Commission of Enquiry
into the
Collapse of Financial Institutions
in Jamaica in the 1990s

The Jamaica Pegasus Hotel
51 Knutsford Boulevard
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Bank of Jamaica's
Responses to Questions

Contained in Letter dated 11 September 2009

29 October 2009

RESPONSES TO QUESTIONS FROM COMMISSION OF ENQUIRY

1. Does the Bank of Jamaica (hereinafter called "the BOJ") perform the functions of a Central Bank, insofar as the monetary policy is concerned?

Yes, as far as monetary policy is concerned the Bank of Jamaica (herein also referred to as "the Bank") performs the functions of a Central Bank consistent with the internationally accepted responsibilities of a **modern** central **bank.**

Section 5 of the Bank of Jamaica Act establishes the Bank of Jamaica's principal objects to include issuing and redeeming notes and coins, to keep and administer the external reserves of Jamaica, to influence the volume and conditions of supply of credit so as to promote the fullest expansion in production, trade and employment, consistent with the maintenance of monetary stability in Jamaica and the external value of the currency, to foster the development of money and capital markets in Jamaica and to act as banker to the Government.

Section 34 of the Act also refers to the supervisory role of the Bank with regards to banks and specified financial institutions. Other provisions speak to the Bank's regulatory authority over cambios and remittance companies and their agents.

These obligations are considered internationally to be broadly consistent with the responsibilities of a modern central bank, although it must be pointed out that some of these obligations (such as promoting employment and production) are not considered to be direct obligations of central banks.

In addition, the core mandate of the Bank as it relates to the control of inflation and preservation of financial stability is not expressly contained in the Act although reference to monetary stability is understood to relate to the control of prices and inflation generally.

In the performance of its **functions,** is **the BOJ** totally **independent?** If **not, who does** it take its **directions or directives from?**

The Bank of Jamaica is **not an independent central bank according to the internationally accepted definition of an independent central bank.**

However, there are many different concepts of independence that could be considered in answer to this question:

(a) Legal Independence,

(b) Goal Independence (i.e. the power to set policy goals)

(c) Operational Independence (i.e. the power to take action to meet policy goals- e.g. Regulation making powers; Power to issue, suspend and revoke licences)

(d) Managerial Independence (i.e. the power to appoint management and staff)

Based on the foregoing concepts the Bank is not totally independent in relation to some issues, including foreign currency matters, supervisory matters and some monetary policy matters[3].

In relation to matters involving dealings in foreign currency, under the Bank of Jamaica Act the Minister of Finance (hereafter the Minister) has the power to issue orders directing the acquisition of foreign assets by certain persons (i.e. authorized dealers, cambios, insurers, managers of pension schemes etc.) The Minister also has the power to grant exemptions from any or all of the restrictions on foreign currency dealings outlined under the Bank of Jamaica Act. Some of the powers regarding foreign exchange matters (e.g. the licensing of cambios) were delegated to the Bank by the Minister under his statutory powers of delegation in 1994.

In relation to Bank Supervisory matters the Minister appoints the Supervisor of Banks, the Deputy Supervisor and such other officers and employees as may be necessary for the efficient operation of the Supervisory Department. Generally, the Governor, Senior Deputy Governor, Deputy Governors and the Board of the Bank of Jamaica are all appointed by the Minister. While some powers previously held by the Minister have been transferred to the Bank of Jamaica (e.g. the power to issue statutory directions or cease and desist orders), the Minister still retains supervisory powers. These relate to the licensing

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For example: BOJ Act section 22B(I) -- (Minister's power to issue directions re: acquiring foreign assets)

2 For example: BOJ Act section 34A & 34B -- (Minister's power to appoint Supervisor and Deputy Supervisor); see also section 6 (Appointment of Board of Directors). The BOJ Bylaws also provide for the appointment of the Governor and the Deputy Governors of the Bank.

3 For example: BOJ Act sections 29(2) (Power to vary liquid assets requirements);

and revocation of licences of deposit taking institutions; the vesting of their shares and subordinated debt for the purpose of effecting a restructuring; as well as powers to approve other applications made by these institutions (e.g. amending memorandum of associations, mergers, etc.)

In relation to Monetary Policy matters, the BOJ may with the Minister's approval require commercial banks and specified financial institutions to maintain with the Bank special deposits (for money supply management).

Under the Bank of Jamaica Act section 41, the Minister has the powers to issue directions of a general nature to the Bank that appears to the Minister to be necessary in the public interest (e.g. Directions to review the state of credit in any sector of the economy and make recommendations for improving the supply of credit or to take steps to foster the provision of credit to that sector of the economy). These powers have fallen into disuse since the liberalization of the economy in 1992 and the abandoning of credit or price controls as a means to control market conditions in the economy.

I should point out that during my tenure as Governor, the Central Bank has operated on a reasonably independent basis. The Bank seeks to agree its policies with the Government and seeks to co-ordinate its activities with the Ministry. The Government has not, during my tenure, sought to intervene in the Bank's carrying out of its core macroeconomic mandate to control inflation and preserve financial stability.

3. **Does the BOJ regulate and supervise the banking sector, namely** Retail **Commercial Banks, Merchant Banks and Building Societies?**

Yes, **the Bank of** Jamaica **supervises the banking sector, namely Commercial Banks, Licensees under the Financial Institutions** Act **(commonly referred to** as **Merchant Banks) and Building Societies.**

[4] BOJ Act Section 28A.

The Bank of Jamaica Act provides at section 34A:

(1) There shall be established for the purposes of this Act, a department in the Bank to be called the Department of Supervision of Banks and Financial Institutions.

(2) The Department shall be charged with the supervision and periodic examination of all commercial banks and specified financial institutions.

Licensees under the Financial Institutions Act (FIA) are stated in section 2 of the Bank of Jamaica Act to be "specified financial institutions". Building Societies were designated *"specified financial institutions"* under section 2 of the Bank of Jamaica Act by Ministerial Notice dated March 25 1994.

Each of the governing legislation (i.e. the Banking Act, the Building Societies Act, the Financial Institutions Act and the Regulations issued pursuant to these statutes and under the Bank of Jamaica Act) also outline in greater detail the powers and duties of the Bank of Jamaica as the Supervisory Authority for these institutions.

4. In performance of its regulatory functions, does the BOJ carry out inspections on such institutions on a quarterly or yearly basis?

The Bank's Supervisory Division (the Financial Institutions Supervisory Division or FISD) carries out on-site examinations of commercial banks, building societies and licensees under the Financial Institutions Act on an annual basis.

Section 29(2)(c) and (f) of the Banking Act provides for the Bank of Jamaica to carry out annual examinations of these entities and to make reports to the Minister on the financial condition of these entities.

Section 29(2)(c) and (f) of the Financial Institutions Act contains substantially the same terms as section 29 of the Banking Act.

As regards other specified financial institutions such as building societies, section 34D of the Bank of Jamaica Act authorizes the Bank to carry out *"periodic inspections "*.

In practice the Bank's Supervisory Division (the Financial Institutions Supervisory Division or FISD) carries out on-site examinations of commercial banks, building societies and licensees under the Financial Institutions Act on an annual basis.

These examinations entail safety and soundness reviews which involve assessment of the quality of assets, liquidity, sustainability of revenue flows, adequacy of capital, corporate governance and risk management framework, as well as the adequacy of Anti-Money Laundering ("AML")/Counter Financing of Terrorism ("CFT") arrangements.

5. Are these institutions required to make reports on a quarterly, half yearly or annual basis to the BOJ?

The requirement for banks and licensees under the Financial Institutions Act to make returns (e.g. balance sheets and profit and loss statements) to the Bank of Jamaica is contained at section 16 of their governing statutes. In the case of building societies, the issue of returns is dealt with in the Building Societies Regulations, at regulation 44.

In addition to the data specified in these statutes and regulations, the Bank has developed several other forms of prudential returns that deposit-taking financial institutions have to provide to the Bank. These include returns relating to:

(a) Past due loans;
(b) Connected party exposures;
(c) Large exposures;
(c) Foreign assets and liabilities;
(d) Maturity and re-pricing profiles of assets and liabilities;
(e) Risk weighted capital adequacy;
(f) Liquid Assets and Cash Reserve reports;
(g) Sectoral profile of loans;
(h) Investments profile;
(i) Deposit liabilities and borrowings profiles
a) Earnings and expenditure

Returns are provided to the FISD on annual, quarterly, monthly and in some cases on a weekly basis.

The Bank also uses some of this data received from licensees to provide critical financial information to the depositing and investing public. Thus, indicative banking sector performance data relating to key financial indicators as well as unaudited balance sheet data for each of the commercial banks, building societies and the licensees under the Financial Institutions Act are compiled for publication in the two daily newspapers each calendar quarter.

The on-going analysis of off-site prudential returns (together with the results of the on-site examinations carried out by the BOJ as well as other information and updates received via correspondence and reports) form the basis for the Bank's ongoing assessment of the financial condition of individual entities and the banking system as a whole. They also inform the requirements for ameliorative action for entities that are assessed as having significant weaknesses.

6. Is the BOJ a lender of last resort, and if so, in performing such functions, does it make a distinction between liquidity and solvency?

The Bank of Jamaica is a lender of last resort, although the Bank of Jamaica Act does not state this in express terms. The statutory basis for its lending role is contained in section 23(f) of the Bank of Jamaica Act.

The Bank will generally only offer these facilities to entities that are illiquid and ____not insolvent; although if there are circumstances where for example an impending capital injection may render a marginally insolvent entity solvent, the Bank may consider offering this facility.

In addition, the Bank also has to consider carefully whether there are the legal and operational arrangements in place that can accommodate a withdrawal of a financial institution's liquidity support without creating major uncertainty and dislocation for affected parties.

The Bank and Government also has to consider the systemic impact of a refusal to provide liquidity support. This is particularly relevant where there is perceived to be a systemic issue and not an isolated case of bank distress. Such action could have major implications both on financial sector stability as well as on the efficacy and functioning of the country's payment systems[5].

The reality is that the decision to withhold liquidity support is essentially a decision to close an institution. Accordingly, the decision is therefore one that has to be taken together with considerations as to the best interest of depositors, the possibility of contagion to other financial institutions, as well as the likelihood of overall financial system instability. The decision whether to afford support to a distressed entity would also be affected by broader fiscal and social considerations such as the likely burden to taxpayers and the potential effects on the country's relationships with external parties internationally, in particular overseas investors or creditors.

7. **Did the BOJ as a regulator foresee the pending collapse of the financial institutions or any of them in the 1990s?**

The Supervisory Authority identified institutions that evidenced escalating weaknesses and problems which could eventually pose a threat to their solvency as well as to overall system stability.

Based on the Bank of Jamaica's on-site and offsite regime outlined in 4 and 5 above the Supervisor was able to identify weaknesses and monitor developments including the institutions' compliance (or lack thereof) with any requirements to take corrective measures imposed by the Supervisor. The regime also assists the Bank in identifying adverse trends that emerge on an individual institution or system basis.

s See `Current Developments in Monetary and Financial Law' Vol. 3 published by the IMF, chapter 23: "Emergency Liquidity by Central Banks: Systemic Protection or Bank Bailout?" by Delson Ross et al

On this basis the Supervisory Authority identified institutions that evidenced escalating weaknesses and problems which could eventually pose a threat to their solvency as well as to overall system stability. Weaknesses identified included:

' i (a) growing levels of non performing loans.

(b) declining profitability;

(c) shrinking capital bases;

(d) poor management practices;

(e) imprudent use of accounting practices to *"window dress"* financial conditions and hide the true situation from the Supervisors (for example artificially inflating profits; or "evergreening" problem loans (refer footnote 19)to make them appear as if performing; or use of "circular" capital transactions to give the impression that capital was being injected when it was not);

(f) submission of inaccurate, and in some cases misleading, financial information relating to the entity's true financial status/condition;

(g) significant liquidity deficiencies;

(h) increasing use of depositors' funds to resolve difficulties that were being experienced by affiliated insurance companies and other group companies (e.g. Crown Eagle/Eagle Financial entities, Mutual Life/NCB), as well as funding imprudent real sector investments by subsidiaries such as hotels, farms and expensive head offices. In at least one other case, there were instances of the depositors funds being used to meet the obligations of `managed funds' administered by the deposit taking entity on behalf of investors (as occurred in the case of Billy Craig Finance and Merchant Bank). This was notwithstanding the fact that such entities were not licensed to carry out securities business.

Some of these negative trends revealed by the prudential data submitted by entities over the period 1990 and 1998 are summarized in Table 1 below[6].

Table 1
Select Prudential Indicators (%)
(Based on unaudited Prudential Return Submissions to BOJ)
1990 -1998

Ratio It eatof	1990			93	1994	1995	1996	1997	1998
Commercial Banks									
PDL :Total Loans	8,2	6.3	5.7	5.4	7.4	10.9	14.0	28.9	25.7
Capital Base :Total Assets	3.8	3.1	4.0	4.5	4.7	3.3	2.9	1.9	3.2
Pre-Tax Profit Margin	13.9	18.0	16.3	16.5	17.9	12.7	8.1	-17.7	-2.8
						8.0	23.8	48.8	37.2
							12.1	4.9	20.2
							5.2	-27.4	3.3

1. PDL - Past Due Loans; Prior to 1996 PDLs represent facilities in non-performing for 6 months of more. PDLs for 1997 onwards represent facilities in arrears for 3 months or more in keeping with legislative amendments.
2. n.a. - Information not available, Prudential reporting for building societies commenced after the passage of the BOJ (Building Societies) Regulations in 1995.
3, Pre-tax Profit Margin-- Gross Profit (before tax) as a percentage of total revenue

It should also be noted that the financial data published quarterly by the Bank of Jamaica, whilst subject to close scrutiny and cross referencing with other available data (e.g. audited accounts), are provided by the licensees. Over the referenced period, the Bank's examiners and other third parties such as temporary managers and auditors noted fundamental flaws in some institutions' information systems and significant instances of under-reporting of negative data or the overstatement of positive data. Consequently, there was always the strong possibility that the performance of the industry in various areas was worse than was actually being reported by licensees.

Indicators extracted from the Bank of Jamaica Annual Reports for the period 1990 - 1998

FIA (FDA pre-1993) Licensees PDL :Total Loans 6.8

Capital Base :Total Assets	4.6	6.4	4.3	7.9	11.4	
Pre-Tax Profit Margin		*5.2*	*5.9*	11.1	12.9	12,7
	<u>6.1</u>	5.8	11.1	7.4	12.8	11.1

Building Societies

PDL :Total Loans

Capital Base :Total Assets

Pre-Tax Profit Margin

Notes:

n.a.	n.a.	n.a.	n.a.	n.a,	n.a.	11.	13.	12.
n.a.	n,a.	n.a.	n.a,	n.a.	n.a.	4.9	4.0	3.4
n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	5.6	-2.8	-0.3

In addition to the Bank's regulatory responsibilities, the Bank also prepared a comprehensive paper[1] which outlined the Bank's assessment of the issues affecting the financial sector, indicating the weaknesses in the system and the potential for adverse systemic impact as well as articulating measures that were recommended to address these issues. This paper was prepared in consultation with the IMF, Inter-American Development Bank and the World Bank and formed a key resource in the future dialogue that was to take place.

The later work done by these multilateral agencies substantially reflect the findings of this initial report, particularly as it related to causes and remedies for the then looming crisis.

Additionally, in several meetings with the banking sector over the period 1994 - 1996, the then Governor cautioned about the problems that were likely to arise as a consequence of the downward trend in the inflation rate and the imminent bursting of the real estate bubble, which would likely manifest in a decline in asset/collateral values and consequent negative impact on profitability and capital adequacy of institutions.

8. As a regulator, can the BOJ give any reasons for the cause of the failure of some of these institutions resulting in a meltdown in the 1990s.

The Bank considers that there was no one factor that caused the difficulties in the financial sector. There were a number of factors that interplayed with each other which led to the financial sector difficulties.

Some of these were macroeconomic in nature while others were peculiar to the particular institution and the individuals who had control of them. All institutions faced the same macroeconomic conditions which were characterized by an acceleration of asset

Super inflation over 100%

"Jamaica: Assessment of and Recommendation for the Financial System" Bank of Jamaica, August 1996.

and consumer price inflation, the liberalization of the foreign exchange market and the anti-inflation policies that followed this episode. From a regulatory perspective, the key explanatory factors were:

(a **An outdated legislative framework for banks and near banks** that dated back to the 1960s, which lacked key substantive provisions relating to prudential limits on key financial activities, as well an absence of sanction powers[8].

(b) **Phenomenal growth** in **the financial institutions** (to a high at December 1994 of 11 commercial banks, 31 licensees under the Financial Institutions Act, 34 registered building societies, and 13 insurance companies) which finally led to the system experiencing the extremely negative effects of over-competition. Competitive forces were in fact exacerbated to an unsafe level where very high risk activity was pursued by market participants in their anxiety to increase market share at any cost. Noting the increasingly negative impact of over-competitive forces, the Central Bank at one point actually recommended an indefinite halt to the issue of banking licences - this was adopted only for a specific period[9].

(c) **A corollary to (b) was the severe strain on managerial expertise in the banking sector as well an overbanked system** in which at December 1997, 34 deposit taking institutions lacked critical mass and were in fact competing for less than 10% of the assets in the system, as seen per Table 2 below. This led to an anxiety for growth and consequent imprudent and risky behavior.

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8 As a consequence the Bank lobbied for various legislative reforms some of which finally took place during the 1990s. The legislative provisions carried out in 1992 to strengthen the framework (i.e. passage of the new Banking Act and the Financial Institutions Act) still lacked key sanction and intervention power. Some of the shortfalls were identified in the IMF Report on "Banking Supervision Issues" dated November 14 1995.

9 Refer correspondence October 1989 - September 1990 between Bank of Jamaica and the Financial Secretary on this matter.

TABLE 2

RELATIVE SIZE OF FINANCIAL SYSTEM BY ASSETS

AS AT **31 DEC 1997**

	INSTITUTION	**J$T000**	**Market**	**Cumulative**
I.	Barclays Finance Corp	348	0.00	0.00
2	Partner Merchant Bank	19,545	0.01	0.01
3	Sterling Building Society	31,718	0.01	0.02
4	The West India Co. of Merchant Bankers	59,898	0.03	0.05
5	Homeowners Building Society	88,198	0.04	0.09
6	Buck Securities Merchant Bank	88,577	0.04	0.13
7	Fidelity Finance Merchant Bank	121,807	0.05	0.18
8	Citifinance	135,337	0.06	0.24
9	Billy Craig Finance & Merchant Bank	204,385	0.09	0.34
10	Caribbean Trust & Merchant Bank	205,057	0.09	0.43
11	Knutsford Capital & Merchant Bank	210,419	0.09	0.52
12	George & Branday	222,353	0.10	0.62
13	Island Life Merchant Bank	231,604	0.10	0.73
14	Jamaica Savings & Loans Buldg. Soc.	236,008	0.11	0.83
15	Pan Caribbean Merchant Bank	246,203	0.11	0.94
16	Intercontinental Merchant Bank	255,652	0.11	1.06
17	Caldon Finance Merchant Bank	263,198	0.12	1.17
18	CIBC Building Society	387,632	0.17	1.35
19	MF&G Trust & Merchant	434,572	0,19	1.54
20	CIBC Trust & Merchant Bank	481,338	0.22	1.76
21	Capital & Credit Merchant Bank	813,463	0.36	2.12
22	Eagle Perm. Build. Soc.	820,923	0.37	2.49
23	Citimerchant Bank Ltd.	884,898	0.40	2.89
24	Trafalgar Commercial Bank	892,835	0.40	3.29
25	Citizens Trust & Merchant Bank Ltd.	900,821	0.40	3.69
26	Corporate Merchant Bank	1,055,021	0,47	4.16
27	Issa Trust & Merchant Bank	1,066,590	0.48	4,64
28	Manufacturers Merchant Bank	1,169,238	0.52	5.16
29	Capital Assurance Building Society	1,191,554	0.53	5.70
30	Horizon Building Society	1,246,513	0.56	6.26
31	International Trust & Met.	1,265,663	0.57	6.82
32	Scotiabank Jamaica Trust & Merchant Bank	1,347,688	0.60	7.43
33	NCB Trust & Merchant Bank	1,681,548	0.75	8.18
34	Eagle Merchant Bank	2,489,685	1.12	9.30
35	Eagle Commercial Bank	3,137,131	1.41	10.70
36	Island Victoria Bank	3,335,617	1.49	12.20
37	Scotia Jamaica Building Society	3,656,465	1.64	13.83
38	Horizon Merchant Bank	4,016,719	1.80	15.63
39	Citizens Building Society	4,153,945	1.86	17.49

TABLE 2 (cont'd)

RELATIVE SIZE OF FINANCIAL SYSTEM BY ASSETS AS AT 31 DEC 1997				
	INSTITUTION	J$'000	**Market Share** %	**Cumulative**
40	Citibank	6,109,036	2.74	20.23
41	Citizens Bank	9,037,038	4.05	24.28
42	Workers Savings & Loan Bank	10,396,914	4.66	28.94
43	CIBC la. Ltd.	10,596,678	4.75	33.68
44	Victoria Mutual Building Society	12,929,807	5.79	39.48
45	JNBS	13,666,943	6.12	45.60
46	Bank of Nova Scotia	51,872,188	23.24	68.84
47	National Commercial Bank	69,560,398	31.16	100.00
	Total	**223,219,168**	100.00	

Includes Contingent Liabilities (e.g. Guarantees, LICs etc) and before adjustments for provisions for losses

(d) A further obvious effect of the factors outlined in (b) and (c) above was that **the regulatory capacity of the supervisory authorities was severely strained.** This was aggravated by the fact of the on-going regulatory arbitrage where licensees, in response to the Central Bank's increasing concerns and requests for ameliorative action, constantly moved their questionable activities to other group companies outside the purview of the Central Bank, where regulatory strictures were either lax or nonexistent.

(e) **Attempts by the Central Bank to have some licensees closed before their insolvency reached huge levels were in most cases unsuccessful, because of:**

(i) interminable discussions with owners and managers who did not accept the need for intervention action and whose `conditions precedent' for intervention were unrealistic and unreasonable[10]

(ii) the consideration of multiple proposals for the rescue of these entities by sale of assets or by capital injection by third parties that never materialized[11],

(iii) in other cases, the awaiting of reports by other external parties on entities' conditions, which ultimately

[10] For example CNB's CEO wished to retain executive control, even following intervention.

[11] This was a feature of the Blaise, Century and Workers entities.

reflected and justified the Bank's initial assessment of the situation, but which nevertheless extended the time before intervention[12];

(iv) the exercise of forbearance by the Administration in the expectation that the required improvements would have been effected by the shareholders, Boards and management of the affected institutions.

These delaying issues led to an eventual situation where when these respective entities were finally closed, the financial impact was much more severe.

A practically non-existent supervisory framework for nonbank deposit-taking financial institutions, particularly industrial and provident societies (I&Ps) and building societies. These entities were established and monitored essentially only by a system of registration administered by the Deputy Keeper of the Records.

(f) A similar but more critical situation existed as regards regulation of insurance companies (given the size of the sector in terms of assets and funds garnered by the public.) The regulation of insurance companies and unit trusts was at the time undertaken by the Superintendent of Insurance. Unfortunately the framework for insurance supervision was outdated, there was a lack of credible and up-to-date data on entities, and the Superintendent of insurance's office lacked necessary technical resources, hence the focus was in the main, on the registration of insurance agents.

This **lack of supervision in the insurance sector played a fundamental role in the crisis, insofar as the liquidity crisis experienced by insurance companies (when faced with encashment of largely short-term, deposit-like liabilities in conditions where there was severe asset liability mismatch structures and their assets were illiquid) spread to affiliated banks.** The role of insurance companies in the crisis was seen as so fundamental that the IMFIWorld Bank/ IADB in their technical assistance report "Jamaica - Resolution Strategy for

12 See footnote 32

Financial Sector Distress: Draft Guidelines" (dated November 1996), specifically proposed that the Governor of the Central Bank should have been designated the Superintendent of Insurance to achieve effective oversight. The then existing regime for insurance supervision was described by these
agencies *as "non-existent".*

Appendix 5 of that Report provided a rough assessment of the financial health of three distressed insurers, two of which were connected to banks. The mis-match between the maturities of these insurers' liabilities (much of which were not even insurance related) and the assets held by these companies were the hallmark of the difficulties faced by the sector. See footnote 19 for further details on these non-insurance related liabilities.

(i) In the first case, the insurance company was almost totally funded by short term promissory notes amounting to $4.5 billion compared to $0.5 billion in" normal insurance liabilities. The company was out of cash and unable to raise any funding save though the BOJ overdraft provided to its affiliate bank. In its proposal to the Government it requested assistance along the following lines:

(a) $4.5 billion in equity

(b) $3.7 billion in guarantees

(c) $3 billion in purchases of units in its troubled linked fund.

The multilateral agencies' assessment was that even these measures may not have been sufficient to restore the company to financial health.

In the second case of a mutual company, 60% of the liabilities were short term non-insurance obligations. It had a very small insurance portfolio and investments across a number of industries.

The company was engaged in a dispute with its auditors over the carrying value of its assets and faced liquidity exposures of approximately $7-8 billion.

The request for assistance was via the request for a bond in the amount of J$4.5 billion. The consultants to the agencies believed the amount necessary to close the gap was closer to MO O billion.

(iii) In the third case, the company carried on more conventional insurance business. However it feared contagion resulting from pressures from runs on other life insurance companies. It requested government support in the amount of $1.9 billion in convertible preference shares. This insurance company was the only one assessed as solvent of the three considered.

(h) With reference to the framework governing the types of entities at (f) and (g) above (viz. I&Ps, building societies, insurance companies and unit trusts), **the lack of any meaningful** legislative **or institutional** systems **for regulation of these entities formed the** basis **for regulatory arbitrage among sector players that became** a **feature of the** crisis. In particular, certain groups adopted the practice of transferring poorly performing assets from supervised entities to these functionally unregulated affiliate entities in order to mask the true financial performance of the supervised entities.

These types of challenges confronted the entire financial sector. However the institutions that were eventually intervened evidenced particular characteristics and weaknesses[13] which exacerbated the effect of the broad economic and financial infrastructure challenges that the country was facing. These characteristics included:

(a) Excessive risk appetite, poor management and governance practices and in particular weak decision-making by boards some of which were subject to `dominant shareholder syndrome' (i.e. majority shareholder/CEO/Board Chairman dominating decisionmaking at the board level) to the detriment of the licensee and the interests of depositors. In many cases, the Boards and management of these entities refused or were unable/unwilling to recognize the assessed weaknesses in the entities and thus took no meaningful action to address the respective situations.

13 See for example Second Interim Report of Temporary Manager (PW and associates) on CFEs dated 8 August 1996, page 3.

(b) The formation of conglomerates (often mixing financial and real sector businesses), which also resulted in excessive and nonarms length connected party transactions[14] and which sought to take advantage of the differing legislative regimes across types of entities (which were subject to different standards of regulation). These conglomerates were structured to obfuscate regulatory scrutiny of the transactions between group companies.

For example in the case of the Eagle Financial Entities (EFEs), an application was made to the Minister of Finance regarding the restructuring of the Eagle Financial Group that would vest the ownership of the deposit taking entities of the Group in the Eagle Premium Growth Fund (a unit trust). It was subsequently discovered that ultimate ownership of the Group had also been restructured where ownership of holding company Crown Eagle Life Insurance Company Limited (CEL) had been transferred from majority shareholder Paul Chen Young, such that Eagle Group was ultimately held by Jellapore Investments (a blind, offshore trust registered in the Cayman Islands). This ultimate holding structure was not disclosed to the authorities and the result was that the authorities had no supervisory reach to the holding companies under the existing legislation and the ownership responsibilities for and control of the bank and building society in the group legally passed from Mr. Chen Young to the blind trust. It should also be noted that the ownership of the bank and building society passed without the knowledge or sanction of the regulatory authorities at a point where the law allowed such passing of ownership without the need for the authorities to even be advised.

Because the existing laws contemplated supervisory reach/scrutiny only in relation to immediate holding companies, the insertion of both a unit trust and an offshore trust into the ultimate ownership structure allowed the EFEs to frustrate and successfully resist the Supervisor's attempts to scrutinize the activities of the entities at the top of the corporate group structure, including those of CEL.

Guarantees extended by banks to their subsidiaries which funded themselves through the issue of commercial paper at rates that were more attractive than deposit rates. See Temporary Management Report on Workers Entities dated 8 April 1998 (Ernst & Young) page 30.

In addition the use of the Jellapore Trust to hold the EFEs also allowed the de facto owners of the EFEs to argue that they had no influence or control, and were not in fact responsible as owners and thus were not liable to provide the necessary financial support to assist the group in times of crisis[15]

(c) Reckless/Irresponsible and very high risk banking practices[16] including:

- excessive non-arms length and non-performing connected party lending[17];
- extremely imprudent and inadequate levels of loan loss provisioning
- *"evergreening"* of loans[18],
- imprudent concentration levels in the loan and investment portfolios,
- growth in off balance sheet exposures, particularly via issue of "commercial paper" and similar transactions structured to avoid recognition of liabilities in the entity's balance sheet;
- lending based solely on collateral as opposed to the ability to repay;
- poor credit underwriting and administration practices;
- weak and, in some cases, reckless investment decision making; and
- lack of effective systems of risk management and internal controls.

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15 See the comments of Downer JA in *Paul Chen Young and others v Eagle Merchant Bank, SCCA 23, 45* and 46 of 2000, delivered July *23, 2002*

16 These practices are outlined in much detail in the Bank of Jamaica Examination Reports on various institutions. However for an overall consideration of the practices in the banking sector and other supervisory issues see: Report on "Bank Supervision Issues" in Jamaica prepared by IMF November 1995.

17 See for example Workers Bank Examination Report 1997, Table 4.3.2 which indicated connected credits exceeding 50% of total assets and of which, in excess of 90% was non-performing and for the most part unsecured..

18 "Evergreening" - This is a term that is used generally to describe "non-performing" loans that are renegotiated, often repeatedly, where outstanding interest is capitalized and the loan repackaged as a "new" loan but without any change or improvement in the borrower's circumstances including the ability to repay. This had the effect of representing the loan as performing, thus overstating profits with unrealized/unrealizable income and inflating the balance sheet.

(d) Rapid growth of banking type activities in the non-deposit taking sector outside the purview of the Central Bank (e.g. insurance products that had volatile characteristics of deposits or which were equity linked), resulting in a severe misalignment between the maturities of the assets and the funding liabilities[19]. Insurance companies that pursued this course all ran into severe financial difficulties and massive liquidity constraints. This led to contagion pressures[20] being placed on the related banking entities within the group, which had to fund the repayment of these "policy" holders.

Inadequate documentationlrecordkeeping[21] as well as use of accounting techniques to disguise problems, particularly by inflating the value of fixed assets as well as in recognizing uncollected and uncollectible income, thus substantially overstating profits and capital. There were also incidents of failing to record transactions which would have the effect of understating liabilities[22].

(e) Misrepresentation of the capital position of entities through the use of "buddy loans"[23] with other financial groups and institutions or through structured inter-group transactions. A "buddy loan" transaction is where one entity may invest in another entity in exchange for that entity in turn investing in the lending institution, usually through the use of opaque offshore vehicles. Such "*investment", "loan" or "deposit"* recorded by

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19 This entailed the taking of funds via the issue of policies which carried a very thin "wrapper" of minimal insurance and with short term encashment features to fund long term illiquid assets (such as real estate developments) which could not be liquidated on a speedy basis to meet the demands of encashing policy holders- See IMFIIADB/IBRD Technical Assistance Report "Jamaica Resolution Strategy for Financial sector Distress: Draft Guidelines" (November 1996). Note that the BOJ continually took the position that such "policies" were more in fact representative of deposit-type liabilities that were not in the remit of insurance companies.

20 See World Bank Country Study the Road to Sustained Growth in Jamaica (2004) at Chapter 4 "Revitalizing Jamaica's Financial System", para. 4.7. Examples included Crown Eagle Life/Eagle Group, Mutual Life/NCB.

21 See for example, Temporary Management Report (Ernst & Young) on Workers Entities page 14 Documentation.

22 See Temporary Managers Report (Ernst and Young) on Caldon Finance and Merchant Bank Limited 14 April 1998, section 2 Key Findings. See also Second Interim Report of Temporary Manager Report (PW and Associates) 8 August 1996 on CFEs page 2-6 re: Investment in Jamaica Grande.

23 Temporary Management Report (Ernst & Young) on Workers Entities page 10, para. 3 re preferential treatment on loans extended to companies owned by executives of the Horizon Group.

the respective transacting entities would also then be represented to the regulators as a capital injection in the final "receiving" entity. However, these were in effect merely accounting entries with no funds actually passing.

A major example of one such scheme involved CNB. In 1995, it was represented to the Bank Examiners that CNB had rectified a breach of the Banking Act via a capital infusion of $165 million via issue of preference shares at 31 March 1995[24].

Closer examination of information which finally emerged revealed the following:

(i) *A* company *"Shelltox"* was incorporated in The Bahamas circa August 1994. CNB paid the incorporation costs.

(ii) The Group President of the Century Financial Entities ("CFEs") was subsequently advised by an agent of Shelltox by fax as to what would be necessary in order to complete a transaction in which Shelltox would purchase shares in CNB in response to CNB's public offer.

(iii) The CFEs Group President then instructed that agent to arrange for Shelltox to purchase US$2.2 million in preference shares of CNB and US$1.3 million worth of preference shares in CNB's parent Century Holdings.

(iv) CNB then placed deposits of US$ 3.5 million with a Bahamian offshore Bank First Trade, in which CNB had a material ownership interest. First Trade then lent Shelltox that amount secured by covenants that effectively hypothecated the CNB deposit until the indebtedness was liquidated.

(v) Shelltox then used the loan proceeds to purchase the shares as instructed by the President.

(vi) It was represented to the BOJ that CNB had received a capital injection via this "investment" and further that the deposit of US$ 3.5 million on the books of CNB represented liquid funds, when in reality they were hypothecated. The audited financial statements of CNB

24 See Affidavit of Audrey E. Anderson dated 13th March 1997 in suit numbered CL 1996/C368, pages 14 and 15.

similarly reflected the said "share issue" and "capital" proceeds as well as "deposit", with no disclosure as to the hypothecation and situation otherwise.

(vii) The scheme unraveled when Shelltox defaulted on the loan and the deposit was realized by First Trade[25].

Another example of capital misrepresentation was a transaction[26] within the EFEs where Eagle Merchant Bank of Jamaica Ltd. (EMB) reported the sale (in December 1992) of half of its shareholding in Eagle Commercial Bank (ECB) to CEL for a purchase consideration of $220.5m. However this transaction was noted by examiners to have coincided with EMB's granting of a demand loan of $240m to that same insurance company. Thus in reality EMB lent CEL money to finance CEL's purchase of the shares from EMB.

(g) Poor performance by external auditors where material financial weaknesses were either overlooked, not detected, or <u>deliberately not reported.</u> In one instance there was evidence of substantial conflicts of interest where the external auditor had not only benefitted from loans (which were not being serviced per original payment terms), but he was also passing actual accounting entries in the commercial bank's books[27]. In the same case, the audit firm refused to qualify the entity on a going concern basis, even whilst the managing partner acknowledged that fact to the regulators.

(h) Questionable accounting practices also facilitated recurring revaluation of assets, whereby fixed assets were revalued annually or as necessary in order to inflate the balance sheet of entities without any fundamental change taking place relative to the financial condition of the entity.

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25 The Chief Justice described this transaction as "steeped in fraud", a description the Privy Council found understandable: *Crawford v FIS,* [20051 UKPC 40 at paragraph 15

26 See EMB Examination Report as at November 30 1993.

27 In this case, the auditor (Aulous Madden & Co.) was sanctioned by the Public Accountancy Board upon the investigations and findings of the Disciplinary Panel of the Institute of Chartered Accountants of Jamaica, pursuant to the complaint lodged by the BOJ and supported by the Temporary Manager for the CFEs.

(i) Overall poor compliance culture, manifested by widespread breaches of Board Undertakings and Statutory Directions as well as a host of other major statutory requirements.

In this regard, these issues were all recorded in the Examination Reports produced by the Central Bank prior to intervention of the respective entities, as well as in specific correspondence between the Central Bank, the licensees and the Minister of Finance. These issues and the findings of the BOJ examiners were, as well, subsequently corroborated and substantiated in the various reports issued by the Temporary Managers and Forensic Auditors who examined the affairs of these entities post intervention as well as by the multi-laterals and other agencies that reviewed the issues impacting the system. McKinsey & Company (international consultants), who were contracted by the GOJ to assess weaknesses in the regulatory framework and recommend action, also highlighted these issues[28]. Further these factors have also been recognized by the IMF and World Bank in their reviews and assessments of the Jamaican financial system.

9. Did the BOJ foresee the pending failure of some of these institutions, and if so, what actions were taken to avoid same?

Refer response at item (7).

The Bank of Jamaica provided comprehensive advice to the Minister on the state of the institutions it regulated on an on-going basis, including the on-site examination reports[29] which provided the BOJ's findings, clear status updates on the deteriorating conditions of the inspected institutions, required remedial action by licensees and made recommendations for regulatory sanctions. In addition the Bank also recommended to the Minister what it considered to be critical changes to the existing suite of legislation. The Bank also as a part of its day to day supervision maintains close contact with the management of licensees, who are also advised of the BOJ's findings and concerns inclusive of receipt of the on-site examination reports..

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28 See McKinsey Report on "Strategic Plan for Revitalizing, Jamaica's Financial Sector and Supervision" dated December 18 1998

29 Section 29(2) of the Banking Act and the Financial Institutions Act and section 34F of the Bank of Jamaica Act.

As a result of information brought to the BOJ's attention that in some instances exam reports were being with-held from board members, the Bank introduced the specific requirements that board members expressly acknowledge that they had read and considered the on-site examination reports and its findings. The Bank also established key target timelines for ameliorative action, as per its usual policy and practice, and followed up with the respective entities as to ensure that these actions were in fact taken.

The regulatory sanction action for breaches and non-compliance with requirements for action, that could be taken by the Bank of Jamaica at the time, was severely constrained by the limited powers available to the Supervisory Authorities under the then existing legislation. However, wherever it was assessed as appropriate and necessary with respect to identified weaknesses and issues of concern, the Bank made specific recommendations to the Minister for sanction actions to be taken against the relevant licensees.

The 1992 legislative amendments provided certain key improvements in the legislative framework (particularly as it related to the FTA) including broadening of the range of prudential limits and interventions/sanctions[30]. However, critically, the power to impose such sanctions continued to reside with the Minister of Finance.

Under the 1997 amendments, some intermediate sanction powers were transferred to the Bank of Jamaica, specifically the power to require bank boards to issue Voluntary Undertakings which committed them to carry out particular and identifiable remedial action, as well as the authority to issue Directions and/or Cease and Desist Orders requiring remedial action. Note that intervention actions such as temporary management and licence revocation remained with the Minister of Finance[31] and the new power for vesting was also given to the Minister. Other sanctions relating to breach of statutory requirements were limited to proceeding in the criminal courts.

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[30] Refer to Part A, Bank of Jamaica's "Report on Legislative Developments in Jamaica's Banking Laws 1990- Present" (forwarded to the Commission on 31 August 2009). [31] Further legislative amendments in 2002 transferred the power of Temporary Management to the BOJ

The Central Bank also did not have powers necessary to conduct consolidated supervision of groups that contained deposit taking institutions. This led to the fundamental difficulty of the Bank being unable to assess transactions between non-bank entities in the group or assess the financial conditions of these entities, or to follow questionable transactions that were moved from the licensee to other group entities, all of which had strong contagion potential/consequences for the deposit taking affiliate.

With the above-mentioned powers conferred in December 1997, consequent on the failure/intervention of several financial institutions/groups, the BOJ imposed the following statutory supervisory actions:

(a) Issue of statutory Directions to **Caldon Finance Merchant Bank** (9 February 1998 and on 16 February 1998).
(b) Issue of statutory Directions to **Partner Merchant Bank** (10 February 1998).
(c) Requiring of a Board Undertaking from **Island** Life **Merchant Bank** (24 February 1998)
(d) Issue of statutory Directions to **Horizon Merchant Bank** (2 March 1998).
(e) Issue of statutory Directions to **Fidelity Finance Merchant Bank** (18 March 1998).
(f) Requiring a Board Undertaking from **National Commercial Bank** (2 April 1998).

All the above entities were among those which had to be intervened by the Government.

In addition, the Bank sought to use moral suasion to pressure management, Board and majority owners of problem institutions to take remedial measures, inject capital and/or seek merger partners. The Bank also led the discussions for those takeovers that would not have involved the taking of temporary management. Examples include Buck Securities Merchant Bankers; Caribbean Trust and Merchant Bank; Fidelity Finance Merchant Bank; Intercontinental Merchant Bank and Partner Merchant Bank.

The Bank also sought to make key recommendations as regards the exercise of the Minister's statutory powers. These recommendations were based on the financial condition of the affected licensee as ascertained by the Bank's technical findings/evaluations. However, the final decision taken with regards to the entities would also have been influenced by other determinants including the representations of the affected entities as regards remedial measures proposed or negotiations with external parties. In other cases the Government sought independent opinions to verify the true financial position of these entities,[32] which opinions confirmed BOJ's earlier findings. In several cases, the Minister engaged in lengthy discussions with the owners which ended in deadlock (particularly where owners demanded to retain executive control, even after intervention action as occurred in the case of CNB). Such factors would have contributed to the perceived delay in taking intervention action.

Sanctions effected by the Minister of Finance on the recommendation of the Bank of Jamaica, for the period 1990 - 1998 included:

1. Assumption of Temporary Management of **Tower Merchant** & **Trust Bank on** 8 **February 1993** by the Minister, following recommendations by BOJ on 15 January 1993 (and 25 June 1992, pending passage of the new FIA).

2. **Blaise** Entities
   - i Issue of statutory Directions by the Minister to Blaise Trust & Merchant Bank Limited (BTMB) **on 23 March 1994**
   - it Requiring a Board Undertaking **(18 April 1994)**
   - iii Issue of further Directions to BTMB on **22 July 1994.**
   - iv Assumption of Temporary Management of BTMB by the Minister on **18 December 1994.**
   - v Assumption of Temporary Management of Consolidated Holdings Limited (a BTMB affiliate) by the Minister on **10 April 1995** (pursuant to powers under the Bank of Jamaica

[32] In 1993 when BOJ recommended Temporary Management for the CFEs the Government sought external confirmation from Coopers & Lybrand to determine the viability of these entities. This report clearly indicated the insolvent nature of the entity (deficit of $149.2mn) together with the major issue of mismanagement. Later, in 1996 Price Waterhouse Canada also carried out work on a proposed restructuring plan for the CFEs. In the case of the Blaise entities the Government commissioned an independent assessment from PriceWaterhouse to ascertain the true value of assets, level of losses and capital requi'ed. These findings echoed the earlier findings and assessments of the BOJ Examiners.

(Industrial & Provident Societies) Regulations which were promulgated on 7 April 1995.

vi Assumption of Temporary Management of Blaise Building Society by the Minister on 24 **April 1995** (pursuant to powers under the Bank of Jamaica (Building Societies) Regulations which were promulgated on 7 April 1995).

3. Assumption of Temporary Management of **First Metropolitan Building Society on 27 February 1996**

4. **Century Financial Entities (CFEs)**[33]
   i. Requiring a Board Undertaking from CNB **on 10 March 1993** to address the deficiencies revealed in the BOJ inspection reports and the Coopers and Lybrand Report;
   ii. Assumption of Temporary Management by the Minister of Century National Bank, Century National Merchant & Trust Co. Ltd. and Century Building Society on **10 July 1996**[3]**.**

5. **Eagle Financial Entities -**
   i. Requiring Board Undertakings from Eagle Merchant Bank; Eagle Commercial Bank[35]; and Eagle Permanent Building Society **(July/August 1996).**
   ii. Ultimate takeover of the EFEs on 14 March 1997 by way of nominal sale of Crown Eagle Life Insurance (and its subsidiaries) to the Government for $1.

6. Assumption of Temporary Management of **Caldon Finance Merchant Bank on 20 February 1998.**

7. Workers Financial Entities -
   i Requiring Board Undertakings from Workers Savings & Loan Bank; Corporate Merchant Bank; and Capital Assurance Building Society **(August 1996).**

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33 See Affidavit of Audrey E, Anderson in Suit Numbered CL 1996/C368 dated 13 March 1993

3a See footnote 32. In addition there were also extended negotiations between proposed investor groups and the CFEs, which also delayed the final intervention action. These proposals were assessed as not being sufficiently robust to address the fundamental weaknesses in the financial conditions of the CFEs,

35 The liquidity stringencies which emerged at Eagle Commercial Bank were a clear case of group contagion as up to the point of the supervisory action there were no major issues of supervisory concern regarding that entity.

ii Assumption of Temporary Management of Workers Bank, Corporate Merchant Bank and Capital Assurance Building Society on **23 February 1998** simultaneous with Court petitions for vesting the shares of the Workers Financial Entities in the Minister of Finance.

8. **Island** Victoria **Bank** --
   i. Requiring a Board Undertaking from Island Victoria Bank on 1 **August 1996** which Directors initially resisted but eventually signed and returned to BOJ (24 **June 1997)**[36]**.**

9. **Fidelity Finance Merchant Bank -**
   i. Requiring a Board Undertaking from Fidelity Finance Merchant Bank (1 **July 1997).**[37]

In addition, the Bank also made recommendations to the Minister as regards other non-statutory resolution measures (e.g. orderly exitltransfer to new owners). Such measures included capital injections via FINSAC paper andlor the purchase of bad assets and replacement with FINSAC instruments[38]. In other instances, unconnected deposit liabilities were transferred to other FINSAC assisted entities, and institutions wound up' or bad assets acquired by FINSAC for subsequent resale.

The Central Bank also put forward and piloted substantial and extensive regulatory reforms to address the emerging threats and weaknesses that were beginning to manifest themselves. The details of these legislative initiatives have already been provided to the Commission by way of the "Report on Legislative Developments in Jamaica's Banking Laws for the Period 1990 - Present" (forwarded to the Commission on 31 August 2009.)

However key reforms included:

(a) The designation of building societies in 1994 as specified financial institutions and passage of the BOJ Building Societies Regulations to address the hitherto unregulated status of these

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36 Take out of bad loans by FINSAC and merger along with certain other FINSAC assisted entities into Citizens Bank Ltd (which was subsequently renamed Union Bank and sold to RBTT).

37 Assumption of deposits liabilities of Fidelity by Citizens Bank which after merger with other FINSAC assisted entities was renamed Union Bank and sold to RBTT.

3s For example in the cases of NCB, Billy Craig Merchant, and Citizens Bank (subsequently Union Bank) '9 For example, Partner Merchant Bank, Caribbean Trust & Merchant Bank, Buck Securities Merchant Bankers and Intercontinental Merchant Bank.

entities and bring them under the formalized regulatory purview of the BOJ[40].

(b) Similar legislative action in the same year was taken with respect to the I&Ps to deal with the emergence of these institutions as unregulated deposit takers[41]. Essentially, I&Ps were prohibited from taking deposits except with specific authority of the Minister of Finance.

(c) In 1997, the Banking Act, the Financial Institutions Act, the Building Societies Act and related BOJ regulations were amended to provide for more stringent investment and lending limits both to unconnected parties but even more so to connected parties because of the gravely negative role played by such facilities/exposures in the collapse/demise of several financial entities; stronger "fit and proper" criteria both on licensing and on a continuing basis; regulatory access to the books of all holding companies; increased capital requirements; reducing the non-accrual period for interest on non-performing loans (from 6 to 3 months); minimum solvency standards, and the imposition of new obligations on external auditors;

(d) In the same year the Supervisor received further powers (some of these had been transferred from the Minister of Finance) relating to sanctions such as the power to issue directions, issue cease and desist orders and require board undertakings.

(e) In that year, the Minister was granted the power to vest the shares and subordinated debt of insolvent entities in order to effect necessary restructuring.

10. What action, if any, did the BOJ take in relation to the failed institutions in order to rehabilitate them or any of them?

Once Temporary Management of these entities was assumed by the Minister, the Bank's role was to interface with the Temporary Manager to assess losses and consider the best options for resolution. The actual rehabilitation measures were not a direct

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4° This was further to Central Bank recommendations arising from findings related to the Blaise Building Society and further information as regards a plethora of recently established building societies, some registered by licensed deposit taking entities.

41 Critical examples included Consolidated Holdings (affiliate of Blaise entities) and Caribbean Trust Finance & Investments (affiliate of Caribbean Trust & Merchant Bank)

responsibility of the Bank, given the fact that such a role constituted a conflict of interest/moral hazard given the role of the Central Bank as Supervisor. These rehabilitation measures would in the main have been undertaken by FINSAC. The Bank's role would have been to continue its supervisory surveillance of the entities under rehabilitation as well as provide its technical advice to the Minister on proposed resolution measures.

The majority of the rehabilitation work on these entities involved:

a) FINSAC's purchase of bad loans and replacing same with FINSAC paper (which would later be converted to Government paper). The Bank of Jamaica would also receive FINSAC Paper in consideration of its extension of Lender of Last Resort (LOLR) facilities[42].
b) Replacement of management and improving internal systems and controls;
c) Finding new owners with sufficient capital and the expertise to improve the operations of the institutions.
d) Merger with stronger and better capitalized institutions or merger of institutions and re-packaging for sale[43]

As Supervisor, the Bank gave its technical recommendations to the Minister of Finance on issues relating to the viability of business plans, financial projections and the "fitness and propriety" of prospective new owners. The Bank was also involved in the ongoing monitoring of the state of financial health of the intervened/merged entities including assessing the arrangements for the financial assistance rendered by the Government.

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42 It should be noted that the financing and wind-up arrangements for the Century and Blaise entities were effected through FIS Limited, (which predated FINSAC) for resolution and exit of these entities.

43 This was the method adopted in relation to a number of distressed entities that were restructured and merged into a single entity called Union Bank and later sold to RBIT. (Island Victoria Bank, Eagle Commercial Bank, Horizon Merchant Bank, Island Life Merchant Bank, Workers Bank and Corporate Merchant Bank were all merged into Citizens Bank)

11. **Is it a fact that all the depositors in the failed Institutions were repaid 100% of their deposits? If so, from what source were these funds provided?**

In the case of the Blaise entities, the depositors and creditors received 90% of their funds and in the case of the other intervened entities which followed, the depositors received 100% of their deposits. The funding for these deposits would have come from the Government. The funding arrangements would have relied on the issue of FIS and FINSAC Bonds which were backed by GOJ undertaking/guarantees.

In the case of the Blaise entities, the depositors and creditors received 90% of their funds pursuant to a Scheme of Arrangement under the Companies Act approved by depositors and the other creditors on 15 October 1995. The payments to these parties would have been effected through the Financial Institutions Services (FIS), a special purpose vehicle established by the Government for financial institution resolution purposes.

In the case of the other intervened entities which followed, the depositors received 100% of their deposits. The decision to make a 100% blanket payment to depositors, after Blaise, arose as a result of the fear by the Government and the Central Bank that capital flight and depreciation would result from a more limited scheme of deposit protection.

The method in several cases involved the assumption of deposit liabilities by stronger or FINSAC sponsored merged institutions who received either Government paper or FIS/FINSAC paper guaranteed by Government as the backing asset for these liabilities.

12. **Did the BOJ, as a lender of last resort, advance monies to the failed institutions or any of them? If so, which ones and how much?**

At the respective dates of intervention, the BOJ had made lender of last resort (LOLR) advances to 4 of the 6 intervened commercial/clearing banks via the existing current account overdraft facilities at the Central Bank.

Table 3
LOLR FACILITY **BALANCES**
AS AT **DATE** OF **INTERVENTION**

Bank	**BOJ OID (Alm)**	**Intervention**
Century National Bank	4,349.7	10 July 1996
Eagle Commercial Bank	10,871.1	14 March 1997
Workers Bank	4,434.0	23 February 1998
National Commercial Bank	1,223.1	30 March 1998

Note: With the exception of NCB which received capital injection and take out of bad assets, these entities were wound up/merged with other intervened institutions.

Licensees under the F1A and the building societies did not receive this type of assistance from the BOJ as they did not have current accounts with the Central Bank. With regards to assistance to these latter entities, this was effected by FINSAC via the issue of its own debt instruments which were guaranteed by the Government.

It should be noted also that in all cases, the O/Ds were extended on the approval of the Minister/Cabinet. Such facilities would have been extended to maintain the depositing public's confidence in the system and to allow the authorities sufficient time to prepare the requisite resolution strategies.

13. Did the BOJ make any advances to any of the failed institutions which were insolvent at the time?

As clearing banks, commercial banks were able to access lender of last resort facilities (via BOJ Overdraft). However where such entities ceased operations as a result of Government intervention (temporary management) they were no longer able to access these facilities[44]. The Bank made advances to these entities notwithstanding their assessed insolvency (particularly for Century, Eagle and Workers Financial Entities).

Again these advances would have been made in the context of the particular circumstances existing including proposals for recapitalization whether by third party, sale of assets or other proposed

44 There were two cases where banks received Governmental assistance but continued in operation (NCB, as well as Citizens Bank, which after merger with certain other intervened entities, was renamed Union Bank.) One of these entities utilized BOJ LOLR facilities (NCB) but the other did not.

means. Additionally, the action by the Bank would also have been influenced by the issue as to whether there were in place the appropriate laws that would lead to orderly exits/resolutions. Apart from the laws, it would also be critical that there be an appropriate resolution strategy in place that would have served to protect the stability of the system. Where such laws and/or strategies were not in place, the Bank would have had little option but to continue to provide support or else risk destabilization of the sector.

14. The view in the public domain is that the collapse of the financial institutions was due to high interest rates in the 90s.

While the macroeconomic environment, including interest rates, exposed the vulnerabilities of financial institutions, the collapse of some of these financial institutions was due to a confluence of factors, which were mainly microeconomic in nature. These factors related principally to the rapid growth that took place in the financial system and in its component segments in the late 1980s to early 1990s, poor institutional management practices, excessive risk-taking and the consequent asset related issues that led to the changes in the relative asset positions of the various entities within those segments. Differences in the supervisory and regulatory standards relating to the component segments of the financial system facilitated poor management practices and allowed reckless investment behaviour to go unrecognized and unpenalized.

To appreciate the factors that contributed to the collapse of **some** of the financial institutions, it is important that we understand the structure and development of Jamaica's financial system in the late 1980's to early 1990s, bearing in mind that all institutions were operating in the same macroeconomic environment and hence faced the same economic conditions. It is also important that we understand that any impact of interest rates on the various institutions would have been conditioned by the way the. individual institutions responded to the prevailing macroeconomic conditions.

A quick review of the development of the Jamaican financial system shows that in the late 1980s to early 1990s there was rapid growth in the financial system. In terms of number of institutions within the banking sector the growth in merchant banks was most marked (see Table 3). However, the merchant banks' share of the total assets of the financial system declined from 15.4 per cent in 1990 to 8.0 per cent in 1995, suggesting that some of these institutions were relatively small. The number of building societies also increased rapidly from 6 in 1990 (accounting for 10.1 per cent of financial assets) to 15 in 1995 with assets accounting for 13.4 per cent of total financial system assets. The number of life insurance companies remained relatively stable over the same period although there was significant growth in their assets. The life insurance companies' share of total financial assets, which was 12.8 percent in 1990, grew to 19.0 percent by end 1992 and increased further to 20.3 percent in 1995.

Table 4: Jamaican Financial Sector Development

	1985	1990	1995	1997
Commercial Banks				
No. of Banks	10	11	11	9
No. of Branches	155	170	188	171
PDA/PIA Licensees				
No. of institutions	26	29	29	27
Building Societies				
No. of institutions	5	6	34	10
Life Insurance Companies				
No. of institutions	13	10	12	12

Source: Bank of *Jamaica.*

Commercial banks and merchant banks which were supervised by the Bank of Jamaica were subject to the regulatory requirements imposed by the BOJ, including the statutory cash reserve. Authorization for the supervision of building societies was not granted to the BOJ until 1996. All deposit taking institutions operated under different statutes. The life insurance industry was governed by the Insurance Act of 1971 with supervisory oversight provided by the Office of the Superintendent of Insurance, which remained a department of the Ministry of Finance at the time of the collapse.

The existence of widely **different statutes and regulatory regimes governing the institutions, and the reporting to different oversight bodies with marked differences in the supervisory capacity,** were factors that contributed to the growth in the industry and facilitated the demise of some of the entities. In the early 1990s, some financial managers of building societies, for example, saw these institutions as avenues to attract funds and avoid the statutory cash reserve requirement which was imposed on entities supervised by the BOJ. Consequently, there was the observed growth in building societies without a commensurate expansion in private housing stock (funded by these institutions), their intended core line of business. In the case of merchant banks, the Protection of Depositors Act (1960) allowed for minimal capitalization and provided few restrictions on the scope of operations in terms of loans and investments. Similar to the building societies, the entrants to the merchant banking market were able to exploit the differential liquid reserve requirement (LAR) that existed for commercial banks and institutions operating under the Protection of Depositors Act (PDA)[45].

With respect to the insurance companies, **weaknesses in supervisory framework and to a lesser degree the legislative framework facilitated poor management practices and allowed reckless investment behaviour to go unrecognized and unpenalized. In** many instances, financial returns were made to the Office of the Superintendent of Insurance several years after the due date. Regulation in general and supervision in some instances were also deficient in restricting the operations and management of most of these institutions who tried to take advantage of a recently liberalized environment without proper risk assessment. Consequently, **institutions became more aggressive venturing not only into more innovative financial activities but also extending beyond the boundaries of prudent financial practices into investments in real sector activities.** These conglomerates oftentimes engaged in the acquisition and operation of agricultural enterprises and tourism ventures, such as the acquisition and operation of hotels, among other things.

Concurrently, the life insurance industry entered into the aggressive marketing of short-term and equity-linked products. **The short-term savings that were attracted by the high return on equity were imprudently invested in longer-term assets, mainly real estate, and in particular large head offices.** This eventually resulted in severe

[45] Whereas the liquid asset reserve (LAR) requirement for commercial banks was 48 per cent in 1985 and was subsequently increased to 50 percent in 1992, the requirement for merchant banks remained at 25 per cent for the period, only being increased to 35 per cent in 1996, at the height of the financial system problems. Of the LAR for the merchant banks, 17 per cent had to be held in non-interest-bearing cash reserve with the central bank, while the commercial banks were required to hold 25 per cent in non-interest bearing reserves.

liquidity problems for the insurance companies, and for the affiliated commercial banks when the equity market collapsed in 1992 as policyholders sought to encash short-term deposit-like policies to mitigate against severe losses. For example, encashment jumped to J$3.3 billion in 1993 from marginal encashment of J$148.6 million in 1991. Encashment subsequently declined to J$1.1 billion in 1995 but by 1997 encashment again accelerated to J$3.5 billion, this time associated with the sharp decline in the real estate market in which these companies were heavily invested.

The establishment of financial conglomerates was therefore an important feature of the financial architecture in the early 1990s. However, **the laws governing the financial system at the time were not in line with the financial innovations and the growth that was taking place.** In addition, amendments to the various pieces of financial legislation, which had commenced in the late 1980s, were not only slow in going through the parliamentary process but still inadequate to address potential problems in the sector. Some **institutions used this weakness to increase the levels of connected party loans.** Although the Banking Act (1992) sought to constrain the quantum and proportionate growth in these loans, the evidence shows an average quarterly growth rate of 18.8 per cent between 1992 and 1995 (Stennett et al, 1998)[4]. A large percentage of these loans was associated with insurance companies and their related commercial banks. Related party loans were even higher in 1996 to 1997 when the encashment of insurance policies was reflected in the overdraft facilities extended by affiliate commercial banks. Similarly, **there** was **evidence of insider lending with either inadequate or no collateral.** Forensic auditing, which has been a very expensive procedure has led to the unraveling of transactions, which the courts have held to be fraudulent in nature.

All the insurance companies were linked within a "group", or as in the case of Island Life Insurance Company and Victoria Mutual Building Society, tied to each other in a financial venture partnership. Jamaica Mutual Life Assurance Society was part owner of National

46 Stennett R., Green P., Foga. *C, Stabilization and the Jamaican Commercial Banking Sector, (1991--1997),* Social & Economic Studies, Vol. # 48, Nos. 1 & 2 (1999)

Commercial Bank. Life of Jamaica owned Citizens Bank. Crown Eagle Life Insurance Company was associated with Eagle Commercial Bank and Eagle Merchant Bank, owned or participated in ownership of hotels and considerable real estate holdings, and owned and managed two unit trusts (mutual funds).

The commercial banks which had been contaminated through their inclusion in Groups with troubled insurance and other institutions include Eagle Commercial Bank, NCB and Workers Savings and Loan Bank, which had lent considerable sums to members of their groups. (Refer response to Question 8)

Also of significance in the breakdown of the financial system, was the **evidence of** weak **management** as well as **the absence of adequate internal** systems **and controls.** The evidence of managerial inadequacies was manifested in the large expenses carried in the sector. As an example, for the commercial banks, the ratio of overhead expenses to core net revenue declined from 102.5 per cent to 69.2 percent between 1991 and 1994, but subsequently increased to 143.9 per cent by the end of 1997 Stennett et al (1998). In addition, the ratio of overhead expenses to total assets increased from 1.5 per cent in 1991 to 2.0 percent at the end of 1997 suggesting that the rapid expansion in assets in the banking system was accompanied by rising diseconomies of scale. Panton (1998)[47] also noted that the ratio of employee remuneration to average assets averaged 3.3 per cent over the period 1991-1995 in comparison with the United States benchmark of 1.6 percent. This suggested that employees in Jamaica's commercial banking sector enjoyed a relatively higher share of operating costs than counter parties in the United States.

Improper initial risk assessment in the granting of loans including as to adequacy of collateral, taken together with changes in loan term/ borrower circumstances in some cases contributed to the collapse of financial institutions. Private sector credit grew by 39.4 per cent in 1991, peaked at 68.9 per cent in 1993 and subsequently slowed to 25.3 per cent in 1996. The rapid expansion in loans in the early 1990s was fuelled by liquidity emanating from high capital

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47 Panton, N., *The Commercial Banking Industry in Jamaica: Some Issues of Efficiency, 1990 --1995,* Money Affairs, Vol. XI, No., 1, January - June 1998

inflows consequent on the liberalization of the foreign exchange rate regime. High inflation rates during the period encouraged the overvaluation of real assets, especially property, which served as collateral for loans. Loans were extended primarily to the tourism sector, professional and other services and for personal activities. In particular, between December 1992 and rune 1996, loans to the tourism sector increased to 8.1 per cent of total loans, from 6.3 per cent over the previous two years and mainly reflected real estate acquisition by related parties. Simultaneously, loans classified under the categories of Professional & Other Services and Personal loans increased from 11.8 and 11.5 per cent of total loans, to 12.6 and 17.3 per cent respectively. These categories include loans for real estate acquisition, real estate services and home improvement.

Due to poor risk assessment and given increasing challenges in the macro-economic environment, by 1994, non-performing loans six months and over as a per cent of total loans in commercial banks stood at 7.4 per cent and increased to 28.9 per cent at the end of 1997. The four most significant categories of non-performing loans were construction & land development, tourism, personal, professional & other services, with construction & land development accounting for 18.7 per cent of the total. Non-performing loans in the manufacturing sector, which accounted for the second largest share of loans in the early 1990s, was lower than that of tourism which received almost one half of the volume of loans extended to manufacturing. **While the** increase **in** interest rates **may have contributed to the** rise **in the ratio of non-performing loans in** all **banks, the much** larger **deterioration of the ratio for indigenous banks suggests that this** was **in part due to the poor management practices spoken to** in **response to questions 8 and 9.** With respect to individual institutions, the ratio of NPLs in BNS, for example stood at 2.6 per cent as December 1997 and averaged 1.5 per cent throughout the period. In contrast, the ratio averaged 9.7 per cent for NCB and 26.4 per cent in Workers Savings and Loan Bank.

Another area of concern was the **inadequate provision for loan losses** made **by banks despite the deteriorating quality of the loan portfolio.** Over the period March 1993 to December 1997, although the banks' portfolio of doubtful debt grew by a quarterly average rate of 18.5 per cent, there was no commensurate increase in provisioning. In fact, during that period, provisions for loan losses grew by a mere 9.8 per cent. As a consequence, the ratio of Loan Loss Provisions to Non-Performing Loans declined precipitously from 63.0 per cent in March 1993 to 38.3 per cent in 1998. While the low level of provisions was facilitated by the inadequacy of the legislation governing commercial banks, this also reflected errors in judgment on the part of the banks' management. The amendments to the Banking Act and the FIA which classified as non-performing when 6 moths past due was inadequate and not in keeping with the BOT's recommendations on this issue. The laws were ultimately amended in 1997 to reflect the more prudent classification of non-performance at the point of 3 months. In addition these entities were required to make specific provisions for loan losses as well as reverse from income any interest accrued on such non performing loans.

With respect to the direct impact of interest rates, which averaged 35.6 per cent in the period prior to the collapse of financial institutions, shocks to real interest rates shifted the incentive structure away from speculation in land, towards more paper based transactions. In this context, income flows of borrowers involved in real estate activities, would have declined and could have resulted in difficulties in meeting contractual obligations to the banks. To the extent that a material level of non-performing loans on the banks' books were related to real estate related activities, this would have affected the income stream from loans. This information in itself, is however insufficient to determine how bank liquidity and hence profitability was affected by interest rates. What is germane to the question is the net impact of interest rates on commercial banks' core earnings. Stennet et al (1997) examined how changes in the spread which are attributable to market volatility affected the banking system's profitability, or net interest earnings on core business. The study found that notwithstanding the increases in interest rates, reported net interest income on core business remained positive.

Table 4
Sectoral distribution of Past Due Loans*
{6 months & Over at March 1996

Sector	% of Total
Construction & Land Development	18.5
Tourism	16.4
Personal	15.8
Professional & Other Services	14.0
Manufacturing	11.7
Distribution	7.5
Transport, Storage & Comm.	6.7
Agriculture	5.8
Entertainment	2.1
Mining	1.4
Electricity, Gas & Water	0.3

Source: Department of Supervision of Banks, BOJ
****Loans overdue, six months and over***

The declining profitability of the sector, especially commercial banks and insurance companies was reflected in the return on assets of commercial banks which declined from 3.8 per cent in 1991 to 2.6 per cent in 1995 and at the end of 1997 was negative 3.2 per cent. This was driven by the domestic banks while the foreign banks recorded positive returns ranging from just under 2 per cent to almost 3.5 per cent. In essence, proper managerial procedures were in place in these institutions thus avoiding a collapse of these institutions.

The foregoing would have no doubt contributed to a "flight to quality" within the domestic financial system as depositors withdrew their savings from what were perceived to be weak institutions, mainly indigenous with local managers, and deposited these funds with mainly foreign banks which were also managed by local personnel; further contributing to the collapse of these institutions.

15. Another view expressed is that the monetary policy of the BOJ did not meet its objective. Instead it caused increases in interest charges and penalties which could not be met by borrowers and resulted in the collapse of the Financial Institutions and the real sector. Does the BOJ agree with this view, and if not, what reason can the BOJ advance for disagreeing with same?

With respect to intent, the objective of monetary policy was to engineer a sharp deceleration in inflation which would set the foundation for economic growth. The monetary policy actions undertaken in the early 1990s were successful in meeting this objective, thus contributing significantly to the general macroeconomic stability that subsequently prevailed.

The tightening of monetary policy did imply an intent to curb the expansion of money and credit by domestic financial institutions. As pointed out earlier, the change in the environment, in particular, the deceleration of inflation, exposed the extent to which some institutions and borrowers had relied on the continuation of the escalation of asset and consumer prices. The BOJ's annual reports in the early 1990s under the signatures of various Governors ranging from the tenure of G.A. **Brown to Jacques Bussieres (June 1993 -- March 1996) referred to the Bank's battle against high inflation, a challenge which emerged following the liberalization of the financial system in late 1990.**

The early 1990s saw the culmination of a series of economic and financial sector reforms, which started in the 1980s under various structural adjustment programmes financed by the multilateral financial agencies, mainly the IMF. The programme of structural adjustment, which also included trade reforms, was aimed at creating a more efficient market-oriented economy that was export-driven, with the private sector as the main instrument of growth. One of the features of the programme was the liberalization of the foreign exchange regime by the Government which commenced on 17 September 1990. This was followed almost immediately by a precipitous decline in the nominal exchange rate from US$1.00 = J$7.90 at the end of that month to US$1.00 = J$27.38 by the end of March 1992. Given the openness of the Jamaican economy and the almost immediate pass through of movements in the exchange rate to domestic prices, there was a significant spiral in the inflation rate which exceeded 80 percent in fiscal year 1991/92 (see Table 4)[48]. The Central Bank was faced with the mammoth task of bringing down inflation to more acceptable levels.

Table 5: Jamaican Selected Indicators

	1991	1992	1993	1994	1995	1996	1997	1998
Growth in GDP	0.7	1.4	1.5	1.0	0.7	(1.4)	(2.1)	(0.7)
Inflation rate (point-to-point)	80.2	40.2	30.1	26.9	25.5	15.8	9.2	7.9
M2 growth rate	54.6	**59.3**	39.9	36.6	**38.5**	15.4	12.6	7.3
BOJ signal rates	44.7	**25.5**	46.6	28.2	41.5	27.0	29,0	22.0
Commercial Bank AM Loan Rate *	34.0	46.0	49.6	**45.8**	48.6	42.2	35A	33.0
Commercial Bank AM! Deposit Rate	27.5	23.0	39.8	27.9	26.2	20.8	14.1	**15.5**
Growth rate in Private Sector Credit	39.4	22.4	68.9	**24.3**	**51.9**	**25.3**	-33.5	-16.9
Exchange Rate e.o.p	20.9	22.20	32.70	33.37	39.80	35.03	**36,59**	37.16
NIR (US$mn.) e.o.p.	(443.0)	(67.4)	51.1	, 398.6	418.6	694.9	540.0	579.4

Source: Bank of Jamaica & Statistical Institute of Jamaica *
Average weighted rates as at the end of the period.

With interest rates at already high levels and given the state of the Bank's own balance sheet, the initial response of the Bank to these developments was the reintroduction of the non-cash portion of the liquid asset requirement, which had been gradually reduced since the mid-1980s. The Bank also increased the penal rate imposed on commercial banks in respect of breaches of the cash reserve and liquid asset ratios from 1/6 of 1.0 per cent per day to '/4 of 1.0 per cent. These policy actions engendered a return to stability in the system allowing for an easing of policy during the first half of 1993. However, with demand pressure on the exchange rate between late 1993/94 and 1994/95 the Bank became more aggressive in its open market operations. Monetary conditions were again tightened through a significant increase in interest rates on CD's. Interest rates on these instruments, which had approximated 25.5 percent in the early part of the year, were increased to 35.7 percent by July, and further to 48.4

48 Inflation **was** 17% in 1989

percent by December 1994. Additionally, liquidity support to commercial banks was curtailed by the central bank and penal rates on overdrafts were increased to 120.0 percent. The liquid asset requirement at the same time remained at 50.0 percent. The objective was to reduce the amount of money and hence credit in the system. Authorized foreign exchange dealers were required to charge no more than a 1.5 percentage point spread between buying and selling prices on all currencies in an effort to reduce speculative pressure in the foreign exchange market.

Other developments in the period included the broadening of the foreign exchange market by the establishment of a network of authorized foreign exchange dealers. This was aimed at unifying the official and the black markets. The Bank also introduced a system of primary dealers, aimed at stimulating trading activities in the secondary market. This network was comprised of a select group of commercial banks, merchant banks and brokers which provided underwriting support for all new issues of Government of Jamaica securities while providing liquidity in the market.

The tight policy stance coupled with the liberalization of the foreign exchange market contributed to an increasing level of capital inflows in the first half of the 1990s. As a consequence, the net international reserves of the Bank improved from a negative position of US$443.0 million at the end of December 1991 to positive US$418.6 million by December 1995. During that period, the BOJ had to buy foreign exchange in order to restrain the appreciation of the Jamaica Dollar, but this contributed to an increase in the money supply. To slow the rate of accumulation in the net international reserves and the attendant expansion in money supply, the Bank subsequently reduced the level of purchases of foreign exchange from commercial banks and cambios from 25.0 per cent of total flows to the banks, to 10.0 per cent, and then to 5.0 per cent in January 1995. Purchases from cambios were also gradually adjusted downwards to a maximum of 30.0 per cent by April 1995. In addition, the Bank of Jamaica adjusted its pricing arrangements with authorized dealers so that foreign exchange purchases would take place either at the weighted average selling rate, or the average buying rate of the authorized dealers, plus a margin of 1.25 per cent, whichever was lower. In early 1995 the margin was adjusted down to 1.0 per cent.

Notwithstanding the significant accumulation of foreign reserves, the exchange rate continued to depreciate fuelled by speculative pressures in the market. In this context, the exchange rate depreciated by 17.2 per cent from US$1.00 = J$33.95 at the end of June 1995 to US$1.00 = J$39.80 by end December 1995. During this period, the Bank introduced selective special deposit requirements for commercial banks, complemented by intervention sales of foreign exchange in the market. By then also the Bank had shifted to the daily management of its high powered money, employing reverse repurchase agreements as its primary open market instrument.

The authorities' objective of attaining a significant deceleration in the rate of overall price increases was gradually achieved over the period. From the significantly high twelve months inflation rate of 80.2 percent in 1991, the inflation rate was lowered to 25.5 per cent by 1995 and reached single digits by 1997. This was followed by a number of consecutive years of single digit inflation. The exchange rate remained relatively stable between 1995 and 1998, albeit with sporadic periods of appreciation or depreciation. At the end of 1998, the exchange rate was US$1.00’- J$37.16 having moved from US$1.00 = J$39.8 at the end of 1995.

During the review period GDP growth was low but remained positive (averaging approximately 1.0 per cent between 1991 and 1995) until 1996, when it declined (see Table 7). The low growth in the early 1990s followed strong growth of 6.8 per cent in 1989 largely reflecting the tail of a construction boom and rapid expansion of the financial sector. The primary reason for the decline in 1996 and the subsequent years was associated with the Government's resolution of the problems in the financial sector, which cost approximately 40.0 per cent of GDP. Real interest rates, for the most part were positive, and this would have also served as a deterrent to growth.

All central banks will argue that the very objective of monetary policy is to regulate the amount of money and credit in the system in line with levels compatible with inflation. Hence, if a central bank tightens policy for example, it is expected that the levels of interest rates, money supply and credit will adjust in the same direction; otherwise policy would have been ineffective.

In commenting on the monetary policy stance of the 1990s, Persaud (2006)[49] noted that "these elements provide the actual bedrock upon which any financial sector is built and with which it must continuously cope. Banking executives and risk assessment managers must consider the economic and business environment in which they, and more importantly, their clients, operate". Firms and households therefore needed to have done the necessary risk assessment associated with entering into new contractual arrangements at higher rates. Most of these contractual arrangements related to the construction industry, given the price of real estate at the time. No consideration was given to whether or not there was `overbuilding' in the industry and the possibility of price declines if there was a burst in the real estate bubble. In any case, commercial bank loans and advances and sectoral GDP growth suggest there was evidence of a slowing down of the real estate sector by 1990 before the Bank's contractionary monetary stance began. After a high growth of 18% in 1989 the Construction and Installation sector essentially ceased to grow, and except for 1995 declined every year during the five years ending in 1997. It is also true that, by the very nature of monetary policy, market conditions no longer validated overly optimistic re-valuation of real estate assets as inflation decelerated.

16. Still, **another** view is **that the increase in** fiscal **expenditure nullifies any impact that the** BOJ'**s monetary policy may have had. Does the BOJ agree with this view, and if not, what reason can the BOJ advance for disagreeing with same?**

The BOJ does not agree with this view. The stance of the fiscal and monetary authorities was largely coordinated during the 1990s.

For fiscal year (FY) 1991/92 and FY1992/3, despite strong increases in fiscal expenditure, there were fiscal measures to enhance revenue and contain expenditure, resulting in surpluses from Central Government operations during these periods (see Table 4).[50] A major revenue enhancement measure involved the replacement of the menu of indirect taxes with a single General *Consumption Tax (GCT)* in October 1991.

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49 Persaud *W., Jamaica Meltdown: Indigenous Financial sector Crash 1996, (2006)*

50 Government built its FY budget for 1992/93 around the achievement of a sharp reduction in the rate of inflation by way of a social contract & efficient management of the public sector.

This tax was applied at an almost uniform rate of 10.0 per cent on domestic production and imported commodities, with the exception of a few commodities. The introduction of the GCT, which was a broad based tax on expenditure, was more difficult to evade and led to increased efficiency in revenue collection.

In addition, relatively tight fiscal conditions resulted in the government's overall operations generating a surplus of J$1.7 billion in FY1993194, while Central Government recorded a surplus of J$3.6 billion. Government's performance reflected continued fiscal prudence through efforts to control operating expenditure and improving revenue performance.

Table 4
Summary of Central Government Operations (J$mns)
FY1991/92 - FY1999100

	1991/92	1992//93	1993/94	1994195	1995/96	1996/97	1997/98	1998/99	1999/00
Revenue & Grants	15,075.4	23,557.5	33,614.1	44,596.3	58,523,8	63,085.5	66,495.9	74,084.9	90,372.6
Total Expenditure	13,018.3	20,386,0	29,997.1	39,802.9	54,717.6	78,051.5	86,388.1	92,996.9	102,947.8
-Recurrent	10,638.9	16,321.9	25,369.3	34,454.6	44,441.8	64,225.3	72,112.9	84,504.4	93,166.3
-Capital Expenditure & Net Lending	2,379.4	4059.8	4,627.4	5,882.0	7,908.0	11,156.1	12,118.9	6,900.4	8,400.5
Surplus/deficit	2,057.1	3171.5	3,617.0	4,793.4	3,806.2	-14,966.0	-19,892.2	-18,912.0	-12,575.2

The Bank continued its contractionary monetary policy stance during 1994 and 1995 on the basis that economic stability is predicated on the containment of inflation to low and predictable levels. This policy stance was complemented by strong surpluses from government operations during FY1994/95 and FY1995196. The impact of these measures was reflected in a marked slowing in the growth of money balances and further containment in inflation during 1995. The exchange rate stabilized towards the end of the year.

During most of the second half of the 1990s, despite the more expansionary posture of fiscal policy consequent on the financial sector bail-out, the Bank was successful in achieving levels of single digit inflation.

17. In your opinion, given the large number of financial institutions that failed (the vast majority of banks and insurance companies by assets) does the financial sector collapse of the 1990s constitute a systemic crisis?

Systemic crisis is generally considered one in which the stability of the banking system and, as a consequence, the payments system and real sector, are threatened[51]. The Bank of Jamaica is of the view that whilst the financial system did undergo severe distress, some of the features that have manifested themselves in other crises did not develop.

A key example of this was the fact that Jamaica did not experience significant capital flight (as occurred in several other jurisdictions[52]), but rather a `flight to quality' (where funds moved from distressed entities to local financial institutions that were perceived to be stronger). Additionally the Jamaican payments system did not suffer dislocation. To a large extent, these positive outcomes were attributable to the strong actions of the authorities which sought to engender confidence in the system. Such actions included the decision to provide a 100% guarantee for depositors, pensioners and policy holders, as well as the refusal by the Government to close the system for two weeks as initially recommended by the multilateral financial institutions.[53]

As a consequence of the Government's refusal to accede to this recommendation, the multilateral agencies did not initially provide the financial support necessary to assist Jamaica through this crisis. The Government therefore was forced to proceed on the basis of using FINSAC paper and government undertakings and guarantees to stabilize the system. This action resulted in the rapid build up of fiscal obligations that were consistently rolled over resulting in the compounding of interest costs to the Government from interventions in 1996 and until 1998 when the multi-laterals finally determined to provide assistance to the Government in paying down the FINSAC debts.

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51 IMF, Managing Systemic Banking Crises by a Staff Team Led by David S. Hoelscher and Marc Quintyn (2003) International Monetary Fund, August 28, 2003

52 Other countries such as Thailand and Mexico experienced significant capital flight during their times of crisis.

53 The Joint IMF/IADBBIWorld Bank November 1996 Report at page 3 of the Executive Summary stated: *"Optimally, in the current circumstances of Jamaica, the resolution strategy should aim at <u>removing all insolvent and unviable financial institutions through a preemptive and wide scale intervention.</u> However, the authorities have indicted that this approach is not now politically possible and would pose logistical dculties. "*

The potential for major disruption and turmoil had the administration not rejected that recommendation was borne out by the very harmful repercussions that occurred in other countries which subsequently adopted such advice[54].

There were also appropriate arrangements for the repayment of depositors on a seamless basis usually in the form of the transfer of deposit liabilities to other stronger entities. These arrangements resulted from the use of a Ministerial vesting order (established in the 1997 amendments to the Banking laws) which statutorily vested an institution's book of business to another entity. In other cases, some boards and managements agreed to these transfer transactions on a voluntary basis.

In the case of the Century and Blaise entities, these earlier interventions were particularly difficult as the Authorities had to rely on the provisions of the Companies Act, in the absence of appropriate banking laws relating to the vesting of assets and liabilities. As indicated earlier, other factors which delayed prompt action including protracted and ultimately unsuccessful discussions with the owners and management of these distressed entities, who consistently refused to accept the fact of major problems including insolvency, or acknowledge their role in the demise of these entities.

The Jamaican resolution process as regards the restructuring of the banking sector and insurance sectors and the safeguarding of the interests of depositors, policy holders and pensioners has been assessed by outside observers as "...on*e of the costliest in terms of GDP worldwide, but its cleanup was one of the quickest*[55]*".*

The distress to the system also resulted in substantial longer term reforms and actions by the fiscal and monetary authorities and substantial and far reaching legislative and regulatory reforms. The latter include among others the establishment and capitalization of the Jamaica Deposit Insurance Corporation and the Financial Services Commission, and the establishment of the Financial Regulatory Council.

5' Some writers are of the view that heavy handed intervention action on a wholesale system basis can destroy confidence and add to the costs of the crisis. See for example The East Asian Financial Crisis, Diagnosis Remedies prospects, Steve Radalet and Jeffrey Sachs, Harvard Institute for International Development, April 20, 1998

55 World Bank Country Study - The Road to Sustained Growth in Jamaica, Chapter 4 para.4.8.

18. What reason does the BOJ have for the maintenance of the high interest rates during the 1990s and for what purpose were such interest rates prescribed, moreover in relation to what aspect of monetary policy?

Against the background of continuous erosion in the value of the domestic currency as well as the sharp and sustained increases in domestic prices, the Bank of Jamaica employed a restrictive monetary policy stance that was manifested in high interest rates in the post-liberalization period to contract aggregate demand and to bring aggregate spending in line with supply conditions.

The macroeconomic environment that prevailed during the first half of the 1990s and the Bank's policy response were shaped by a liberalization and economic refomm process which started in the 1980s. This process engendered *inter alia* financial system and foreign exchange market reforms, including the removal of credit and interest rate controls, as well as implementing a market determined exchange rate regime and the opening of the capital account of the balance of payments.

Developments consequent on the Government's decision to accelerate the liberalization process presented new challenges for the Central Bank in maintaining monetary stability. In particular, the implementation of a market determined exchange rate[56] in the context of pre-existing macroeconomic imbalances, precipitated episodes of exchange rate depreciation in late 1991. On 25 September 1991, all major controls on foreign exchange flows were repealed. By the end of 1991, the Jamaica Dollar had depreciated by 35 per cent to US$1.00: J$21.57 from US$1.00: J$13.97 on September 25, 1991. In the wake of this depreciation came a rapid acceleration of the inflation rate to record levels in 1992. The 12-month point-to-point inflation attained a level of 80.0 per cent at the end of 1992 relative 30.0 per cent at the end of 1991.

Against this background of continuous erosion in the value of the domestic. currency as well as **the sharp and sustained increases in domestic prices, the Bank employed** a restrictive **monetary policy stance.** The pursuit of tight monetary policy by the Bank in the postliberalization period was manifested in high interest rates to contract

56A flexible exchange rate inter-bank system was instituted in September 1990.

aggregate demand and to bring aggregate spending in line with supply conditions. The approach included greater reliance on market-based instruments to conduct monetary policy. This approach was successful in achieving substantial moderation in the growth in domestic prices and the exchange rate. In particular, the 12-month point-to-point inflation rate declined to a range of between 25.4 - 25.6 during 1995 from a high of more than 100.0 per cent during '1992.

In 1993, the BOJ continued to rely on open market operations coupled with a liquid assets ratio (LAR) of 50.0 per cent in order to absorb excess liquidity in the system. The Bank's policy focus of containing inflation and bouts of significant exchange rate instability continued well into the second half of the 1990s with a strong degree of success.

19. Did the BOJ have any input in the amendment of the Bank of Jamaica Act in 1992, the Banking Act in 1992, and the Financial Institutions act in 1992 and their amendments in 1997? If so, what were the reasons for their amendment where the BOJ is concerned?

As indicated earlier in this report the BOJ was in the forefront of and played a major role in putting forward, validating and piloting all the reforms to the banking statutes in the 1990s. The Legislative Report earlier tendered to the Committee provides specific advice on the legislative measures relating to the history of reforms to the Jamaican banking laws and the Bank's input in that process. Please also refer to our response to Question 8 of this statement which also outlines many of the prudential issues, problems and concerns which were evident at the time and which would have underscored the need for several of the reforms finally approved by Parliament.

20. As regulator and supervisor of these financial institutions, what can be done to avoid the occurrence of another meltdown, particularly having regard to the prevailing global financial crisis?

Promote sound banking and risk management practices within licensees such that their Boards and managements will prudently and profitably guide their operations.

It is internationally recognized that the objectives and functions of prudential regulation is not to prevent failure of individual institutions, nor to preclude every improper or ill advised practice. Rather it is, to the extent possible, to promote sound banking and risk management practices within licensees such that their Boards and managements will prudently and profitably guide their operations. This role therefore redounds not only to the protection of individual groups of depositors, but to the integrity of the payment system and ultimately overall systemic stability[57].

In the event of problem institutions, the role of the regulator is to seek timely resolution, which may include orderly exits. The business of financial intermediation is inherently risky, and must rely principally on the board of the institution to set its risk appetite and parameters and for management to implement the Board's policies, and in doing so, taking the appropriate steps to identify, control and mitigate the risk that are attendant on its activities.

It is also accepted that overly intense regulation would stifle lending, investments and other financial activities which promote commerce and saving and wealth building. However there are international standards that are accepted to be necessary ingredients in an effective system of banking regulation. In Jamaica's case, this issue stretches beyond banking supervision into the wider regulatory framework for the financial sector (e.g. for insurance and securities activities) as well as other non-regulatory issues such as the existing legal framework governing commerce, the efficacy of courts and other institutions as well as the prevailing macro-economic conditions and the fiscal environment.

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57 In addition to the supervisory techniques, additional measures to ensure systemic stability are the establishment of the JDIC and the use of Lender of Last Resort financial facilities extended by the Central Bank as well as other specialized supervisory techniques such as the establishment of a Ladder of Enforcement and the issue of Standards of Best Practice relating to key operational areas of financial institutions (eg. credit administration, liquidity management)

Nonetheless, with the experience of the 1990s to guide us and in the face of more permissive regulatory regimes worldwide, the Bank of Jamaica has insisted on promulgating and adhering to rational, judicious and far-sighted regulatory policies, especially as regards capital, such that very strong capital buffers have been built up through the following:

- relatively stronger capital requirements than many other jurisdictions (required risk based capital ratio of 10% versus the 8% international norm as required under Basel 1 - this measures capital in relation to the level of risk in different asset categories);
- The definition of capital base is also more strictly drawn than provided by Basel. The Jamaican definition excludes categories permissible under international standards;
- despite the option provided under Basel 2 for regulators to allow banks to assess and determine on their own capital adequacy requirements, BOJ has prudently maintained the right to assess and determine on the mandatory capital levels necessary for banks to operate safely on an individual basis (if necessary);
- additional 6% primary ratio (which acts as `belt and braces' and sets the floor for capital in relation to total assets, irrespective of their inherent risk levels);
- capital base components more stringently determined hence for example,
    - "loan" capital like previously allowed special debentures have been phased out and are no longer permissible;
    - preference shares not eligible for Tierl (core) capital;
    - retained earnings not eligible for capital base <u>unless</u> it has been allocated to a non-distributable retained earnings reserve;

  unrealized revaluation gains are <u>not</u> eligible to be taken to profits and therefore are no longer possible to be used to artificially inflate capital"
- prudent loan loss provisioning requirements as to specific as well as general provisions for potential losses that do not attach to specific assets, so as to ensure prudent buffers in times of

58 , "This was a serious issue in the case of the CFEs where capital was constantly being `manufactured' literally by the `stroke of a pen' through the persistent unrealized revaluations of fixed *assets*, until the practice was stopped by changes to the law in 1992.

balance sheet stress. This therefore results in stronger capital since these provisions accumulate over time and act as an additional capital buffer against losses

All of these regulatory measures have meant that despite the resulting fallout in our economy as a consequence of the current global financial crisis, the Jamaican banking sector despite showing an increasing level of non-performing loans has nonetheless continued to benefit from a strong capital and loan provisioning base, as borne out by stress tests. This is an area in which many industrialized countries have been found wanting. Hence, we note also that since the global meltdown several G20 jurisdictions are now reviewing their regulatory arrangements and have already determined on or are considering the re-introduction of several approaches similar to those taken by Jamaica, including a primary capital ratio to ensure their banks adhere to strong capital enhancement programmes.

The above notwithstanding, in our view, the following are measures that could serve to further strengthen the framework for supervision and increased surveillance over the financial system.

1. The independence of supervisory authorities is internationally acknowledged to be a key ingredient of effective banking supervision[59]. Independence on its own does not ensure that crises will be averted or that key decisions will be made on a timely basis. However, where the Banking Supervisor is vested with independent powers to act and also possesses the technical expertise and adequate resources, this allows the Supervisor to intervene when problems are first discovered and to take appropriate and timely action. It is however acknowledged that the decision to take action always has to be balanced with the particular circumstances that exist at the time, including the stance of management (whether cooperative or hostile), the financial capacity of owners to inject capital and/or the existence of interested parties to invest and provide new capital to such entities as well as the broader socioeconomic implications.

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59 Per Basel Core Principle 1- the Basel Core Principles for Effective Banking Supervision issued by the Basel Committee/BIS provide internationally accepted norms and guidance for supervisory authorities worldwide.

There have been moves to grant the Supervisory Authorities greater autonomy, including the transfer of some key powers (such as the power to take temporary management) to the Supervisor in 2002. However the country's banking supervisory framework has been assessed as "marginally non-compliant" in this critical element of independence by the IMF/World Bank[64] in their FSAPIBCP Assessments of the country.

2. The experience of the Central Bank has been that in the majority of cases of Jamaican banking failures, there were clear instances of a distinct lack of a serious culture of compliance and prudence within the financial entity (and in some cases extreme recklessness). This was also coupled with a high appetite for risk, exacerbated by an overall weakness in management as detailed in our response to Question S of this statement.

There is some difficulty in addressing the conduct of management, which must in large part depend on an appreciation that good governance enures to the benefit (and not to the detriment) of the entity and its shareholders. Supervisors receive data from institutions and carry out inspections annually to assess safety and soundness and adherence to law. However, it is the Board and management which have the main fiduciary responsibility to shareholders and depositors of ensuring that entities are run prudently and soundly with appropriate risk mitigating policies to engender and sustain profitable operations.

However the measures taken to date to improve on governance practices include:

(a) enhancement and significant strengthening of the "fit and proper" criteria under the banking laws[61];

(b) The issue by the BOJ of Corporate Governance Standards of Best Practice, which focus on the proper controls that are

6' IMF FSAP - Jamaica's Detailed Assessment , April 2006 Table 1, page 18. (Full Report forwarded to the Commission of Enquiry on 31 August 2009)

61 The revised fit and proper criteria instituted for banking entities in the banking statutes has now been replicated in other financial sector industries such as in the Financial Services Commission Act and Insurance Act.

necessary to ensure that there are appropriate checks and balances in the various operations within an institution via measures such as segregation of duties, robust internal controls, the role and responsibility of audit committees, the role of independent un-connected external directors, the role of independent and uncompromised external and internal auditors and the encouragement of a strong compliance culture in ensuring that these standards are met. A failure to meet these Standards now amounts to statutory grounds for regulatory sanctions.

(c) The issue of Standards of Best Practice regarding the separation of deposit-taking business from `managed funds' business. This is an integral measure that has sought to impose a greater level of transparency into the operations of Jamaican banks by virtue of the legislative separation of banking business from securities/managed funds business. The view of the BOJ has been that given the operational weaknesses identified in the banking system, permitting deposit taking and managed funds (i.e. the banking book and trading book) operations within single organizations can lead to commingling of these operations and funds, as well as potential conflicts of interests between protecting the interests of investors vis a vis the interests of depositors. In addition, it was felt that investors who place funds with a bank would feel that the bank guaranteed or would make good losses on these investments. We note that this separation measure is now being contemplated by several major jurisdictions, in response to the global crisis and its genesis in the investment banking sector.

(d) The increase in the frequency of meetings by the BOJ with the Board and senior management to review in detail regulatory findings arising from the on-site examination of the entity as well as any other regulatory issues that relate to the entity. These meetings are a key part of the supervisory annual cycle and serve to impress particularly on the Board, the major implications of the existing conditions and the likely ramifications for the financial entity and the directors themselves, if these conditions are not addressed in a timely manner. We have also found that this most useful practice adopted by the BOJ with increased rigour since the earlyl 990s, does not yet have universal application, but is increasingly being adopted by major jurisdictions.

(e) Special emphases has also been placed on improving the risk management and internal audit functions within these entities.

(f) Training for the industry. In this regard, the BOJ has ensured that the industry receives training as it relates to new regulatory requirements that are imposed on institutions and their management. These have included seminars on areas such as anti-money laundering and countering the financing of terrorism, risk management as well as customary training relating to new procedures and/or formats for prudential reporting.

3. Another key challenge that would have arisen during the crisis would have been the fact that often financial difficulties spanned different types of financial entities with different regulators working with frameworks of differing levels of robustness, thereby facilitating regulatory arbitrage. Thus in several cases, the weaknesses of the insurance entity within the group (notably Crown Eagle and Mutual Life) served as an incapacitating drain on the resources of the related banking institutions, which were forced to provide liquidity to fund policy encashments[62].

The core difficulty here was that the banking supervisors were unable to get a clear view of the financial conditions of the insurance arms and in fact there were differing standards of regulation and differing levels of regulatory resources being deployed to various industries. Indeed over the earlier part of the period several types of financial institutions were not under any substantive form of regulation. Thus for example, building societies prior to 1996 were registered with the Deputy Keeper of the Records under the Building Societies Act and were not subject to any form of financial regulation. Consequently several banking conglomerates sought to establish building societies (and similarly industrial and provident societies e.g. Blaise and others) as vehicles

G2 Jamaica Resolution Strategy for Financial Sector Distress Draft Guidelines Prepared by IABD, IBRD and IMF (November 1996) Part 2, Section B, page 12. See also Appendix VI Solvency Assessment: Insurance Companies to transfer bad loans or to carry out other questionable transactions (such as the issue of debt instruments), all of this away from the scrutiny or legal reach of banking supervisors.

The role of unit trusts in the 1990s also led to the Minister of Finance imposing an administrative moratorium on the licensing of new unit trusts, as these also became vehicles for garnering public funds without the requisite level of transparency. In some cases, they became receptacles for bad assets that deposit taking entities wished to dispose of.

The remedies for these problems are threefold:

(a) **There should be the appropriate regulatory regime for every type of financial business operated in** Jamaica. The fairly recent passage of the amended Insurance Act represented a significant strengthening of the regime for Insurance Companies. Significant revisions to the regime for Building Societies has taken place via revisions to the Building Societies Act and the enactment of the Bank of Jamaica (Building Societies) Regulations, which now bring these societies under a regime similar to that which exists for banks and licensees under the FIA.

Work on the regime for credit unions is continuing (BOJ Credit Union Regulations are yet to be passed by Parliament); while regulatory regimes have been established by BOJ for even smaller non-deposit taking financial entities such as cambios and remittance companies.

The FSC is also carrying on additional work in the area of pensions. However there are still some businesses (such as money lenders) that are not regulated. Whilst these entities cannot be said to be repositories of savings nor are they systemically important, they should be regulated at least from an anti-money laundering or consumer protection point of view.

(b) **Supervisors must have access to financial information relating to the activities of other entities that are within the same group/conglomerate which can impact on the financial conditions of the banking institution.** This can be via direct access and/or communication between regulators.

For banking supervisors, the Basel Core Principles require that supervisors extend their surveillance beyond the banking institution to include consideration of the activities of related companies via a system of Consolidated Supervision. In 2002, the Bank of Jamaica piloted changes to the banking legislation[63] to improve the regime for consolidated supervision. These provisions include powers to obtain information from any entity within a group containing a deposit-taker, powers to direct/require the restructuring of groups to separate non financial companies from the group structure, and issuing directions relating the control of risks within the group particularly as these relate to group capital requirements and inter-group transactions/exposures.

(c) **Coordination between/among regulatory agencies -** The Financial Regulatory Council was established in 2000 to facilitate information sharing among regulatory bodies and other key agencies (BOJ, FSC, JDIC, the Financial Secretary (Ministry of Finance) and Solicitor General). The Council was established pursuant to a Memorandum of Understanding which was signed in December 2001. Interagency collaboration continues outside of the FRC through other fora which has included the coordination of on-site examinations where the FSC has joined the BOJ in assessing a bank affiliated FSC licensee. These measures afford the authorities a means of viewing the workings of the major institutions in the sector as a whole and to co-ordinate regulatory action where necessary.

Given the modern trend for cross border expansion of financial groups, the Bank has in conjunction with regional and international regulatory colleagues established information sharing arrangements relating to financial entities whose

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6a Sections of the BAIFIA 29A to E and BSA 75A to E corporate group structure spans multiple jurisdictions. The Bank is a signatory to a Memorandum of Understanding for the sharing of information among Caribbean regional banking supervisors.

The Bank also regularly participates in Supervisory Colleges that are held to discuss regulatory issues relative to specific entities that span jurisdictions. Such colleges have involved supervisory agencies such as the Office of Supervisor of Financial Institutions (Canada) as well as the Financial Services Authority (UK).

The Bank, as a member of the Caribbean Group of Banking Supervisors, also sits on a Task Force that is seeking to establish a regional financial crisis management plan which seeks to establish the relevant information sharing and other protocols that will prevail in the case of a financial crisis that affects a cross border regional financial conglomerate.

The legal reform carried out as regards banking legislation has served to address key issues that have arisen in the sector. However there are additional measures that are required for the system to modernize itself.

The Bank of Jamaica has recommended the passage of **Omnibus legislation** which will serve to synchronise the prudential requirements for the three deposit taking sectors and remove any remaining regulatory gaps (e.g. differences in transaction limits) as well as entrench enhanced international banking supervisory standards per Basel Core Principles (BCPs). This would include for example, crucial provisions to address the supervision of bank holding companies as well as Regulation making powers for the Supervisor. The provisions also would deal with emerging trends such as the centralization of anti-money laundering controls groupwide, centralization of back office functions, outsourcing and other trends. The regulatory response would be to allow greater flexibility (e.g. as regards intra group information-sharing) in particular areas to take into account the modern trends relating to centralization/decentralization. Another issue that would be addressed under these reforms would be international refolans such as the Basel II Capital Accord, where banks and other deposit takers are required to among other things hold capital against a wider range of risk exposures (e.g. operational risks[64]) and make certain market disclosures as regards their operations.

On an institutional level, the Central Bank has also implemented strategic measures towards promoting financial stability through the establishment of an early warning system and stress testing regime for the financial sector. The Financial Stability Unit commenced operation in 2004 and this unit develops various stress testing models to assess the impact of macroeconomic system/external shocks to the banking and wider financial system (inclusive of insurance and securities) on the adequacy of capital and liquidity levels. This Unit's reports have been publicly available since 2005.

Increased resources - Modern supervision also requires greater technology and human resources (to deal with growth in number but even moreso, the growing complexity of financial products and transactions; increased financial services that are subject to regulation; expanded role of supervision to include for example, the areas of AML/CFT; conglomerate/ consolidated supervision; credit union supervision and more recently regulation of credit bureaux), as well as continued training for supervisors to maintain relevance of skill sets.

Promoting Financial Literacy --- Additionally to deepen the awareness of the public with regards to the different financial instruments, products and services, statutory requirements and the risks involved in investing in or conducting business with financial service providers which are not regulated, greater financial literacy and awareness is required. This includes the responsibilities of investors and in this regard BOJ has participated in island-wide public education campaigns with the JDIC and the FSC. BOJ also has a routine publication in the print media as well as regularly participates in electronic media programmes, which all seek to educate the public on the role and function of the Central Bank and on general financial matters.

64 The Basel Committee defines `operational risk' as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. (This includes for example the risk of loss arising from business interruptions, systems failures and fraud.)

Other financial sector reforms - The World Bank post financial collapse review[65] for Jamaica posited that the establishment of credit registries can provide better information to allow financial intermediaries to distinguish between borrowers who are likely to repay their debts and those that are likely to default. The Credit **Reporting Bill** that will facilitate the establishment of credit registries is currently being considered by a Joint Select Committee of Parliament.

The recent emergence of the unregistered investment schemes in Jamaica has pointed to the need for greater flexibility in the existing laws to accommodate the emergence of these hybrid products. The Bank has, at the request of the Minister of Finance and in conjunction with the Financial Services Commission, the Ministry of Finance and the Director of Public Prosecutions, produced a report examining this issue with recommendations for the reform of the financial system to address these issues[66]

In the areas of **Anti-Money Laundering,** the Financial Investigations Division Bill (which is also being considered by a Joint of Select Committee) is also a critical element of the national framework. This Bill will establish a statutory basis for Jamaica's financial intelligence unit which is a key player in the national anti-money laundering framework and thus impacts on the operation and governance of financial institutions.

Bank of Jamaica
29 October 2009

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65 World Bank Study -- The Road to Sustained Growth in Jamaica - Chapter 4 page 95-96
66 See `Report on Recommendations of Task Force Established to Advise Government on Necessary Institutional Measures and Legal Amendments to Preclude Recurrence of Ponzi and Pyramid Schemes dated July 2009 (forwarded to the Commission of Enquiry on 27 October 2009).