:
 - a. Firstly, it offers me an opportunity to share a few thoughts from the perspective of someone who has had to deal “hands on” with recent problems in the financial sector in Jamaica.
 - b. Secondly, despite globalization and the blurring of walls between countries, with the easy movement of capital across borders, one has to consider whether there is still a place for strong indigenous local and regional organizations.
 - c. Thirdly, having associations at a regional level seeking to improve the effectiveness and management of entities makes

the work of regulators easier. This is easily borne out if some of the objectives of the association are achieved:

- i. To foster a spirit of goodwill and camaraderie among the indigenous banks of the region with a view to solving their common problems through understanding and co-operation;
- ii. To assist in and influence the development and improvement of the codes of conduct and standards of the Banking Industry in the Caribbean;
- iii. To provide a forum for the exchange of ideas and information on various aspects of operations in order to broaden the scope and knowledge of its officers;
- iv. To assist its members wherever possible in the areas of training, management, systems and processes inspection or any other related areas of operation.

The Importance of the Financial Sector

2. Economic Development Theory recognizes the critical role that *financial intermediation* plays in the economic development of countries. To the extent that it facilitates the efficient movement of funds from savers to investors in both the private and public sectors, there is no doubt that the financial sector – and more importantly banks, which are usually one of the biggest players in the sector – plays a pivotal role.

3. Proper stewardship of these resources becomes important because of the important role played and the volume of the funds involved. Improper management of such funds can have significant costs to an economy, as we have seen.

4. While not diminishing the important role of the regulators in ensuring the soundness of the system, in many cases the regulators are playing “catch up” given the innovations and development of new products, e.g. derivatives, and the blurring of the differences between financial institutions and institutions seeking to take advantage of these factors.

5. The role of the regulators is made even more difficult if other responsible “checks and balances” in the system do not function appropriately e.g. boards of directors and accountants.

6. I do not need to remind you that this is one of the major reasons for the recent upheavals in the United States and was partially responsible for the problems in Jamaica.

Thrust of Presentation

7. For the remainder of the presentation I want to focus on the following areas:
 - a. The concerns of the authorities and regulators;

 - b. The concerns of financial sector interests;

 - c. Challenges/Pressures Faced by Regional Indigenous Banks;

- d. Brief look at Jamaica's economy; and
- e. Some concluding thoughts.

The Concerns of Authorities and Regulators

- 8. Regulators, because of recent events in the financial sector, have become even more concerned about regulatory standards because of the number of countries, which have experienced significant problems, most recently the Dominican Republic.
- 9. The main issues which arise from these concerns can be summarized as follows:
 - a. Should standards in developing economies be even more stringent than the BASLE standards, given greater vulnerability of financial institutions to shocks?

- b. Should there be one agency which monitors the whole financial sector or should there be separate regulatory bodies for deposit and non-deposit taking institutions?
- c. The accuracy and frequency of reporting data
- d. The fit and proper criteria to be met by persons operating financial institutions.

10. Jamaica's position, against the background of our recent experience, generally goes beyond BASLE standards. We are more conservative. This we believe to be necessary at this time to build on the rehabilitation and rebound in confidence in the financial sector.

11. Generally, we are seeing better financial indicators for most institutions including: better capitalization, better profits and reduced delinquent loans despite more new loans being made by several institutions.

12. Jamaica has opted for the model whereby there is a different regulator for deposit and non-deposit taking institutions. The strength of the other model is the comprehensive oversight by one agency. However, this is overcome in the alternate model by the exchange of information between the Bank of Jamaica (BOJ), the Financial Services Commission (FSC), the Ministry of Finance and Planning (MOF) and the Jamaica Deposit Insurance Corporation (JDIC). Moreover there is a Regulatory Council, consisting of all the above institutions, which meets regularly to achieve comprehensive oversight of the system.

13. Whatever the model is, what is critical is that the regulators have a complete picture, with sufficient knowledge about the similarities, differences and risks of the various financial entities and so that “fire walls” exist, where conglomerates operate, so that there is reduced possibility of contagion when one area has problems.

14. The problem is compounded by the fact that for many products being offered by non-deposit taking institutions, there is a blurring of what constitutes a deposit. In addition because of globalization, many

institutions are now investing funds overseas which require additional standards to ensure financial soundness, quality investment and no over-exposure.

15. We have ensured that the “fit and proper” criteria are uniform for both regulatory agencies and the institutions they supervise.

16. In terms of the specifics of the banking system we consider the following as the three critical elements

- a. Banks should be operated and maintained as sources of funds for borrowers;
- b. Depositors should have some reasonable level of guarantee by the government against loss (this is addressed by the JDIC); and
- c. There should be competition amongst providers of lending and deposit services.

17. Achievement of these three elements should safeguard both the banking system and most individual banks from collapse, except in cases of significant macroeconomic shocks.

Concerns of Financial Sector Interest

18. Banks, along with other financial institutions, generally require an environment where the following are some of the major desirable characteristics of the operating environment:

- a. Sound predictable macro-economic policies;
- b. Regulatory environment where the rules are clear and transparent;
- c. Reporting requirements are not onerous, duplicated and complicated;
- d. Attractive returns can be achieved.

19. The Government of Jamaica, even before problems in the financial sector surfaced, clearly recognized the correlation between macroeconomic stability and developments in the financial sector. To this end, the government at the beginning of each fiscal year, presents macroeconomic targets for the year and gives regular updates of performance vis-à-vis targets. Moreover just two weeks ago, local financial sector interests were included in our regular conference call on economic development to update external financial institutions and external holders of Government of Jamaica bonds.

20. Both the BOJ and the FSC are in regular dialogue with institutions they are responsible for monitoring. In addition, we have sought to ensure, where new regulations are to be enacted, that dialogue is held with all the relevant parties prior to implementation. Usually also, a transitional period is allowed for institutions to come into conformity with the changes.

21. We have also sought to ensure that the reporting requirements are adequate to facilitate monitoring, but not onerous.

22. Here, there is a meaningful role for the CAIB to play.

23. Unlike their foreign counterparts, the average indigenous bank does not have access to the well-established banking infrastructure of an overseas parent. Against this background the role of CAIB assumes even greater significance in providing the **support mechanisms and infrastructure to enable indigenous banks** to successfully meet the challenges of a changing global environment. Examples of such mechanisms would relate to information sharing through data bank services and other means, training, knowledge transfer, standard setting, the issue of guidelines, best practices and so on. CAIB may also wish to consider serving as a catalyst for more informed risk management by promoting and facilitating the establishment a regional credit rating agency.

24. Promotion of **sound corporate governance and risk management** amongst its constituents must be a prime goal of CAIB. These are critical components of prudent banking and are evidenced by the existence of competent and effective Boards of Directors and Executive Management, strict adherence to laws, regulations and

other governing statutes, a comprehensive and effective risk control environment, and efficient Management Information Systems. These are of particular importance in an environment where banks are constantly developing new product offerings and undertaking previously unfamiliar risks.

25. In fact with the aim of curtailing the contagion risks arising from certain non-traditional banking activities (i.e. managed funds operations) being undertaken in the Jamaican market, in the interest of protecting depositors' funds and promoting the soundness of the sector, the Authorities recently effected legislative changes aimed at **segmenting banking operations from managed funds** and securities dealing activities. Under the new requirement all deposit-taking licensees were required to transfer the segmented managed funds portion of the business, to a separate legal vehicle. The point should be made here that separation is just a first step in the containment and management of risk across the Jamaican financial system.

26. Establishment of a robust support framework is also of critical significance when viewed against the background of international

pressures on banks' operations since 9/11, brought on specifically by the imposition of more stringent requirements with regard to **combating terrorism financing and money laundering**. Under new legislation being enacted across the world, banks and all financial intermediaries are being required to implement effective monitoring systems for preventing/and or detecting the infiltration of the banking system by terrorist groups/individuals, and money launderers. Collaboration on approaches and systems used to address the new requirements should be encouraged and the possibility of cost sharing explored. *Another area of co-operation in which CAIB can play a part, is in the sharing of relevant information.*

Challenges/Pressures Faced by Regional Indigenous Banks

27. Indigenous banks are increasingly challenged to adapt to the changing demands of financial markets in order to assure their continued viability. Some challenges faced by the indigenous bank today are:

- a. **Globalization** and the **lowering of trade barriers** in international financial markets;

- b. **Competition from large international financial conglomerates** – those operating extra-regionally as well as those with business presence in Caribbean markets;
- c. Financial **dis-intermediation** reflected in some countries, in exponential growth in the non-deposit taking financial services sector resulting in diminishing market shares for the deposit taking banks. This has led to a tendency on the part of banks to venture into new areas of risk in an effort to build customer base, maintain market share, and preserve profit margins;
- d. New and emerging international standards, particularly those relating to **capital requirements** which have the potential to create an uneven playing field for indigenous banks in relation to their international counterparts. Emerging international regulatory capital standards may result in large international banks with sophisticated internal risk assessment models, having comparatively lower capital requirements than banks operating with simpler internal systems;

- e. **Increased operational costs** of banking particularly as it relates to implementing the necessary measures to mitigate against the facilitation of terrorism financing and money laundering.

28. In fact, when I received your invitation, my first question was why an association of regional indigenous banks and not a Caribbean Bankers Association? In the framework of the above challenges, globalization and competition in particular, the market does not recognize or make any concessions for indigenous banks. As our own experience in Jamaica has clearly demonstrated, what the local, regional and international markets do distinguish and demand is well run institutions with robust risk management and resource infrastructures, which are able to operate soundly and compete effectively.

29. Globalization is forcing small economies to forge operating alliances, whether in loose associations or stronger structural ties. In the context of the CSME and given that all regional banks have a real, vested interest in working amongst themselves as well as partnering with

their respective governments in fostering a stable economic environment for sustainable growth and development in the region, I continue to look forward to the establishment of a Caribbean Bankers Association.

The Banking Sector and the Jamaican Economy

30. There is no chance that I would have such an opportunity and not seek to make some points about the Jamaican economy and role which the banking sector, in general, and the indigenous banks, in particular, can play in economic expansion.

31. Interest rates in Jamaica, both nominal and real, are significantly higher than in the rest of the Caribbean. This has less to do with inflation and more to do with the fiscal deficit. The supreme irony is that the large fiscal deficit resulted from the crisis in the financial sector.

32. The GOJ took the decision to protect depositors, pension funds and insurance policy holders. There are no regrets in that regard, but that came at a significant cost, specifically 40% of GDP.

33. We have announced a programme to reduce and eliminate the deficit over a three-year period. This exercise necessitates running primary surpluses in the range of 11-13% of GDP per annum.

34. This will be difficult but we have little choice. Given the need to finance the deficit, the GOJ has no option, in the short term, but to borrow at the prevailing high interest rates.

35. In such a situation there are three implications for banks:

- a. They stay with “safe” government paper;
- b. Profitability comes easier than in countries with lower rates;
and
- c. There is need for caution lest inefficiencies creep in.

36. When the deficit is eliminated, it will require harder work to maintain the levels of profitability to which banks operating in Jamaica have become accustomed. You need to search out and support viable private sector projects as dependence on government paper, paying high interest rates, is not a sustainable long-term option.

37. I am not for one moment advocating the support of marginal projects to demonstrate nationalism. Adherence to rigor in project analyses must never be neglected. However, those institutions which begin developing a long-term strategy to shift the bulk of their business to the private sector will be in the best position to respond to the opportunities when they arise.

38. The signs are positive. There has been positive growth over the past four quarters and the prospects for the medium-term are good. Two sectors lead the way: bauxite/alumina and tourism.

39. Whilst the former is externally financed in the main, there are opportunities to support complementary activities. In the case of

tourism, 2003 will be a record year for arrivals and the investments slated for the next 2-3 years provide financial institutions with an opportunity to be both a supporter and a beneficiary of the significant growth which will be coming.

Concluding Remarks

40. Given the intense competition in the regional and international financial sectors as well as the necessary imposition of stricter regulatory guidelines within each jurisdiction, banks need to be ever cognizant as to whether they possess **the critical mass to survive** in the changing environment. Mergers and amalgamations may be necessary to achieve economies of scale and increased competitiveness. In Jamaica, the indigenous banking sector has experienced considerable consolidation since the mid-1990s evidenced by marked reductions in the total number of commercial banks (from 9 in 1997 to 6 presently); non-bank deposit-taking entities (27 to 7); and building societies (10 to 4). The transformed financial landscape now reflects fewer but **larger and stronger**

institutions with the critical mass to promote viability in the future marketplace.

41.However, size is only one of the critical fundamentals for success.

Importantly, the adoption of prudent risk management systems within an environment where bank managements embrace a collaborative approach to ensuring stable financial systems would demonstrate enlightened self-interest. Our collective experiences underline the fact that a confrontational approach to necessary supervisory guidelines, which unfortunately we have seen in so many jurisdictions at different times in our history, is not conducive to stable systems.

42.I hope that, besides seeking to fulfill the objectives you have stated for your association of indigenous banks, that there can indeed be associations of a *concrete nature*, that enhances your ability to compete locally, regionally and even internationally.

I thank you.