

November 10, 2009

BOJ

Mr. Hylton:

As Regulator, can the Bank give any reason for the cause of the failure of some of these institutions resulting from the question of say, a meltdown in the 1990s?

Audrey Anderson:

Yes, and I think there were a number of factors that were in play at the time. Some were macro-economic in nature such as acceleration of asset and price inflation and in fact, we reached a period of height in inflation in the early 1990s following the

Answer: Between 1990 to 1991; 1992

Question: And to put it in context you said, the following liberalization...

A: Following the liberalization

Q: When was the liberalization?

A: The liberalization of the FX market was 1990.

Q: Well continue. You started with macro-economic factors and talked about height in inflation

A: Right. And looking more from regulatory perspective we had issues of an extremely outdated legislative framework governing the banking sector and to a lesser extent the insurance sector. Suddenly the legislation covering deposit-taking entities lacked key regulatory powers and sanctions. And so, just to give an example at that point if there was a problem in deposit-taking entity the powers available at that point resided in the Minister because at that point the Central Bank had obviously no sanction powers in relation to the licensing which he supervised; the powers available to the Minister were at two extremes. You either could appeal to the banks to improve their operations through more prudent behaviour by the use of moral suasion or you went to the other extreme where the Minister had the power to revoke the licences. It was not a very effective way of managing a financial system because for less significant issues you certainly wouldn't want to use the final hammer of licence revocation so just the sketch, legislative framework was extremely deficient. There was also over that period, leading up to that period there had been phenomenal growth in the number financial entities which in our view, in the Central Bank's view led to a situation of over competition where the system was actually overbalanced and it lead to a severe strain on the managerial expertise in the banking system. You had a situation where numerous entities were scrambling for small parts of the

banking pack so the most negative effects of over-competition were becoming obvious. This also created a severe strain on the regulatory resources of the Central Bank. There was also the issue of regulatory arbitrage because at the time there was weak regulation in other parts of the financial system. In some cases weak; in some cases non-existent. For instance, the Building Society really had no formal supervisory apparatus. There was no control from the standpoint of government appointing agencies to oversee their operations. In the case of the insurance entities there was the Office of the Superintendent of Insurance but that agency and it operated as a department of the Ministry of Finance but that agency lacked resources to deal with the issues that were arising with significant.

Additionally.....

Q: Before you leave that. Could you explain for the moment what you mean by Regulatory Arbitrage?

A: Okay, I am sorry. I forgot that I had mentioned it. Regulatory Arbitrage essentially means that entities would move some of the questionable activities of areas which were under significant scrutiny, the areas that were less rigorously scrutinised. So for instance, banking entities that the Central Bank had concerns with in terms of specific parts of their activities, on the basis that since the regulatory oversight in the insurance sector was less stringent a lot of those questionable activities were moved into the insurance entities within the financial groups that they operated in, and you will recall that I already referred to the emergence of massive financial conglomerates. The effect of that was a lot of these questionable activities were removed from the oversight of the Central Bank while we did have concerns we had no legal reach to the insurance companies at that point.

Q: You mentioned Building Societies and Industrial Provident Groups; did any of these problem groups also have entities in those sectors?

A: There were some problems IMPs. To be honest Mike, at this point I am a little hazy on the actual composition of some of the groups. Building Societies – because at the time Building Societies were not subject regulation, there was – let me say, there was at least one financial group that had a Building Society which was being used to deal with transactions which could not be scrutinised. That entity .....

Q: two of the most problem groups were Blaise and Century?

A: Exactly. Blaise certainly had a Building Society within that group.

Q: If you don't remember we can move on

A: Right

Q: We are going through the factors that there may have been the reasons for the failure of institutions, any others?

A: As a sketch, some of the broad system issues; but certainly there were specific characteristics within the individual entities, I will name a few. We saw excessive risk capital and very poor management of corporate governance strategies We saw conglomerate structuring, which I had referred to before, done specifically to avoid scrutiny by the regulators. We saw that eagle Group where the actual ownership structure of the group was deliberately changes so that the Central Bank could only go so far and in fact, the ownership of the group was moved outside of the Jamaica jurisdiction. And I do believe that in the full Report we have provided very detailed comment on that particular entity. We saw reckless and also irresponsible banking practices. There were significant non-arm length transactions between connected parties. This was a problem because in a lot of instances these were facilities that were not only granted licences on questionable bases but the credit facilities were not being repaid in relation to the original term of the loans. There was significant misrepresentation of capital positions and this was a critical problem the Central Bank faced because in assessing the need for additional capital we had situations where entities would purport to have capital injection by various means which after digging into the entities ----- going on cite and digging into the entities it was found that these were mere paid entities and did not reflect real injection of capital. And I will give an example.

There was what we call a 'buddy loan' facility where one entity; the owner of one entity would purport to inject capital in another unconnected entity but when the examiners would go into the entities and check behind-----and in fact, at one point our examiners almost become forensic auditors and that is a tribute to their insistence in getting to the bottom of some of the transactions----- what we found was that loans were given between the entities. Say one Merchant Bank would lend a loan to another and the incoming funds would be booked as the capital coming in and it was a really circular transaction where the endpoint was that the loans would cancel each other, no real capital would be injected into the capital. There are other instances where capital was purported to have been introduced by external parties and on checking it again, was found to be an accounting entry.

Q: External to the entity or external to the country?

A: External to the entity and also external to the country. There was an instance involving the Century Financing entities which again – it's fully detailed in the Report. Another problem that the Central Bank had was that even where it sought to get external auditors' confirmation that the capital injections, they were real, the auditors themselves were being flummoxed by the entities. We saw where one particular transaction where we were advised that capital had been injected and the auditor were ----we were asked to receive external confirmation that this was the case because by this time, we had realised that a lot of circular transactions were taking place. So this was one means of trying to ensure that the capital was real. Well, we did the auditors confirmation - we got it fairly quickly. The BOJ examiners went into the entity, I think maybe a week or two after we had received the external auditors' confirmation and when they looked on the accounting entries they saw that the same funds that the auditors had confirmed as having been introduced as capital had come in and had been booked in the morning and the funds had been sent back out the very same afternoon. There was therefore a significant problem that we also had with the external auditors because we certainly felt that their auditing techniques were certainly not assisting in ensuring that the entities were operating on a sound and prudent basis. And in addition to that we identified significant conflicts of interest at least in one case and I think that is a matter of record in the case of Century where the auditor in fact was not only the appointed external auditor for the company but the auditor was also passing actual accounting entries for the bank and there was also a very clear conflict of interest situation because the auditor was in receipt; the auditor and his personal companies were in receipt of significant loans which were also not being serviced and which were severely non-performing at one point.

Q: Were all these problems discovered by the bank before the failure of these institutions or were they discovered subsequently?

A: Several of the problems were discovered before. More detailed information was garnered after the entities had been intervened at which point the temporary managers would have full access to the record but I should indicate that certainly all the problems that were identified by the Central Bank and its examiners prior to the problems actually causing, leading to the intervention, all of these were substantiated by the reports of the temporary managers and in other instances by the reports of the forensic auditors who were contracted by the government to look into specific conditions of these entities following on reports made by Central Bank and following on recommendations made by the Central Bank.

Q: Were there any difficulties, any other reasons for the failures?

A: I would say that there was an overall very poor compliance culture within the banking system. There were several breaches of statutory direction planning; other statutory obligations and there were also delay in the closure of entities resulted from all the events leading up – and I should say that while the Central Bank made technical assessment as to the problems, the overall conditions, and made its recommendations as to actions, decisions were at certain points taken to delay intervention action and to give the entities and their shareholders and management time to take corrective action and in a number of cases to introduce additional capital. You will appreciate that when the Central Bank made recommendations for sever sanction or intervention by the Minister many of these recommendations when put to the entities by the Minister would have been severely resisted.

Chairman:

Excuse me. There was a morale malaise in the banking culture, was there one?

A: There was a moral malaise.

Chairman:

So what can we expect from rogues?

A: What can we expect from?

Chairman:

Rogues.

A: Well, I did not use that word. But am.....

Chairman:

I am using it.

A: I think the word is well used and I am ---well, there was the issue where entities would--- to coin a term 'loophole mine'. They would mine for loopholes in the law and they would use every loophole available not to do the right thing. And so, the problems instead of being addressed early did escalate in instances because the decisions were taken to allow entities additional time to meet the commitments that they undertook to meet. At times we were considering multiple proposals for capital injection, none of which materialised eventually. But all of these things caused time to run and with the situation not improving then the fundamental conditions of the entities were in fact worsening.

Mr. Hylton:

I think that may lead conveniently Mrs. Anderson, to the next question was asked, did the bank foresee the failure of some of those institutions? And I take it from your answers so far that the answer is yes. If so, what actions were to be taken to avoid this?

A: Well, as I pointed out earlier the bank conducts on going examinations of these entities and we report on the condition of entities not only to entities themselves but to the Minister of Finance. There were specific requirements of the banks and their Board and management to take corrective action and I have already detailed that in the majority of cases these requirements were not met. There were also specific recommendations made to the Minister for sanctions where this was assessed as appropriate and specifically in relation to the issues that were identified as weakness or areas of concern. The Bank also made very comprehensive recommendations for upgrading of legislative framework and some of this did take place in 1992 and more substantive amendments took place during 1996.

Q: You said the bank made some recommendations and there were some changes?

A: Yes

Q: Were the changes based on recommendations?

A: Yes. Many of the changes to for instance, the legislative framework were in direct response to the Central Bank's recommendation.

Q: You said that you made recommendations in relation to sanctions to the Minister?

A: Yes

Q: Did the Minister act on any of these recommendations?

A: In some instances, yes. And I would have to say in the final analysis all recommendations were in fact acted on because intervention action was in fact taken in relation to the specific entities. In several instances recommendations for issues of directions were taken on board. Issues of the assumption of temporary management of specific entities were in fact acted on and I think again.....

Q: Would you like to give us some examples?

A: Yes

Q: During the 1990s

A: Okay. During the 1990s temporary management was taken of Tower Merchant and Trust Bank and that was 1993. Blaise Trust and Merchant Bank were intervened by a temporary management in 1994. Consolidating Holdings which was a Blaise affiliate was intervened by the same route in 1995. Blaise Building Society also in 1995. First Metropolitan Union Society, 1996. Century National, the bank and the Building Society were intervened in 1996. And Workers Bank Corporate Merchant Bank and Capital Assurance Society, all of which formed part of Workers Group were intervened by the Minister in 1998.

Q: Under the powers in the new legislation?

A: Under the powers in the new legislation, by the new legislation.

Q: Were there any cases of intervention not by statutory power but perhaps, agreement?

A: Amm.....

Q: What happened for example, in the case of Eagle?

A: Eagle. Well, Eagle was not a straightforward case. Crown Eagle I think was taken over—by the time of the Crown Eagle event three of four major insurance companies had already made specific approaches to the government for massive financial assistance and the Eagle issue was by way of take over normal sale I think, for adoption, if my memory serves me correctly. But you used the word 'voluntary' and I am not sure that the word appropriately described the situation because by the time that happened nothing was voluntary. The commercial banks had run up significant overdraft at the Central Bank. Crown Eagle was in very dire straits and the merchant banks in very significant problems.

Q: Well I used 'voluntary' meaning not a statutory intervention.

A: Yes

Q: There were some of the entities which were failed which was subject to action to rehabilitate them, and perhaps we should go to the next question which asked what action if any, did the Bank take in relation to the failed insurance companies in order to rehabilitate them?

A: Well, one intervention took place and this took place in most instances via the assumption of temporary management. The role of

the Bank sort of changed and certainly the Bank would not have played a role in rehabilitation of the entities because the Bank was still supervisor of the entities so that would have been conflict of interest. The role was specifically the role of the temporary manager to assess the true condition and to take actions where necessary, to either rehabilitate or recommend a final closure of entities. So the role of the Bank at that point would have been very strictly interfacing with temporary managers to assess the loss and consider the best option for resolution, but certainly not a role for resolution, rehabilitation of the entities. We would have provided technical assessments and recommendations to the Minister of Finance based on the report of the temporary manager in relation to issues impacting on the viability of the business plan certainly that were being put forward and financial projections that were being put forward or on the matter of fitness and propriety of potential new owners that were being proposed for some of these entities. Now we would have had that continuing role to advise and recommend to the Minister. And of course, we would have continued to monitor the financial entities or the intervening entities because the temporary managers would have had responsibility for making reports on the financial conditions to Central Bank.