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JAMAICA

Jamaica Financial System Diagnostic and Recommendations

July 2003

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Jamaica Financial System

Diagnostic and Recommendations

January 2003

This study was prepared by Messrs Martin Naranjos Lander and Emilio Osambela Zavala. Mr. Desmond Thomas, Country Division 6, coordinated the study. Carla Moore (RE3/OD6) formatted the document.

Regional Operations Department 3
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1. Introduction

The financial system of Jamaica has undergone several structural changes in the last decades, moving from a heavy foreign participation to nationalization, and from nationalization to privatization. Recently, the government has taken action with strong determination to provide consistency to the relationship of the financial system and its environment. Considerable resources were devoted to provide, through regulation, an incentive framework to minimize the problems of adverse selection and moral hazard inherent to any financial system.

In the last decade the financial system assumed too much risk, increased its vulnerability and, in 1995, generated a financial crisis. Five commercial banks (out of nine) and five insurance companies were intervened. Weak macroeconomic fundamentals, choices of macroeconomic policy, and especially the combination of these factors with aggressive risk taking of the financial system account for most of the crisis outcomes.

Important steps have been made during the last years to correct this state of affairs. This document will focus on what might still be missing or can be done regarding financial system regulation and supervision. We believe that some measures could be taken to marginally improve the solvency and stability of the financial system. These measures will consider the risk management system, the environment in which it is applied and the consistency between them.

Institutional aspects, the financial safety network, as well as the risk management systems should be properly aligned to allow the financial system to reach a sound and solvent position. The purpose of this document is to try to make an evaluation of these three core elements for the Jamaican case.

Given their own nature, financial institutions develop risk management systems. Their characteristics and behavior depend greatly on the environment in which the financial institution operates. This environment is defined by the financial safety network and the institutional characteristics of the economy.

Thus, the risk management system will be appropriate for the financial firms if it is consistent with the institutions of the economy: dispute resolution mechanisms, crime, transparency, informality, etc. and of the financial safety network: financial supervisor, lender of last resort, deposit insurance, corporate governance, and resolution mechanisms.

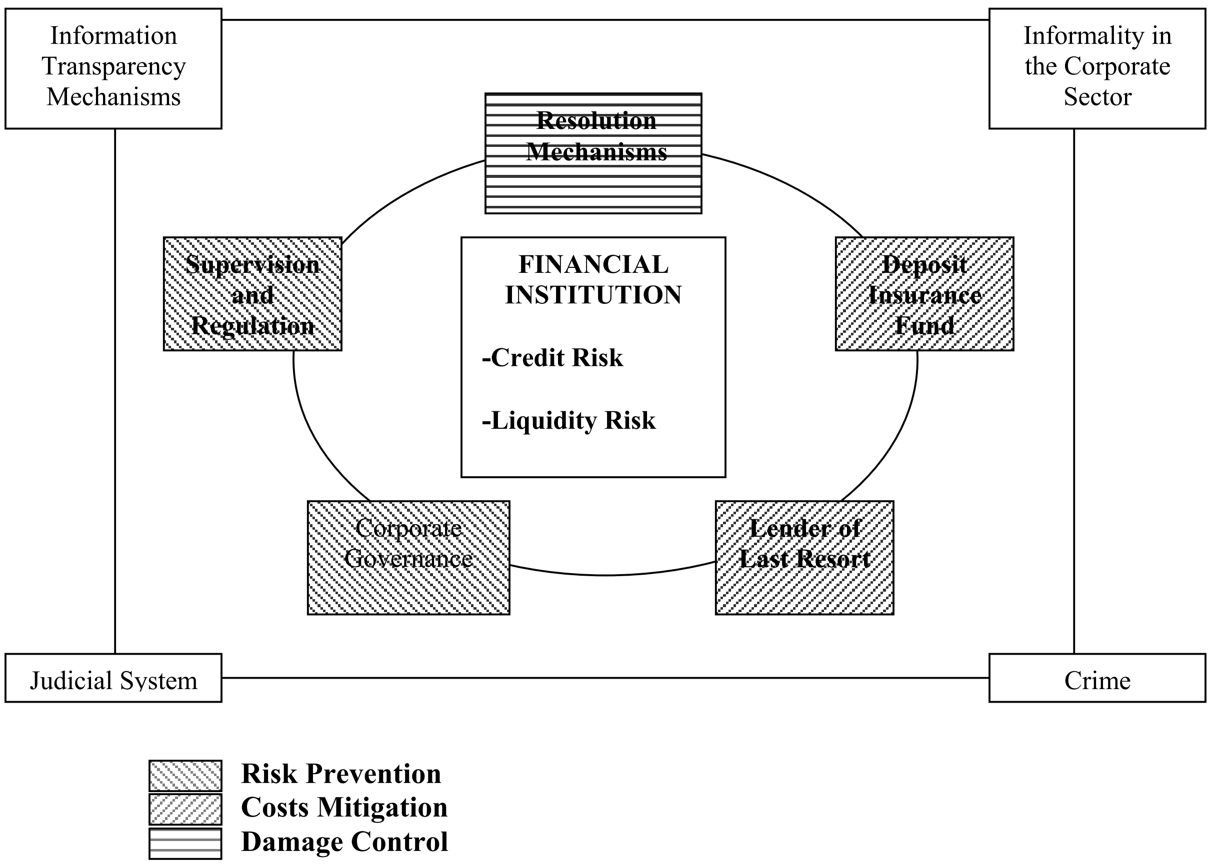
For instance, if the exchange rate risk is not considered in the risk management design, exchange rate risk taking will be considerably more aggressive, and a lender of last resort with a more prudent foreign assets management will be required.

At the same time, the financial safety network of a given economy is expected to be consistent with the rest of the institutions of that economy. For example, in a context where the law can not be efficiently enforced, banking supervision should promote higher private participation in order to encourage market discipline as an additional enforcement mechanism.

According to the proposed focus for the Jamaican financial system to reach sustainability, the current financial risk management regulations, the financial safety network, and institutional characteristics of the economy must all be consistent with a sound financial system. These three elements must be properly aligned to provide an optimal incentive framework to achieve this objective. See Figure 1.

Figure 1

Risk Prevention, Cost Mitigation and Damage Control



The remainder of the document has been divided as follows: Section 2 includes a description of two issues: the problems faced by financial institutions and insurance companies – especially those of the 90's – , and the actions taken by the Government to deal with the situation of the financial system. Section 3 evaluates some institutional characteristics of the Jamaican economy. Section 4 analyzes the financial safety network. Section 5 assesses the risk management system. Finally, Section 6 draws a number of conclusions and recommendations.

2. Background

2.1 Chronology of the Crisis

Prior to the independence of Jamaica, and in its first years as a republic, the financial system was dominated by branches of foreign financial institutions. These companies were subject to prudential standards and controls from their parent companies, and therefore, there was no explicit need to develop locally an effective prudential regulation for the system. Furthermore, foreign banks limited the government's effort to introduce domestic regulations.

In the late 60's and early 70's the Government nationalized (localized) the majority of the financial institutions, and consequently the prudential standards used earlier by foreign administrators disappeared. The implementation of a strong regulatory and supervisory structure was not a priority for the government.

In the late 80's nationalized banks were progressively privatized. This process started in 1986 with the transfer of 40% of shares from the National Commercial Bank (NCB), leading Bank of Jamaica, to the private sector. Later, in 1991, the Workers Savings and Loan Bank underwent the same process. During this period, the lack of supervision, regulations, and entry barriers allowed the massive entrance of financial institutions. This happened in an environment of insufficient institutional control that resulted in a highly volatile situation.

Economic reform included the liberalization and privatization of the financial sector. Short term foreign capital inflows increased and, with them, the vulnerability of the system also increased.

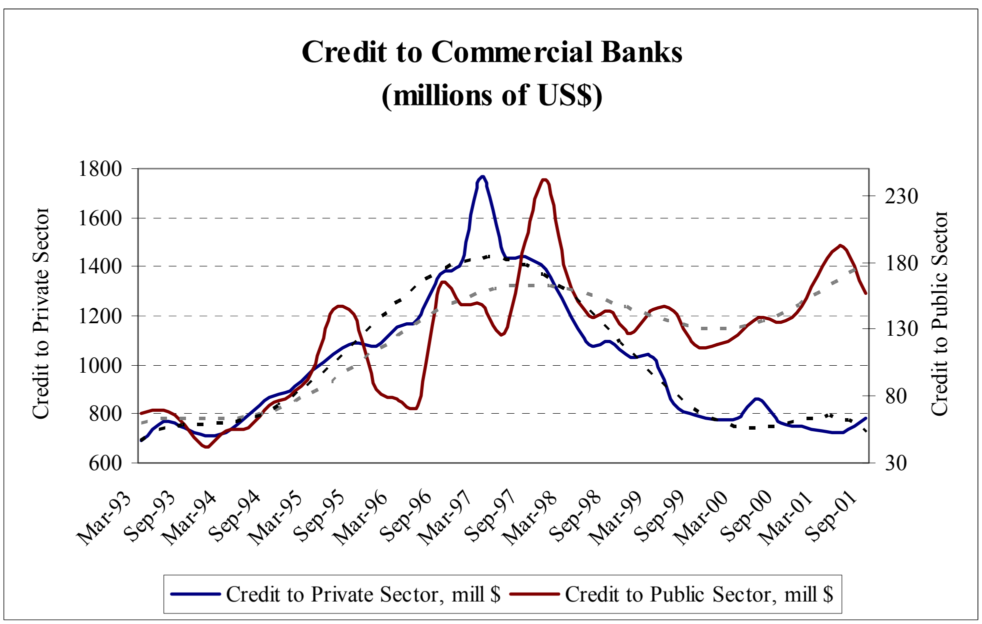
Likewise, the setting of expansive macroeconomic policies generated economic growth for some years, but later, results turned negative: in 1991 inflation reached 80%, with a real growth of only 1% that did not change until 1995. Additionally, the domestic debt issued by the Government to finance the deficit in 1992 was mainly absorbed by the Central Bank and commercial banks, increasing dramatically the debt levels to the financial system. In this scenario, the Government liberalized interest rates and exchange rates, theretofore heavily regulated. The timing for such liberalization was not the best and no safeguards had been established. Sustained fiscal balance, local currency stability, and a prudential financial and regulation system oriented to preserve soundness are necessary conditions to reach a successful transition to market mechanisms and integrate the domestic economy to the global economy. In the Jamaican case, none of these conditions were fully met. As a matter of fact, they were far from being met.

Greater competition levels encouraged financial institutions to search for profitability by assuming greater risks. Bank reserves, capital and provisions requirements were postponed in the search of a lower cost of funds. Likewise, the regulatory frame, at that moment, gave clear arbitrage opportunities to financial conglomerates and to large banks with international holdings. Financial conglomerates confronted less demanding regulations and even tax advantages. For this reason, the number of financial conglomerates that included different kinds of financial institutions, such as commercial banks, mercantile banks, construction societies, general and life insurance companies, leasing companies and investment funds, increased. The number of mixed conglomerates also increased, increasing with it the risk of contagion.

An unsustainable credit boom, concentrated in consumer–oriented credit, was also produced. Credit risk management and collateralization assumed scenarios that later proved to be too optimistic.

This generated a remarkable growth in the financial system in the beginning of the last decade. Contribution from the financial sector to GDP rose from 7% in 1987 to 16% in 1994, although it has now stabilized to an average of 12%. On the other hand, the number of financial institutions - banking entities and insurance companies - increased from 67 in 1989 to 105 in 1995. Commercial bank deposits increased from US$ 1,575 million in the early 90's to US$ 2,670 million by the end of 1995 and it reached a maximum of $3,315 million at the beginning of 1998. Commercial bank credit also expanded from US$690 million in 1990 to US$ 1,158 million in 1995 and it reached a maximum of around US$ 2,000 million in May 1997, just to fall again to US$ 939 million in September 2001. It should be mentioned that credit growth during the first part of the last decade occurred both in the private and public sectors, as shown in Figure 2.

Figure 2



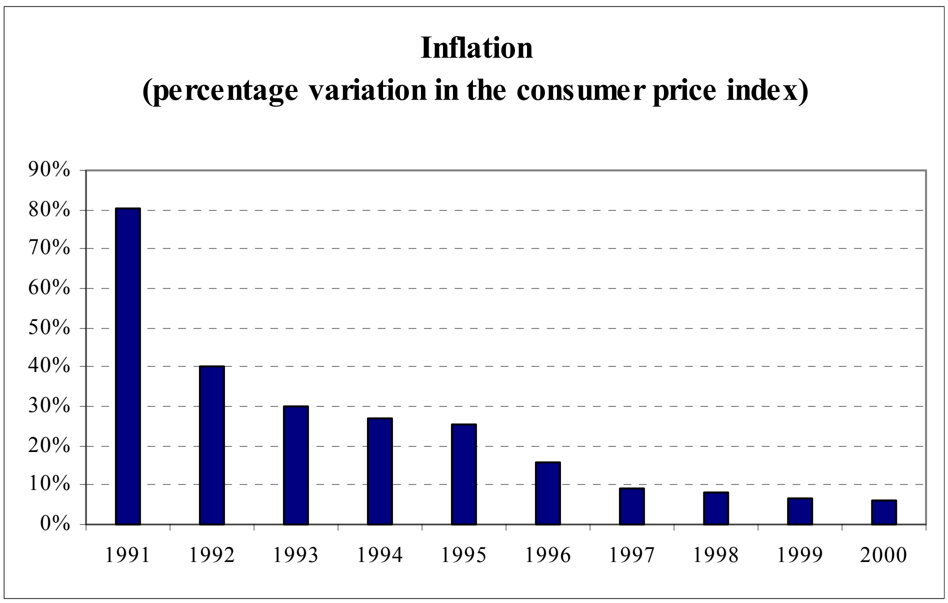
Source: Statistical Digest, Bank of Jamaica

While this was happening in the banking system, many insurance companies were in expansion, and they used their long term funding to increase their participation in banking institutions.

Regulation and supervision were not in place for the financial institutions to properly manage the implicit credit risk they were assuming and an oversized credit growth during that period resulted. This stage was also characterized by increased lending to related parties, as well as a maturity and currency mismatches, among other characteristics, that show that the risk management systems were not working properly. In general, excessive growth periods are clear indicators of the absence of controls and robust predictors of financial crisis.

During the same period, the central bank used a contractive monetary policy to control high inflation levels. Even though this measure allowed to reach the goal (see Figure 3), it also increased the real interest rates, and this had an adverse effect on portfolio quality, investment, economic activity and fiscal accounts. The increase in interest rates also encouraged short term capital inflows, increasing the liquidity of the system, and forcing the Central Bank to adopt a contractive monetary policy to fight this effect and to control inflation. But this encouraged the rise of interest rates, thus resulting in a vicious circle.

Figure 3



Source: Statistical Digest, Bank of Jamaica

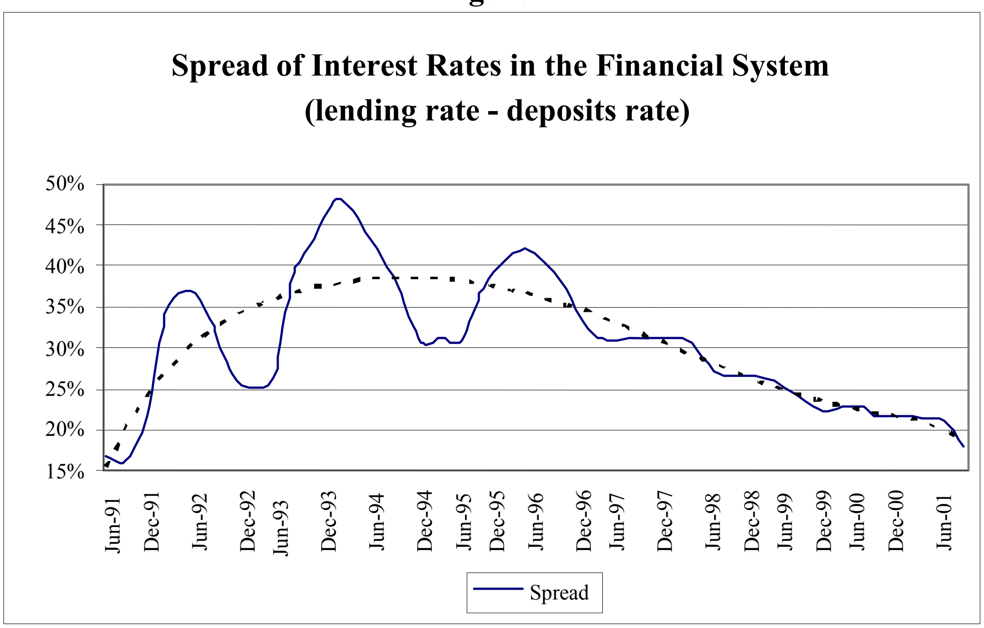
As mentioned above, the liquidity restriction encouraged by the monetary policy had a negative effect on insurance companies, which decided to follow two risky mechanisms to increase their profitability. First, they launched financial saving products, similar to the deposits offered by banks and other deposit taking institutions. These short-term liabilities were used to finance long term assets. With this mismatch, insurance companies were preparing the crisis scenario. This liquidity problem infected the affiliated commercial banks.

The second mechanism was possible due to an early acquired participation in financial institutions. This participation was useful to insurance companies, partial owners of banks, to “induce” the latter to grant them credit exceeding related lending limits.

Interest rates derived from the Central Bank's restrictive monetary policy as well as the poor macroeconomic fundamentals created a serious information problem in the financial system. At the beginning and during the crisis, companies' market value (and collateral as well) was reduced because of the dynamics of a recessionary market. This reduction increased the information costs related with adverse selection problems in the credit market. In these circumstances, the interest rate paid by all companies increased, but the amount of the increase was inversely proportional to the quality of the financial information that debtors could show, so the difference (*spread*) between the rates paid by transparent and not-so-transparent companies started to increase since the beginning of the crisis. A way to approach it is through the spread between lending and deposit rates, assuming that banks have more transparent information than that offered by other companies.

Figure 4, shows that this information problem was present, and it increased throughout the first part of the last decade. In the second part, there was a stabilization period, characterized by the improvement of the macroeconomic fundamentals and the convergence of the exchange rate to a stable level of around 35J$/US$, as well as a reduction in inflation and a relative improvement in regulation and financial supervision. This contributed to the reduction in the information costs present in the credit market.

Figure 4



Source: Statistical Digest, Bank of Jamaica

In this context, characterized by lax financial supervision, disproportionate credit granting, and high risk exposure, a deep financial crisis broke out in 1995 in an environment where macroeconomic fundamentals were poor and with a serious adverse selection problem, thereby resulting in the intervention of five insurance companies and five commercial banks (out of a total of nine banks).

2.2 Actions Taken

In response to the financial crisis, the Government of Jamaica took actions in order to give stability back to the financial system. Some of the general steps taken will be explained in this paragraph while the specific steps will be mentioned in the following sections. Initially, in July 1995 the Government approved US$ 76 million in liquidity aid from the Central Bank of Jamaica to the *Century National Bank.* Nevertheless, in July 1996, it was necessary to change the bank management, and an institution named Financial Institutions Services (FIS) was created in order to solve the liquidity and solvency problems of the banks.

Later, in 1997, the Financial Sector Adjustment Company (FINSAC) was created to manage the failed financial institutions through three stages: intervention, rehabilitation/investment, and privatization (divestment). The first step concluded in March 1998 when FINSAC acquired the five insurance companies and the five commercial banks that had been intervened during the financial crisis. Since then, there was a significant progress in the second stage. The third stage will soon be completed.

Out of the five banks that were intervened, four merged and formed the Union Bank in April, 1999. The sale of Union Bank has been concluded.

As for the bank that was left, the National Commercial Bank (NCB) – a leading local bank– FINSAC and its subsidiaries signed a sales contract with AIC Ltd from Ontario in January, 2002: FINSAC and its subsidiaries sold their share of NCB (75%) to AIC Ltd.

On the other hand, four of the insurance companies have been restructured: deposits were transferred to the Bank of Nova Scotia and the insurance portfolio was sold to the Guardian Insurance Company of Trinidad & Tobago in August 1999. Later, in November 2001 FINSAC sold its shares in Life of Jamaica (LOJ) to Barbados Mutual Life Assurance Society, a subsidiary of Life of Barbados Ltd. This meant the last insurance company restructured by FINSAC.

Likewise, in October 2000 US$ 291 million in FINSAC bonds maintained by Bank of Jamaica were deducted against deposits of the Jamaica government in the Bank. The remaining US$ 296 million were converted to Local Registered Stocks (LRS), which is the medium term debt instrument used by the Government to acquire funds in the domestic market. The rest of the pending debt of FINSAC in the private sector was also converted to LRS, and cash interest payments on the debt stock began in March 2001. All the LRS issued by debt exchange from FINSAC are fully negotiable.

On the other hand, in January 2002, the Government of Jamaica signed an agreement to sell the 'bad' credit portfolio earlier requested from private entities. The buyer was the Jamaica Redevelopment Foundation (JRF) Inc. from Plano, Texas, a subsidiary of Beal Bank from Texas, specialized in secondary market for loans and debt assets. Beal Bank guarantees a punctual and full payment of the debt. Apart from the purchase value, the Government of Jamaica will get a percentage of what is recovered from 'bad' credits.

In the same way, the Parliament created the Financial Services Commission (FSC), now in full operation, as it is shown by its regular Board meetings. Both the executive director and the main executives, including senior directors for inspection and research, (securities and insurance) and the director for corporate services were hired in November 2001. The General Manager was hired in February 2002, and the *senior* director for pensions was expected to start working in April 2002.

In the year 2001, the new Insurance Law was completed (replacing the one from 1970) and it is already being enforced by the General Governor of Jamaica; therefore, it is in full operation. The staff of the FSC successfully conducted a risk based inspection plan in an insurance company qualified as completely appropriate by an international consultant. Additionally, the Fiduciary Act was amended so as to be consistent with the insurance legislation.

An amendment to the Securities Act is currently in progress. The FSC is given authority to settle risk-based capital standards for insurance brokers and dealers with license to regulate prospects standards and information management.

The IADB directly supported this process by approving a program for the reformation of the financial system in September 2000, agreeing to provide enough resources for its execution. The program had the following objectives: (i) Resolution of the financial system crisis in Jamaica and (ii) reduction of the vulnerability of the financial system to future shocks. In order to achieve these goals, the program will: (i) assist in the disposition of assets accumulated by FINSAC. (ii) Support the containment of the debt incurred by FINSAC at the time the assets were acquired, and (iii) Contribute to the vulnerability reduction in the financial system to future shocks by supporting the prudential supervision in financial institutions. This includes the establishment of intervention processes that would have to be followed in a crisis, and the strengthening of the collateral recovery and selling processes. Most of the achievements of Jamaica's government are directly related to the program's components.

Thus, it can be inferred that the work performed by the authorities in Jamaica is satisfactory and represents the first attempt –after several decades– to provide the strength and solvency required for long-term stability of the financial system.

On the basis of these reforms, in the following section we will analyze the factors that influence the performance of the financial system in a structural way, both the environment in which it develops (characterized by institutional aspects and the financial security network) and the risk management system.

3. *Institutional Aspects*

3.1 Information Transparency Mechanisms

Market discipline requires information transparency. Jamaica's financial system can surely benefit from the existence of reliable information of financial institutions and their risk exposures. Even though the existing regulation demands financial institutions to present their financial statements to the Central Bank, the Central Bank does not fully disseminate this information to the public. The only information available to the public is the one contained in the balance sheet of the companies under its supervision. It is worth mentioning that this information is posted on the Central Bank's website but in a format difficult for processing purposes.

Due to the lack of information, creditors cannot adjust their portfolio decisions conveniently or punish banking institutions when they assume excessive risk. This makes the market unable to act as an additional enforcement mechanism, relying solely on the Central Bank resources for these supervision tasks.

We consider that there is much to be improved in the issue of transparency in financial information. The information presented to the public must be organized by type of risk, time frame and has to be readily accessible. We also consider that, to start, each institution should fully disclose its financial statements. This would be an important step forward. Information should be presented in easy-to-read and easy-to-process forms. Additionally, the Central Bank should publish risk based statistical reports about the situation of the financial system periodically.

The Technical Cooperation Program (TCP) to strengthen supervision of non-deposit ranking activity supported by the IADB addresses areas that included the development of policies and procedures related to prospectus and disclosure requirements. Specifically, component II of the program includes, among its specific activities, the provision of guidance and support to the development of policies, rules and procedures governing *transparency* and *disclosure* on regulation making. Another specific activity is to provide guidance on the implementation of enforcing actions for insurance and securities sector and *communicate* these enforcement actions to the public at large.

In addition, component III addresses the problem of prospectus and disclosure requirements. Its specific activities include (i) ongoing disclosure of prospectus requirements, procedures and financial information, (ii) advice on the information system for collecting, receiving and monitoring information, and (iii) public workshops for comprehensive disclosure programs.

Finally, component VI addresses corporate governance requirements and includes the disclosure of activities and information.

Through the TCP program, the FSC is expected to develop and enforce adequate disclosure standards for all public offerings of securities and for the periodic disclosure of information for listed companies. Thus, training of officials was recommended so that they can learn about the best practices in full disclosure and accounting practices for public companies.

Another critical aspect on information mechanism arises from the absence of a credit bureau. This kind of information is essential to protect creditors and to reduce credit risk on the basis of historic information from debtors. It also represents one of the few mechanisms to assign a default cost in credit contracts, given the problems from the judicial system in contract resolutions as we will explain later in one of the following sections.

In this regard, the Government has prepared a draft for the appropriate legislation in order to establish a credit bureau. Nevertheless, there has been no concrete proposal whether it will be a public or a quasi-public entity. Likewise, the Supervisor has been given the power to impose sanctions. One of the causes for a sanction is information inaccuracy in financial statements, as well as "creative accounting". This is an important step in the proposed direction of higher information transparency.

We believe that the process should be accelerated so as to establish a credit bureau. The credit bureau would be a very useful supervision tool and should be completely articulated to the process of in-situ supervision of financial institutions.

Additionally, companies could also be compelled to issue subordinated debt. Even though this signal can be weak under conditions of thin or illiquid capital markets, when they are negotiated, movements in their price and quantity would be indicators of how a particular group of creditors qualifies the situation of the institutions. Another recommendation would be to make the publication of risk ratings by private companies mandatory, as discussed later.

3.2 Informality in the Corporate Sector

The majority of companies do not handle acceptable accounting registers of the operations performed. This leads to a serious information problem which does not permit financial institutions to accurately evaluate the company's situation. The lack of appropriate signals generates obstacles to the credit granting process and also causes an increase in credit risk because it makes the management of adverse selection problems more difficult.

To solve this situation, the IADB and IMF are currently developing a project to strengthen the accounting and auditing professions in Jamaica. To achieve this, they count with the support of the Institute of Chartered Accountants and the private sector to make accounting practices accord to international standards.

We believe that, although the project is going in the right direction, there are some steps that could be taken in order to provide short-term results. At the same time, the Government could foster company formalization as well as appropriate accounting registers. Though difficult, formalization can be fostered through regular mandatory audit.

On the other hand, it is relevant to stress that, in addition to the formalization effort itself, it is necessary to establish an incentive framework that is consistent with company formalization. According to the entrepreneurs we interviewed, formalization incentives are inexistent and the cost of formal operation is too high. They also mentioned that it is very difficult for them to compete with companies that operate informally. The problem of informality is also present in the securities market and is related with the disclosure of information. As mentioned above, component III of the TA Program, addresses the problem of prospectus and disclosure requirements. Its activities include specifically, the establishment of standards of prospectus requirements, forms/filing procedures and type of financial information, the development of regulations and procedures which includes the registration process and the design of administrative and information system structures.

3.3 Crime

A critical aspect observed in Jamaica is related to its crime rates. This environment of insecurity generates a strong obstacle for investment, which constitutes a key element in the financial services demand. A high level of crime, terrorism or drug trafficking contributes to a lower investment level that encourages low levels of intermediation in the domestic financial system, and at the same time reduces the chance to achieve a sustained long-term growth. In this context, investors have an incentive to move their funds abroad when it would be necessary to generate sustainable growth in the country.

Financial crime basically consists of securities fraud and money laundering problems which cause distortions both in the financial system and in the money market. These kinds of crimes were addressed by the Office of the Director of Public Prosecutions (DPP) but the volume of caseloads restrained the specialization and optimum treatment of financial cases. Thus, a Financial Crimes Unit (FCU) was created in order to enhance and enforce capabilities against fraud and abuse. The FCU works with a specific budget, and they have already started training their prospective officers.

The initiative from Jamaica's authorities is appropriate in the way it is oriented to the money laundering problem, due to its characteristics as a major tourist destination and the drug traffic level present in the country. Nevertheless, we believe that to approach the money laundering problem, both prevention and formal coordination between the regulator and the judicial system is highly desirable. Likewise, it is necessary for the private sector to have a more active role in this area.

In addition, we believe that the development of anti-terrorist and anti-drug traffic programs should be encouraged in a first stage because these are the main sources of the murders. Subsequently, there should be an increase in police efficiency for crime prevention and an important improvement in their crime investigation capacity. This last point would be more effective than an increase in punishments.

3.4 Judicial System

The judicial system of Jamaica, like those in many other countries in the region, has long-lasting trials, and conflicts in credit contracts generally take a lot of time to be solved. In this regard, we have observed that 72% of the cases that are presented to the Court of Justice are related with murder, which delays judicial processes associated with other topics. For example, in the case of credit collateral, foreclosure could take between 18 and 48 months. During this period, assets lose value and the collateral misses its purpose.

Judges faced problems of insufficient legal investigation facilities and inadequate information systems. There is a lack of capacity to solve commercial and financial cases, therefore contributing to the perception that financial crimes have a sort of impunity. This impression has to be corrected.

For this reason, the Commercial Court (CC) has been formed as a specialized branch of the Supreme Court and it has been assigned a full-time judge for this exclusive purpose. A cooperation and training program has been agreed upon to address FCU and CC issues as part of the Technical Assistance program in order to specialize judges in commercial and financial matters.

We consider there is still much to be done in this regard, although this step is definitely appropriate since to some extent it solves the overload problem of murder/crime judicial process.

In this sense, we recommend a deeper Judicial System reformation so as to accelerate the recovery proceeding of collateral and the increase in creditor's protection from debtors default. This topic should be included in the CC.

On the other hand, the legal framework does not appropriately protect creditors in the financial system. This increases not only credit risk assumed by financial institutions, but also moral hazard in debtors. Thus, they virtually do not have incentives to repay the credit previously received as they perceive the inexistence of an appropriate legal system that timely punishes default.

It is worth mentioning that the effect on crime reduction by the improvement in the judicial system could be higher than that coming from the initiative of penalties increase that is being discussed nowadays. This is because the main problem nowadays is the lack of a judicial process that can punish law offenders. Even with more severe punishments, if this main problem persists, there will be no possibility for crime reduction without enforcement.

4. Financial Safety Network

International experience in bank crisis resolution shows that the high direct and indirect costs involved are not consistent with the magnitude of the factors that caused the problems. Thus, one shock can generate a financial crisis whose resolution implies big financial costs to the country, while another similar shock may only have a moderate cost with a small economic slowdown. Resolution costs do not therefore depend only on the magnitude of the shock that hits a banking system, but also on the vulnerability of the sector and on the strategy to confront it.

A resolution strategy should address the problems and also prevent and mitigate them. For this purpose, a coordinated body with specific and very clear functions is required to reduce the crisis probability, to minimize the costs of confronting them, and to neutralize the damages that can be generated on the national budget and the economic growth. This structure stands for a safety network over the financial market, so that it guarantees better crisis handling. The financial safety network must be conformed by institutions of the State that play different roles in the different stages of a crisis (see figure 5).

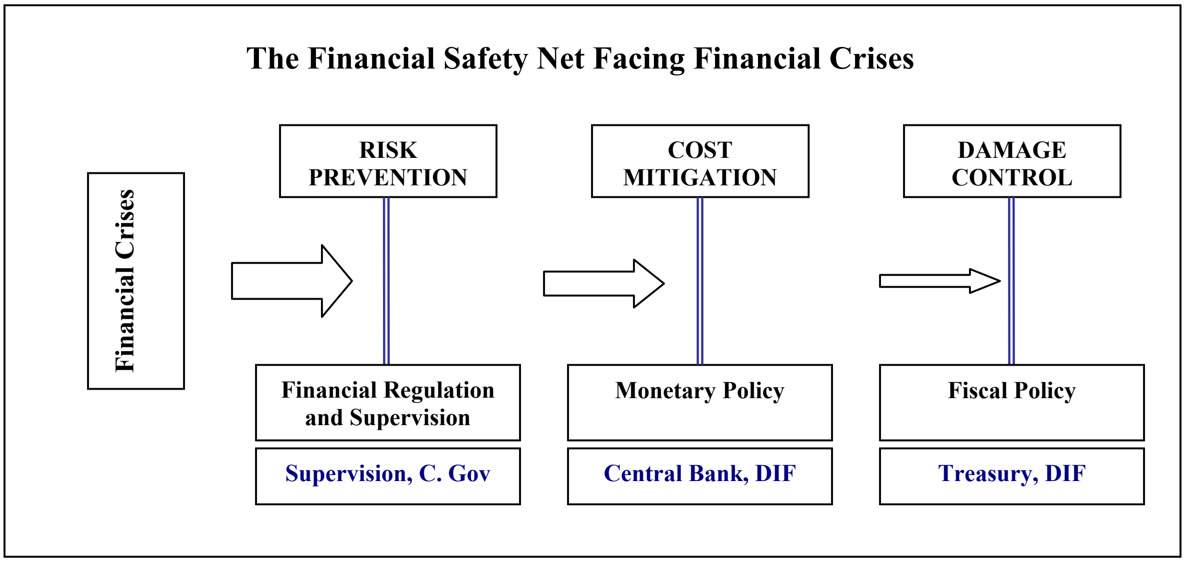
In the first place, in the stage of crisis prevention, strict and efficient regulation policies and risk supervision should be in the hands of a bank regulator with capacity, autonomy and supervision power. Additionally, in this stage, good policies of corporate governance in the financial institutions are essential for better risk prevention, control and management. These mechanisms are in place to reduce the probability of a crisis.

In a second stage, cost mitigation is achieved through quick and efficient action of the Deposit Insurance Fund to cover insured obligations. A Deposit Insurance Fund that is solvent and agile allows reducing the uncertainty in the system and, therefore, to minimize the contagion effects among banks. On the other hand, the Central Bank should participate in the financial safety network in its role of lender of last resort as well as in the role of monetary regulator, through policy instruments that allow a fine and flexible handling of the liquidity in the system.

Finally, in the last stage of the development of the crisis, the participation of the Treasury is important in facing the remaining costs of the crisis and in the design of resolution mechanisms to minimize the losses for the State. An appropriate damage control policy is needed in this stage, making resolution costs explicit and considering optimal strategies under the principles of the smaller cost and of concentration of losses in the shareholders, either through stock transfer, merger, or asset-liability transfers.

Thus, the financial safety network acts as a system of "protection layers" that cushions and reduces the shock effects over the banking system. As shown in figure 5, the first layer is the one corresponding to risk prevention through supervision and bank regulation. The second is cost mitigation through the coverage of deposits and the monetary policy that manages liquidity. Finally, the third layer corresponds to damage control through a fiscal strategy of reduction of costs. Weaknesses in any of these protection layers make shocks have deep effects in the system and in the economy, with high fiscal resolution costs.

Figure 5



The operation of the financial safety network should establish resolution strategies under explicit and well-defined mechanisms, with little or no margin for discretion, always looking for the principle of smaller cost and quick performance with the purpose of minimizing systemic risks. It is necessary to show these mechanisms to the market in a transparent way giving signs that the processes are fixed, not having any margin for political interferences that may imply a differentiated treatment among institutions, thus being able to reduce the moral hazard that motivates excessive risk taking by financial institutions.

4.1 Risk Prevention

4.1.1 Corporate governance

Weak financial industry corporate governance practices contributed to the crisis. For example, it was relatively common that board members either share executive responsibilities in the same financial institution or participate as members of many other boards.

One of the components that were addressed by the Technical Cooperation Program was corporate governance. The Securities Act establishes the requirement to establish audit committees and conduct review committees. The program will enhance corporate governance practices developing: (i) regulations that address roles and responsibilities of commission members, (ii) commission procedures concerning audit and internal controls, (iii) regulations for sound practices and corporate governance at boards' level, (iv) advice on conflicts of interest policies and (v) advice on secrecy standards.

Within the scope of the IMF project carried out to strengthen the accounting and auditing professions in Jamaica, mentioned in section 3.1, a plan to hold workshops and seminars on corporate governance practices has been established. The plan also includes the dissemination of more information about the responsibilities of the Board.

We consider that these workshops and seminars are appropriate. In general, the boards should be conformed mostly by non incumbents that can dedicate enough time to the tasks of the bank, especially regarding their involvement in risk, auditing and remunerations committees. In addition, in order to ensure auditing transparency, auditors must not have any connection with the bank institution, either through consultancies or any other relationship that could hinder to the conclusions drawn. The prudential regulation in this regard will soon be totally developed, we recommend prioritizing this work.

4.1.2 Financial supervision

a) Autonomy

Financial supervision should be concentrated on prevention so as to better promote the soundness, solvency and stability of the financial system. A necessary condition to ensure this is that the supervision work is carried out by an autonomous and independent agency with exclusive dedication to the mentioned objectives. The presence of diverse interests and multiple objectives (that could even be contradictory) would result in the failure to achieve any of them satisfactorily.

In this regard the Minister of Finance virtually overrides all the action power on the topics that are related to regulation and bank supervision. However, it is also in charge of directing the economic policies and other issues different from regulation and financial supervision. This lack of autonomy and the insufficient institutional backing and enforcement capacity were detrimental for the establishment of a sound prudential financial supervision in recent Jamaican history. This was one of the main causes of the financial crisis of 1995 (see section 2).

On the other hand, besides having an unnecessary political dimension, the process of issuing legal norms related with the financial regulation is slowed down significantly. This way, given the fact that it is necessary to go through different instances of the Ministry of Finance and the Central Bank norms are delayed more than they optimally should.

In Box 1, we present a summary of the powers vested upon the Minister by the law that we believe should be exercised by an independent and autonomous organization, with a budget funded directly by the financial institutions themselves, and not from the central government.

In order to give more autonomy to the supervisor, the Financial Sector Reform Program (FSRP), addressing bank supervision issues among other initiatives to reduce the vulnerability of the financial system to future crises, is aimed to lead BOJ to adopt international best practices, especially regarding autonomy and supervision of complex groups according to the Basle principles. Cabinet approval has been given to BOJ to intervene and assess fines. FSC is in full operation with intervention powers equivalent to those of BOJ.

A plan to address existing gaps between current regulation and the Basle Core Principles is being carried out. This will imply an important effort of adaptation to the conditions imposed by the Jamaican economy.

Box 1

Main Ministerial Duties under the Banking Act

Minister may:

- draw up regulations in general.
- define the scope of banking business, approve institutions, receive applications for banking licenses, authorize use of the word "bank" in a name, and also revoke such approval, vary the minimum capital requirement for a bank to get a license, approve ownership of bank by foreign government in excess of 5% of issued shares, as well as the exercise of any voting powers by such government in excess of 5%, approve agreements for transfer of control of a bank and grant conditional approvals (section 20 & 21), take temporary management, revoke the license, or present a petition for winding up a bank and direct bank where persons notified to him not fit and proper.
- request information.
- vary ratio of deposit liabilities and other indebtedness to capital base, grant approval and set conditions for a bank to hold fixed assets of an amount in excess of its capital base, specify that capitalized structure may be paid on a bank's shares without including expenditure to purchase goodwill, vary the percentages applicable to permissible levels of lending outlined in section 13(1)(f), extend the time for disposal of lands held in excess of fixed assets limits, determine other assets which will qualify as "liquid assets", also prescribe the percentage of prescribed liabilities which money at call or short notice will meet, prescribe amounts and bases for calculating proper levels of loan loss reserves.
- draw up provision for the extension of credit in excess of statutory limits where facility secured by cash, other resources of the borrower or a guarantee approved by BOJ, approve the form of returns for BOJ and extend time for filing return.
- appoint a borrower company for a credit facility to qualify as "specified" and approve it.
- **restrict Supervisor** from exercising powers of obtaining undertakings, issuing directions or cease and desist orders.
- require disposal of shares in a local bank acquired (in breach sections 20 & 21), apply to the Supreme Court for an order for the sale or transfer of specified shares.
- notify bank in writing of intention to make vesting order, and acquire powers of the directors and managers.
- pursue transactions to restructure the bank including sale of shares and/or subordinated debt, amalgamation of the bank, sale or assumption of liabilities, any other transactions for the purpose of restructuring. He must also publish a notice in the Gazette specifying the date of completion of such transactions.

Certain progress has been achieved in this area with the recent increase in the intervention capacity of the supervisor, which is now able to take control and the temporary administration of the managed institutions without the Minister's approval. The supervisor also has been endowed with the power faculty to issue Memoranda of Understanding (MOUs) when an institution shows signs of problems, without the Minister's approval.

Although these changes are adequate, as a supplementary step we suggest that at least the supervisor (the vice president of Bank Supervision at the BOJ), is appointed for longer terms, and if possible overlapping with the periods of election of political authorities. Formally the BOJ chairman is, among other responsibilities, responsible for bank supervision. However, it might be convenient to appoint some other board member dedicated exclusively to heading bank supervision at BOJ.

b) Accountability

In order to ensure that the Supervisor has the appropriate incentives to maximize the well-being of the financial system, it is necessary to include in the supervision system a higher degree of accountability, providing the public with enough information so as to be able to evaluate the supervisor's performance periodically.

In this way, two things are ensured: On the one hand, the Supervisor will be required to have the capacity and experience necessary to act in this position properly, and, on the other hand, for a successful administration, he will need to fully use his capacity and experience, as well as the resources that are available to him.

This topic is closely linked to the topics regarding information transparency mechanisms, see 3.1, and the Financial Supervisor's autonomy, see 4.1.2a. So if the Supervisor has enough autonomy, he will be able to set short and medium term goal-oriented measures whose success and importance will be transmitted to the public if appropriate information mechanisms exist.

In the case of Jamaica, the accountability framework is yet to be developed. In this context, we suggest that the regulation establishes a system in which the Supervisor is required to make public a periodic report (i.e. quarterly) of the issued regulations, measures taken and their expected effect.

In the case of short-term measures, the supervisor should be able to show evidence of the success achieved during his term. In the case of mid-term and long-term measures, the Supervisor should be able to explain to the public the advances that have taken place and how he is getting closer to the goal. Likewise, in the case of the goals that are not achieved, the Supervisor should explain to the public the reasons why this happened.

c) Consolidated supervision

There is currently a differentiated structure for banking, insurance and securities supervision. To our view, this structure should solve coordination problems on one hand and problems of redundant costs on the other.

Coordination Costs. As mentioned in section 2, a high proportion of conglomerates exist inside the financial system, and they typically include banks, insurance companies and other types of firms. Therefore, a consolidated approach to the banking, insurance and securities sectors is necessary to properly supervise aggregate risk. It is the risk assumed by the conglomerate as a whole that should be regulated and supervised.

Given the current structure, the identification of this conglomerate risk implies a coordination cost among the different agencies assigned to the supervision of each sector (banks, insurance companies and securities). It might be the case that the current structure is insufficient to properly absorb these costs.

Redundant Costs. Here we refer to operations cost replication, resulting from the holding of a differentiated supervision structure. Thus, there are currently administrative, infrastructure and research costs which are specific to each supervised sector. Therefore, the consolidation of the supervision of all the sectors involved would imply a more efficient cost structure than the existing one. This implies that the modification of the present cost structure could allow important savings.

At the moment, the official supervisors coordinate activities through what is specified in an MOU and through the establishment of a Regulatory Policy Council (RPC). The purpose of these tasks is to consolidate supervision and to reduce contagion effects and regulatory arbitrage possibilities.

Likewise, an integrated model, similar to the one that is employed at the moment in South Africa, has been proposed for the supervision of banking and non banking institutions. In addition, the FSRP includes provisions in order to: (i) enhance regulatory authority over complex groups and (ii) separate deposit/lending from capital market activities via separate subsidiaries or affiliates. Thus, BOJ started a project aimed to develop an adequate supervisory framework for complex financial groups and conglomerates. BOJ has been authorized to supervise complex groups and has prepared a briefing including provisions for prohibiting the mixing of industrial activities with commercial banking in the same group and requiring institutions to isolate deposit/lending activities to be carried out in a separate affiliate.

Coordination among supervisors was formalized through the Regulatory Policy Council (RPC). It comprises FSC, BOJ, Jamaica Deposit Insurance Corporation (JDIC) and the MOF. Furthermore, supervisors have been endowed with the power to issue MOUs to coordinate supervisory policy.

RPC will consider: (i) the harmonization of risk-based adequacy requirements for dually licensed entities, (ii) the review of regulation and supervision of unit trusts, mutual funds and similar products to ensure a level playing field and adequacy of investor protection, and (iii) the adequacy of reporting requirements respecting financial companies and the development of specific rules related to transactions with financial groups, dividends and others, and the management and ownership of the group.

Another power was that the Supervisor can request any type of financial information from the companies that belong to the financial conglomerate. He can also require the restructuring of a group of companies so that the property of the financial institution is managed directly by a holding separated from the property of other group member companies. The legislation also allows the Supervisor to establish limits in the joint risk exposure.

We consider that all these measures are appropriate as they intend to integrate the financial supervision, so that supervised agents are the economic groups and/or the financial conglomerates, rather than the individual institutions that constitute them. However, there is a certain order and sequence in their implementation that might be helpful. In this regard, we believe that the strategy that is carried out by the government through its FSRP has to consider the three stage strategy summarized in Box 2.

Box 2

Implementation of Consolidated Supervision Structure

Introductory phase.

The first step is to design the regulatory framework for the consolidated supervision, establishing definitions and presumptions of control and linking. In this stage, it is important to define the scope of action of the consolidated supervision and the supervisor's powers to carry it out, specially when the firms that belong to a certain mixed-type conglomerate do not fall under the scope of the bank supervising agency.

The definitions and presumptions should be very flexible and leave to the supervisor’s criterion the determination of the presence or absence of control and/or relationship.

The firms can be beyond the supervisor's scope because they operate outside of the financial sector or because they operate abroad. Banking supervision should face these jurisdictional limitations through specific laws or through specific agreements with other domestic or foreign supervisors, depending on the circumstances.

Also in this stage, the identification of consolidation needs for any additional license that is to be granted. No granting of new licenses should be allowed when the possibility of carrying out the consolidated supervision in an efficient way is not guaranteed.

The legislation should allow the banking supervisor to limit the activities that are carried out when he finds that these activities can affect the security of the conglomerate.

From the description of the activities that should be developed in this stage, it is inferred that investment in training is essential. In this specific case, internships in banking supervision institutions with enough experience in consolidated supervision seem recommendable.

Phase One.

This stage is expected to last a minimum of one year including the generation of information and the first approach to the type of risks that are faced.

In this stage both the internal structure of the conglomerates and the type of intra group transactions should be known. For this purpose, consolidated financial statements will be requested, and, the support of outside auditors and private risk rating agencies may be requested. On the basis of the consolidated financial statements, the opinion of external auditors and of the risk classification agencies, a culture of risks of company conglomerates should be promoted, disclosing identification mechanisms and risk management approaches.

It is very important that in this stage a deep knowledge of the legal and administrative structure of the conglomerates is achieved, and that the prudential measures that are settled are consistent with conglomerate compositions and the risks that they may be facing.

Typically, the existing identification and risk management mechanisms are insufficient, so a good part of the required effort concentrates on the design of these mechanisms, from the formats and basic reports for the consolidated financial statements, to the generation of consensus around the need of looking at the risks from a consolidated perspective.

Phase Two.

In this last phase, **capital requirements** and concentration limits of related lending on a consolidated basis are established. Self-regulation should be promoted and the requirements of consolidated information, obtained in the previous phase should be complemented and fine-tuned. In this stage, the banking supervisor should dominate the different techniques to determinate the capital adequacy of any conglomerate. Likewise, he should be in the capacity to detect situations of double or multiple leverages, as well as identifying the risks assumed by the non-regulated entities of the conglomerates. This will allow him to establish the requirements of capital adequacy, and to determinate whether appropriate capital distribution exists inside each conglomerate.

Concentration Limits.

On a consolidated basis should affect, firstly, the financing to related lending, in a way to discourage multiple leverage structures.

d) Approach

At the moment, the financial supervision is executed by means of two approaches: on site and off site supervision, carried out by three different supervision groups inside the Bank Supervision Unit of the Central Bank.

We consider that this approach is not necessarily the most efficient, since it is focused on partitions of the process of information gathering, when the basic distinction should be the type of risk to supervise. In this regard, a more appropriate focus would probably be a matrix approach to financial supervision, by type of regulated agent and by type of risk, as shown in figure 6.

Figure 6

Financial Supervision by Type of Regulated Agent and Type of Risk

	Commercial Banks	FIA Licensees	Building Societies
Credit Risk			
Liquidity Risk			
Exchange Risk			
Operational Risk			

Although the classification of regulated agent types and risk types could vary (i.e., if the structure of consolidated supervision suggested in the previous section, 4.1.2c, is implemented, the columns would be the mixed conglomerates, or insurance or pensions could be included), the suggested approach is more accurate and it allows a bigger control associated with each type of risk present in each regulated agent. Inside each cell, on site and off site supervision are integrated.

This approach requires an important recruitment and training effort. We think that the on the job training and internships are the most efficient alternatives to achieve concrete results of this type of investments.

Considering that the proposed approach is relatively complicated in comparison to the existing one, there could be initially a higher emphasis on the differentiation by regulated agent types and then an additional distinction (risk types) could be added to the structure. The proposed structure could be achieved within a 2 year period.

e) Private sector participation

In a scenario of an inefficient legal system, non-transparent information mechanisms and little accountability, private sector participation in the supervision should be optimized to improve the quality of the supervision through an efficient use of market discipline.

To facilitate this mechanism, we consider that the regulation should require each financial institution to count with at least two risk evaluations carried out by different private risk rating agencies.

Then, transparency should be added to the auditing process. In that sense, both internal and external auditor recruiting and removal should be made with the Supervisor's prior authorization. He should have immediate access to the reports that are generated by the auditors, so as to be able to take prompt corrective actions.

4.2 Cost Mitigation

4.2.1 Deposit insurance fund

The Deposit Insurance Fund recently designed and implemented satisfactorily the desirable characteristics. Thus, it covers a small and limited amount, per depositor and per institution, nearly 2.5 times the Jamaican GDP. Also, it is obligatory for all the institutions that take deposits in Jamaica. Although the law allows the premiums to be adjusted by risk, at the present time a flat premium is charged to all the institutions. There is also an informal target fund of 2% of the insured deposits. Under this framework, 97% of the deposit accounts are insured, or 40% of the deposits if these are measured in terms of value. The Deposit Insurance Fund has contingent access to the resources of the Treasury.

In the long term, the Deposit Insurance Fund should work towards an explicit fund target which must be in a high enough range so as to cover the exit of the biggest (local) bank from the market, assuming the use of the most efficient exit mechanism. Thus, the fund target of the Deposit Insurance Fund cannot be separated from the bank resolution mechanisms available to the authorities.

We think that the system can migrate towards one in which premiums are related with the insured institution risk as soon as a private risk rating for each institution is in place.

Contingent access to resources of the Treasury should be maintained (and probably to additional layers of contingent funds) and their functions and decision capacity should become explicit, in the event of alternative mechanisms for bank resolution.

4.2.2 Lender of last resort

Monetary policy in Jamaica is out of the scope of this document. But, as cost mitigation mechanism suffices to say that the function of the Central Bank as a lender of last resort has to be clearly restricted to support strict short-term liquidity needs. The access to the liquidity provided by the Central Bank must also be subject to interest rates above the market and supported by high quality collateral. The fundamental premise is that the liquidity provided by the Central Bank should not be used to bail-out insolvent banks. For this reason, liquidity restrictions of the Central Bank should be clearly defined in the operational procedures and in its regulatory frameworks.

This condition has been satisfactorily managed by the Central Bank in practice.

We recommend clearly defining the cases when the Central Bank can intervene as lender of last resort, as well as the detailed specification of the criteria analyzed to qualify a financial institution in problems as eligible for loans from the Central Bank. Short term support conditions must also be detailed in the legislation.

4.3 Damage Control

4.3.1 Resolution mechanisms

The financial institutions resolution legislation is relatively well-developed; there is even a resolution matrix that has been shown to market participants so that the capacities of the official organizations in charge of the resolution of financial companies in each stage of the process are known. However, it is absolutely necessary that the principles of smaller cost and loss concentration in the shareholder or manager enter in the mechanism corpus, with little or no margin for discretion, in such a way that market exit costs for financial institutions are minimized and well distributed.

A critical aspect to be highlighted is the fact that, according to the current legislation, capitalization from FINSAC was carried out before writing off the losses of the financial institution. In this regard, all the topics associated with the resolution mechanisms should be guided so that any support to the institution is granted after concentrating the losses on the group that generated them in the first place, in such a way that the shareholders become the first to be affected by the intervention.

A problem that we were not able to analyze is the sustainability of FINSAC's debt with the purpose of covering the needs of crisis resolution. It is important to know if the amounts and currency of this debt are compatible with the projections of the economy as a whole and the projected fiscal position.

A strategy was implemented in order to withdraw a portion of the FINSAC debt and pay interest in cash on the remainder. This strategy for managing FINSAC debt implied that all debt owed to central government agencies would be written off, including the debt owned to the Bank of Jamaica and the amortization of a portion of the remaining debt held by the private sector. The plan agreed upon the cancellation of the debt owed to government agencies has been implemented.

The next step was the government's repurchase of part of FINSAC´s debt. To June 2002, the GOJ was making regular cash payments on the remaining FINSAC debt held by private sector, and equity of NCB was at the point of sale. All FINSAC´s non-performing loans have been sold except for loans made to non-financial government entities. A plan has been agreed for the disposition of all properties remaining in the portfolio. In the insurance sector, the sale of GOJ owed ordinary shares in LOJ has been completed.

Management of FINSAC´s debt would gradually be transferred to MOF as part of a debt containment strategy.

5. Risk Management System

Supervisory processes basically include on site and off site supervision. Even though a Financial Stability Monitoring Committee was established in order to analyze and manage systemic risk, there is a lack of specialization addressing risk management as it is shown below.

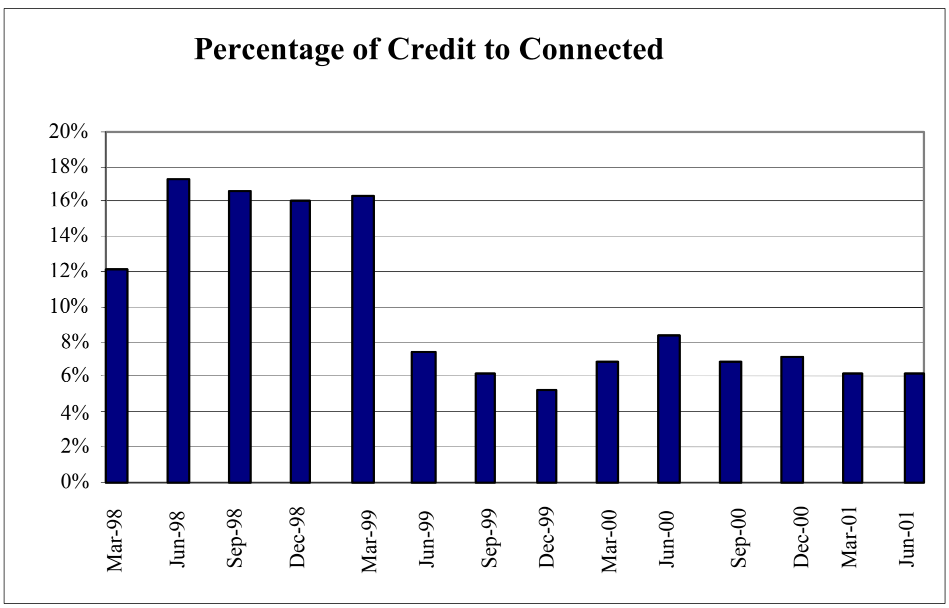
5.1 Market Risk Management

The need to develop a regulatory framework to evaluate and supervise market risks has been recognized. In fact, the TA Program has included market risk regulation and supervision in its agenda in order to strengthening banking supervision. The program includes specific supervisory methodology, policies and procedures, how to implement them and training courses.

5.2 Credit Risk Management

There was a remarkable improvement in the control of related lending from June 1999 when they were lower than 10% of credits (see figure 7).

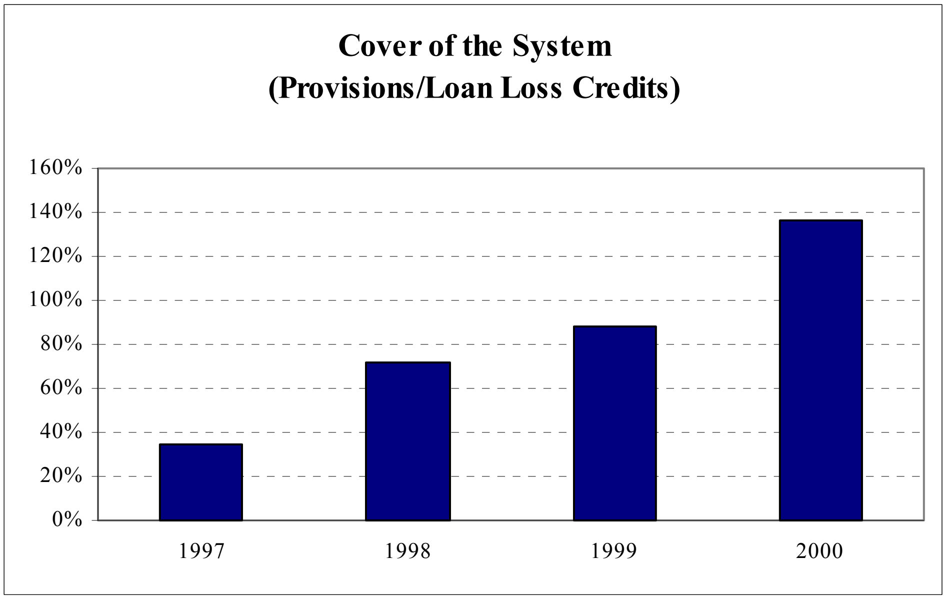
Figure 7



Source: Statistical Digest, Bank of Jamaica

As for provisions, although the system coverage has remarkably improved in the last years (see figure 8), these are still not optimal. According to current regulations, provisions are made over credit risk three months after this has occurred, that is, when the payment capacity becomes doubtful due to the deterioration of the conditions of the debtor. This means that the provisions are applied to ongoing risks, but do not consider the expected credit risk at all times. Thus, bank provisions are static or backward looking and, therefore, they are inferior to their optimal level, since they do not consider expected future risk associated with new credits. Similarly, there is no differentiation based on the currency in which the credit is granted, not considering implicit exchange risk.

Figure 8

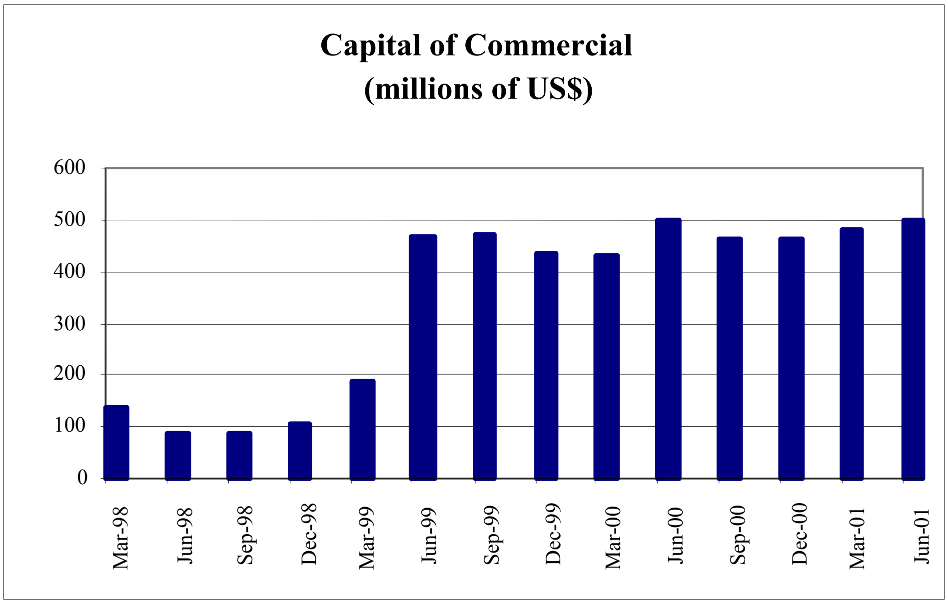


Source: Statistical Digest, Bank of Jamaica

On the other hand, there are no explicit considerations to limit asset-liability concentration of financial institutions in legislation. In this regard, we consider that actions should be taken to consider the assumed total credit risk.

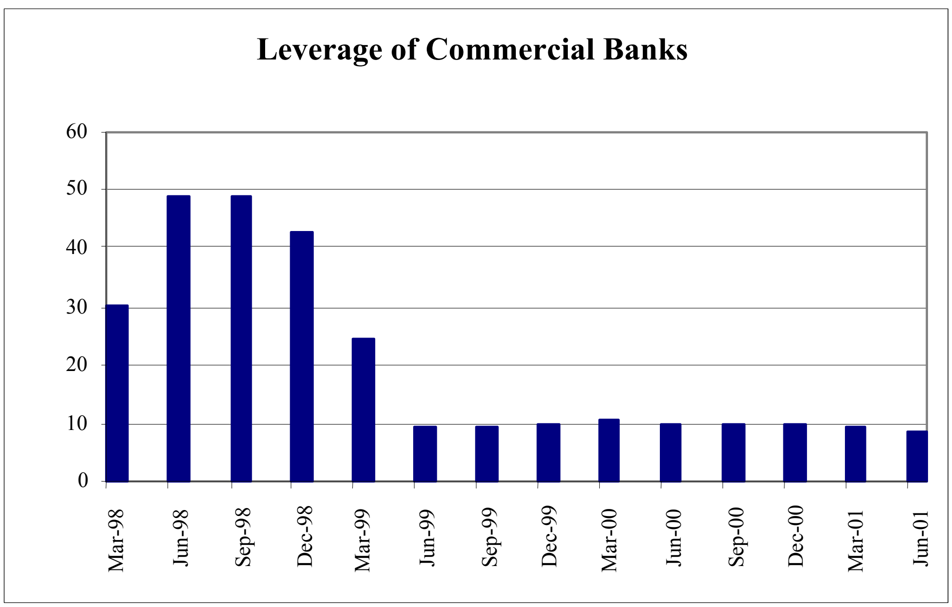
Regarding capital adequacy, its sustained growth has been observed since June, 1999 (see figure 9). This has resulted in banks requiring a smaller leverage percentage from that moment (see figure 10), given the bigger capital base and the relatively stable liability behavior. In general, the liability level ratio has remained approximately at 10 times capital.

Figure 9



Source: Statistical Digest, Bank of Jamaica

Figure 10



Source: Statistical Digest, Bank of Jamaica

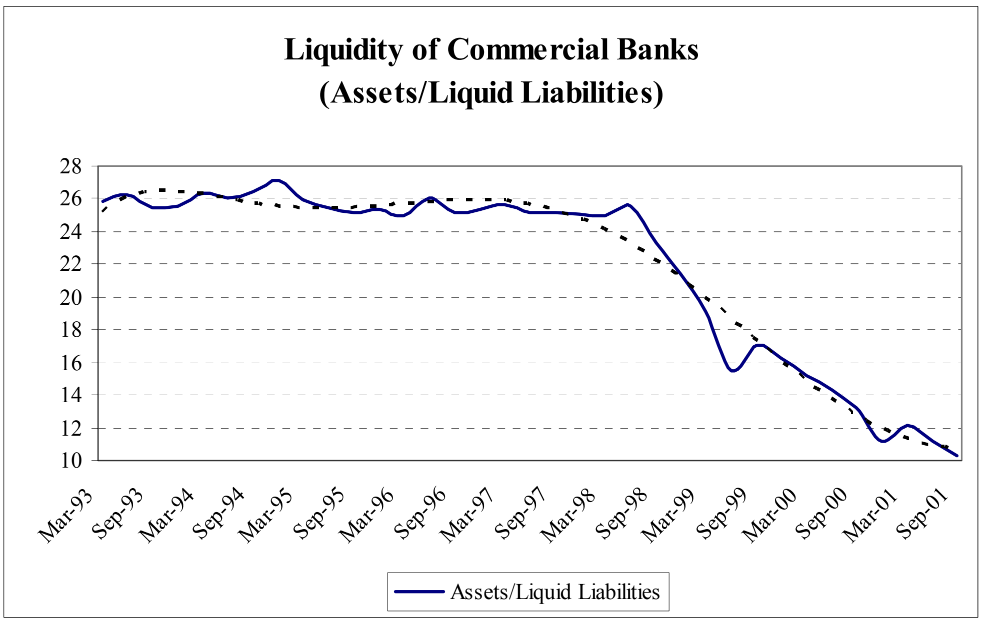
We believe that this level is acceptable; however, it is possible to reflect this condition explicitly at a regulatory level, using an un-weighted Capital Adequacy ratio (a direct leverage ratio), which could be more realistic in cases where Government obligations are in foreign currency or where financial institution obligations are generated on under supervised jurisdictions. In addition, capital and provisions regulations could include the migration of risk that takes place when transferring the exchange risk toward the corporate sector, for example through differentiated provisions by currency.

We also believe that it would be possible to consider a broader risk concept when defining the expected losses that provisions must cover, so as to include other sources of expected losses, such as exchange rate risk, risk migration or interest rate risk.

5.3 Liquidity Risk Management

Since June, the liquidity of the financial system has fallen progressively (see figure 11), resulting in bigger vulnerability stemming from unexpected withdrawal from depositors.

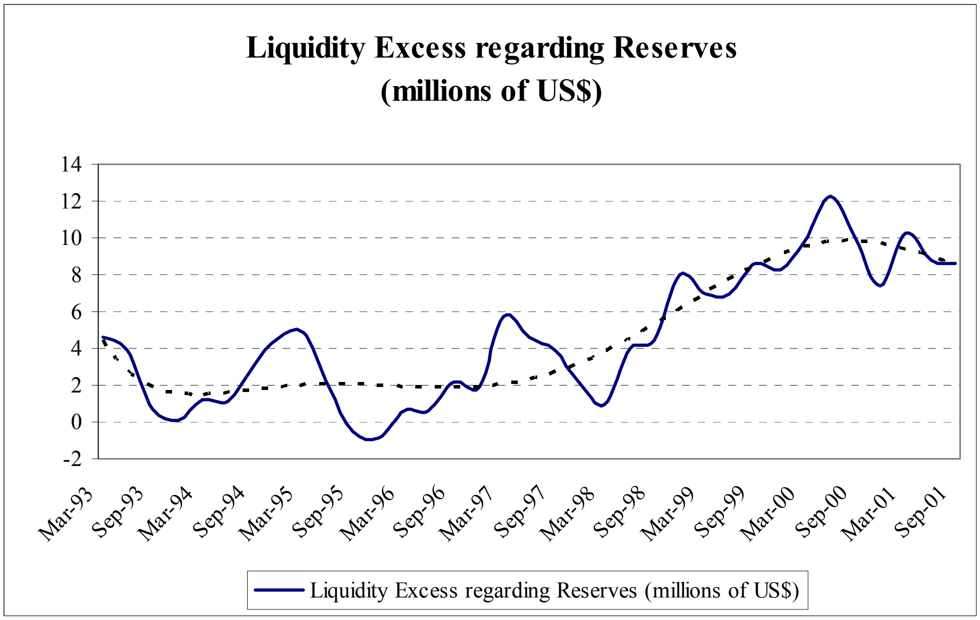
Figure 11



Source: Statistical Digest, Bank of Jamaica

In spite of this, liquidity excess regarding reserves has behaved in the opposite direction, increasing in the period when the previous indicator began to decrease (see figure 12). This apparent contradiction shows that the lack of liquidity was accompanied by the uncertainty of credit lines renewal, which made financial institutions maintain a liquidity excess regarding reserves to prevent any credit line cancellation from their creditors.

Figure 12



Source: Statistical Digest, Bank of Jamaica

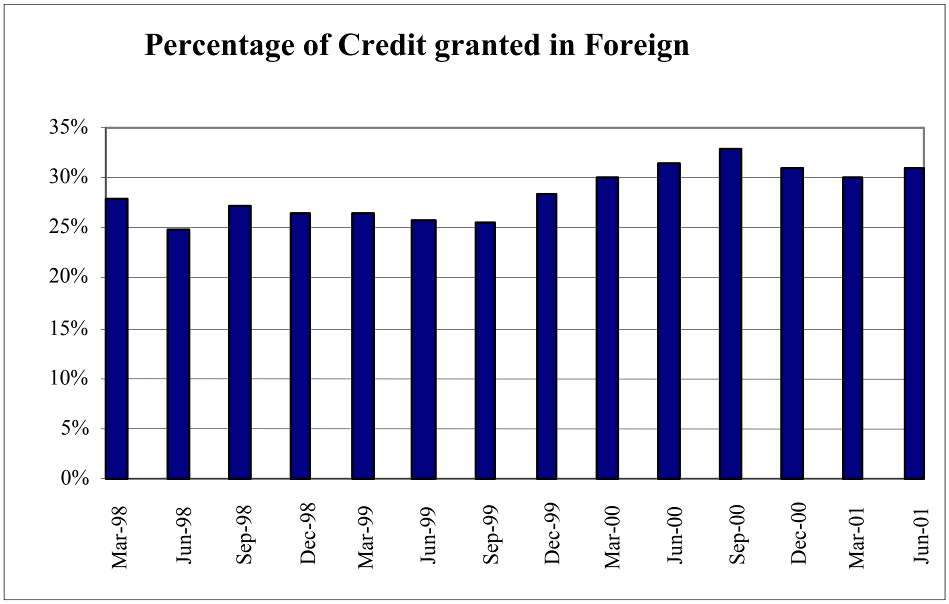
We believe that financial supervision must face liquidity reduction in the financial system establishing minimum liquidity levels, to prevent the system from becoming excessively vulnerable. Also, it is necessary to ensure that the regulation grants precise definitions regarding liquid assets and volatile liabilities. We recommend establishing a prudential liquidity ratio that links short term liabilities with liquid assets, per currency.

On the other hand, the analysis of deposit stability by financial institutions should be encouraged (prediction of the probability of financial institution run, stress testing analysis, etc.). Due to the international nature of the Jamaican banking system, some type of analysis must already exist.

5.4 Exchange Risk Management

According to current legislation there is no regulation regarding exchange rate risk. This omission is explained by the authorities negating its existence, since loans are only granted in foreign currency to exporters. This reason is highly questionable and practically impossible to prove. This is an alarming omission if the growth of new credits in foreign currency in the last years (see figure 13) is considered.

Figure 13



Source: Statistical Digest, Bank of Jamaica

In this regard, we believe that actions should be taken to consider the exchange risk within the current legislation on two levels. First, a symmetric limit should be imposed on the exchange position of each commercial bank, which should not exceed 100% of its capital, and, second, a capital charge should be established on that same position.

Likewise, once the regulation of provisions is based on the debtor's payment capacity, and not only on its historical behavior, a criterion should be introduced to check its foreign currency generation capacity. The provision should be higher in the case of credits granted in foreign currency (or indexed to foreign currency) to clients that do not have enough capacity to cover the exchange risk. This point is relevant not only for a better exchange risk management, but also for liquidity risk, analyzed previously in section 5.2.

5.5 Operational Risk Management

Legislation on operational risk management is appropriate regarding strategic planning and internal control of the financial institution. However, more attention could be given to information systems' integrity as well as to the need to establish clear policies to avoid financial fraud.

6. Conclusions and Recommendations

Except for the last five years, all along the history of Jamaica, a lack of an appropriate regulation and prudential supervision of the financial system are observed. This absence greatly contributed to the deep financial crisis of the year 1995, with the bankruptcy of five insurance companies and five commercial banks (out of a total of 9 of the latter).

In the last years the authorities of the government of Jamaica have intervened and carried out a reform in the supervision and regulation of the financial system. This reform has been successful, contributing to strengthen the system and the achievement of long term stability.

In spite of this, we consider that there is still some space of improvement. We consider it feasible to design a group of recommendations, some of immediate application and others to be applied in a later stage.

6.1 Recommendations for Immediate Application

Information Transparency Mechanisms: The mechanisms of information transparency are of vital importance for the development of market discipline. We recommend continuing the efforts of strengthening the transparency and disclosure of information to the public from the Central Bank (easy access to information organized by type of risk and timely), as well as the acceleration in information compilation that is necessary to establish a credit bureau as soon as possible. We believe it would be appropriate for the legislation to demand the issue of subordinated debt from financial institutions whose secondary market price would provide a signal, though noisy at the beginning, on the real bank situation to the public.

Informality in the private sector: The informality of the corporate sector represents another source of informational problems, since it does not allow financial institutions to accurately evaluate credit risk. We suggest mandatory auditing. Initial efforts within the IMF project are in the right path.

Autonomy: The improvement of financial supervision autonomy should continue. Although the Supervisor has been given recently some additional powers, we consider that it is very important to reestablish the Supervisor's autonomy at a higher scale. We recommend that a BoJ board member, other than the chairman, be appointed as Bank Supervisor.

Accountability: Given the importance of this topic concerning the capacity and experience of the Supervisor, as well as the incentives towards goal achievement, it is necessary to incorporate this as soon as possible into the regulation. Thus the Supervisor must keep a transparent communication with the public, informing continuously about the objectives of the regulations that are issued and the measures that are taken, as well as the expected and the achieved results.

Lender of Last Resort: As for the function of the Central Bank as cost mitigation mechanism, we consider that it is important to incorporate the definitions and criteria to the legislation in detail, in order to clearly define in what cases the Central Bank should intervene as a lender of last resort.

Resolution mechanisms: Resolution mechanisms have been developed adequately but in practice capitalizations from FINSAC were carried out before writing off the losses of the financial institutions. This gives perverse incentives to the shareholders of the financial institution, because the loss is shared with the FINSAC before the institutions fall into bankruptcy, when it should be assumed exclusively by shareholders in the first instance. We recommend making this principle explicit in the law, so that shareholders assume the risk of the activities in which they incur, and this way they will have consistent incentives with a prudent management of risk.

Liquidity Risk: Regarding liquidity risk management, it is observed that since 1997 there has been a strong contraction of the liquidity of the system, and banks have needed to enlarge their reserve excess to prevent an eventual cut of foreign credit lines. We consider that actions should be taken to avoid excessive liquidity restriction generating an excess of vulnerability in the financial system. It is also necessary to make sure that the regulation defines the concepts of liquid assets and short term liabilities and defines a prudential ratio between both concepts. The analysis of stability of the deposits should also be encouraged.

Exchange Risk: Regarding the exchange risk, there is no legislation on the matter; nonetheless, it is an important source of risk, considering the high credit levels granted in foreign currency and the hysteresis generated by the high inflation levels at the beginning of the last decade. In this sense, exchange risk should be included in regulation.

6.2 Follow-up Recommendations

Crime: A formal and constant coordination is required between regulator and the judicial system in order to prevent money laundry problems as financial crimes in general as well as the development of anti-terrorist and anti-drug traffics programs.

Judiciary System: The Judiciary System is under dimensioned and its resources do not let it solve the excessive number of cases (from which 72% corresponds to murder). Likewise, there is a high credit risk generated by a lack of creditor protection in legislation. Although the CC has been constituted to solve the problem of concentration of the system in cases of crime, we also recommend a reformation of the judicial system to speed up the recovery proceedings of collaterals and increase creditor protection. By the other side, the efforts of the government concerning training of staff of FCU and judges assigned to CC in financial topics contribute with the effectiveness and enforcement of the judiciary system.

Corporate Governance: Regarding corporate governance, we recommend to continue the development of this aspect of the prudential regulation, particularly, the requirement for conformation of the Boards by a non incumbent majority, the constitution of risk, audit and remuneration committees as well as requiring the absence of connections between auditors and financial institutions.

Consolidated Supervision: The presence of conglomerates in the financial system implies that it is necessary to continue developing the structure of differentiated supervision. In order to achieve this, we recommend including the consolidated supervision in three stages, where the regulated entity is constituted by a conglomerate of institutions.

Financial supervision approach: The Financial Supervision is exercised through two approaches: on site supervision and off site supervision. We consider that this one is not necessarily the most efficient since it prioritizes the process of information gathering, when the basic distinction should be the supervised risk. We suggest the adoption of a matrix approach, distinguishing by agent-type and risk-type.

Private Sector Participation: In the institutional context of Jamaica, private participation in the financial supervision represents a key element to achieve market discipline. We consider that financial institutions should be legally requested to present at least a couple of different risk ratings from private agencies, in coordination with the financial supervisor.

Deposit Insurance Fund: The Deposit Insurance Fund has been correctly structured. This is why we consider it is ready to migrate to a framework in which premiums are adjusted by the risk of the insured institution, when a private risk rating becomes mandatory for each institution. Also, in the long run a fund target and an access to additional layers of contingent funding should be included. The fund target of the Deposit Insurance Fund cannot be separate from the bank resolution mechanisms available to the authorities.

Credit Risk: Regarding credit risk management, it is observed that the percentage of related lending has considerably reduced, the coverage of the system has increased and financial institutions have a bigger capital, which allows them to reduce their leverage level. However, provisions are static or backward looking, and there is no regulation as for asset/liability concentration in financial institutions. We consider that, legislation should include a loan loss provisions framework that considers all the implicit risks present at the time the loan is granted, and that asset-liability concentration should be regulated as well.

Operational risk: Regarding operational risk, we observe that risk is appropriately managed; however, more attention could be given to information system integrity as well as to the need to establish transparent policies to avoid financial fraud.