MINISTRY PAPER No...79

FINANCIAL SECTOR REFORM

A. Introduction

Since the mid-1990's, the Financial Sector in Jamaica has faced many problems.

The Financial Sector problems stemmed from:

1. The rapid expansion of the Sector in the mid-1980's.

2. Structural reforms of the 1990's which created new avenues of profit for these institutions such as trading in foreign exchange and a wide range of securities;

3. The existence of an inflationary environment which facilitated rapid growth in profitability while at the same time masked weaknesses in the sector. These weaknesses emerged once the anti-inflationary policies were put in place;

4. The severe strain placed on the management expertise available to the Sector as a result of the rapid expansion;

5. Ineffective supervision of the management of these institutions by their Boards of Directors;

6. Creation of conglomerates characterized by complex inter-company shareholders, interlocking Boards of Directors, common management, extensive intra-group transactions and co-mingling of assets and liabilities;

7. Inadequate legislation to regulate and supervise the financial sector; which resulted in regulatory arbitrage; and

8. The apparent failure of professional bodies to insist on compliance with acceptable standards.

2. To respond to the situation, the extent and nature of the problems were determined and appropriate solutions developed. From the analysis done it was clear that the problems of the Sector were caused by a number of inter-related factors which included:

- A Mismatch of Asset and Liability Maturities
- Diversification Away from Core Business
- High Operating Costs
- Financial Conglomerates

Government's Approach to the Problems

3. The Government was obliged to protect the savings of thousands of depositors, policyholders and workers whose pension funds were invested and managed by insurance companies.

4. The Government therefore embarked on a three-pronged approach which was aimed at addressing the problems:

a) a series of fast-track legislation was introduced to strengthen the regulatory framework for the banking sector;

b) FINSAC was established in 1997 to intervene in troubled entities, rehabilitate and divest them to private hands as soon as practicable; and

c) forensic audits were conducted in all failed institutions

B. Legislative Action

5. A significant component of the reform programme is the improvement in the regulatory framework. To close the regulatory loopholes/gaps that existed and provide the regulatory environment that could sustain confidence, a comprehensive review was done of the pieces of legislation governing the sector.

6. Based on that review the legislative framework was enhanced. Amendments were made to various acts governing the sector; the Banking Act, The Bank of Jamaica Act, the Building Societies Act, The Securities Act and the Financial Institutions Act, to provide for *inter alia*:

(a) more efficient and effective powers for remedial action taken by the Supervisory Authorities in respect of distressed institutions;

(b) reduced capacity for institutions to lend to, invest in, related parties;

(c) a more stringent computation of capital adequacy;

(d) a more precise definition of non-performing loans and power for the supervisory authorities to prescribe accounting rules; and

(e) greater control by supervisory authorities over the changes of ownership and a stricter definition of a "fit and proper person' for management, directors and owners of institutions.

7. A Deposit Insurance Scheme was also implemented to provide for insurance of deposits of a maximum of $200,000 against risk of loss when a policyholder/institution becomes insolvent.

FINSAC's Intervention

8. To carry out its functions FINSAC adopted a three-phased approach:

1. The Intervention and Rehabilitation Phase
2. The Rehabilitation/Restructuring Phase
3. The Divestment Phase

The Intervention and Rehabilitation Phase

9. FINSAC has successfully completed the intervention phase; the rehabilitation phase is about 90% complete and is well advanced in the divestment phase.

10. To date, FINSAC has divested a number of assets including hotels, the bulk of its insurance portfolio, and residential and commercial properties estimated at J$11.4B. FINSAC currently has available for divestment another J$20B of assets.

Forensic Audits

11. Forensic Audits have been carried out in all institutions intervened by FINSAC. Specially contracted experts from overseas carried out these audits.

C. Divestment of FINSAC's Assets

12. **FINSAC** currently owns substantial shareholdings in both Union Bank and the National Commercial Bank as well as stakes in some smaller Merchant Banks, Victoria Mutual Building Society, Life of Jamaica, Island Life and Dyoll Group Limited. The timing of the divestment of these holdings is an important factor in determining the point of exit of FINSAC from the financial sector.

13. Currently, negotiations for the sale of FINSAC's 99% shareholdings in Union Bank to Royal Bank of Trinidad & Tobago Financial Holdings Limited are far advanced and the sale should be completed before the close of this calendar year. FINSAC has been advised, in respect of the shareholding in NCB, that the present configuration of this