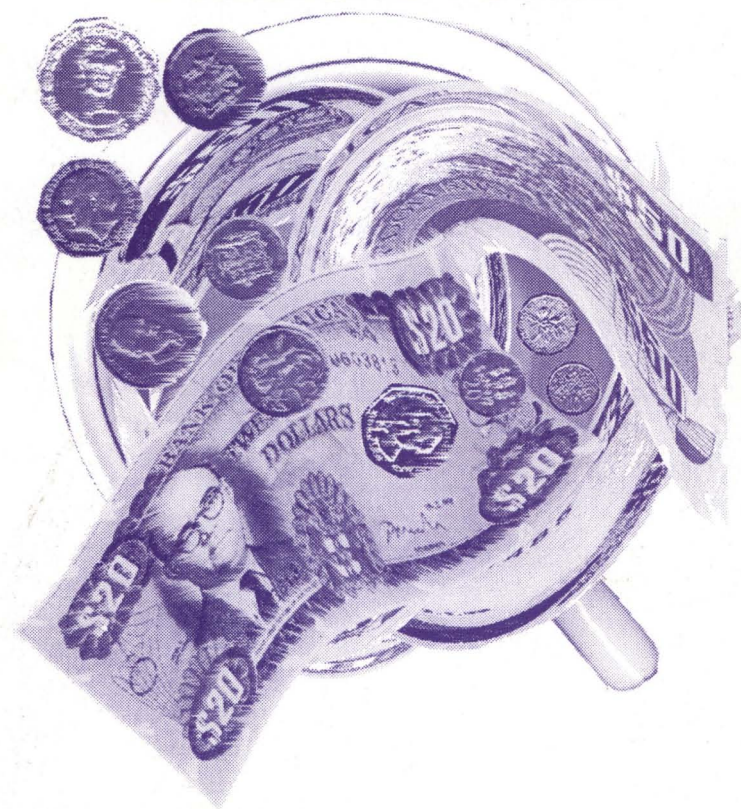


The XIV Adlith Brown Memorial Lecture

# Storm in a Teacup

or

## Crisis in Jamaica's Financial Sector

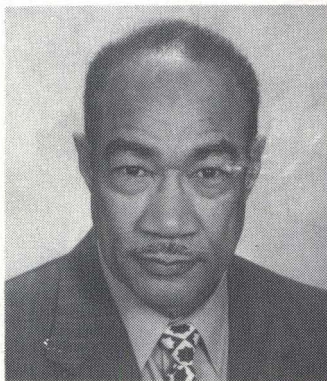


by Gladstone Bonnick



Caribbean Centre for Monetary Studies





*Dr. Gladstone Bonnick*

**Gladstone Bonnick**, a Jamaican national, has rendered outstanding services at a national, regional and international level.

He started his academic career at the Roosevelt University, Chicago, graduating with a B.A. (Honours) in 1958. He then proceeded to the University of Chicago, where he graduated in 1962 with a Master's degree (M.A.) in Economics and Statistics. This was followed by a Doctoral degree (Ph.D.) in Economics in 1965 from the same University. During his studies in the United States, Dr. Bonnick was awarded the Marshall Field Fellowship in 1958 and the Frank Knight Fellowship in 1962 by the University of Chicago.

His working life started with the Government of Jamaica in 1951 in The Administrator General's Office and continued in various positions including Director, Central Planning Unit; and Deputy Governor, Bank of Jamaica.

Dr. Bonnick left the region in 1978 to begin a career in the World Bank which spanned a period of seventeen years. He left the Bank in 1995 as Principal Evaluation Officer in the Operations Evaluation Department.

He returned to the region in 1997 as a member of the Board of Directors of the Financial Sector Adjustment Company (FINSAC). He was appointed Executive Chairman in January 1997 and held that position until February 1998.

For his outstanding service to his native country, Dr. Bonnick had the distinction of being made Commander of the Order of Distinction in 1998 by the Government of Jamaica.



**Caribbean Centre for Monetary Studies**

Established under the Joint auspices of the Central Banks of the Caribbean Community and The University of the West Indies.

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FOURTEENTH ADLITH BROWN MEMORIAL LECTURE

**S**TORM IN A **T**EACUP  
OR  
**C**RISIS IN **J**AMAICA'S **F**INANCIAL **S**ECTOR

*Gladstone Bonnick*

**This paper was delivered on October 28, 1998 at  
the XXX Annual Conference of the Caribbean Centre for  
Monetary Studies of the University of the West Indies,  
St. Augustine, Trinidad and Tobago**

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Fourteenth ADLITH BROWN Memorial Lecture

*Gladstone Bonnick*

**Delivered on October 28, 1998  
at the XXX Annual Conference of the  
Caribbean Centre for Monetary Studies  
(previously Regional Programme for Monetary Studies)  
at the Sheraton Hotel  
Paradise Island, The Bahamas**

**ISBN: 976-620-135-8**

## *The Late Dr. Adlith Brown*

The annual Adlith Brown memorial Lecture honours the memory of Dr. Adlith Brown, Co-ordinator of the then Regional Programme of Monetary Studies from 1980 to 1984.

Although born in Jamaica, Dr. Brown could truly have been described as a Caribbean woman. Her sense of regionalism was nurtured on the Mona Campus of The University of the West Indies where she did her undergraduate work for the B.Sc. (Economics) offered by the University. She subsequently completed her Master's (with distinction) as well as her Doctorate degrees from McGill University.

Adlith returned to teach at the University (St. Augustine Campus) in 1969 and in 1971 was transferred to the Mona Campus where she taught Monetary Economics in 1976 and was one of the main anchors of its Research programmes. She co-ordinated first the Caribbean Public Enterprise Project and from 1980 the then Regional Programme of Monetary Studies. In this period she was also promoted to Senior Research Fellow and in 1982 to the position of Acting Deputy Director, which she held up to her death. These latter years demonstrated most her capacity for intellectual leadership and for creative management.

Adlith revelled in the realm of ideas. It is therefore understandable that she was fast developing a reputation of being an outstanding economic theorist as her writings attest. Indeed, she was an ideal person to co-ordinate the then Regional Programme of Monetary Studies, given her passion for regionalism, her intellectual standing and her understanding of the process and problems of policy-making with which her colleagues in the central banks had to cope.

Each year the Open Lecture at the Conference of the Annual Monetary Studies, now sponsored by the Caribbean Centre for Monetary Studies, is designated the Adlith Brown Memorial Lecture.

# STORM IN A TEACUP

OR

## CRISIS IN JAMAICA'S FINANCIAL SECTOR

*Gladstone Bonnick*

### INTRODUCTION

Dr. Clarke, former Director of the Caribbean Centre for Monetary Studies, asked me in 1997 to address the Conference that year on the problems in Jamaica's financial sector. However, the problems were so demanding on my time and energy that I was unable to accede to his request, but promised to do so later. As soon as I shed the responsibilities of executive chairman at the end of February 1998 he reminded me of my promise. And so I am here with you tonight to share some thoughts on our approach to the problems, the issues to be resolved, and the lessons that we have learnt.

The title of my paper *Storm in a Teacup* needs a little explanation. From the vantage point of the world's financial centres, Jamaica's problem may seem like a storm in a teacup. You will not find that very many, if any, of the major financial newspapers and magazines have devoted any space to the problems in Jamaica's financial sector. But from the perspective of the teacup, much dexterous juggling and manoeuvring has had to be devoted to keeping the cup from tipping over and spilling its contents. The purpose of my talk is to foster among Caribbean neighbours a

deeper understanding of the problems; to identify possible lessons for policy-makers; and to offer a few suggestions for the future work of the Caribbean Centre for Monetary Studies.

During the last three years, Jamaica's financial sector passed through a period of severe difficulty as reflected by the following facts. Six of nine commercial banks accounted for about sixty per cent of deposits in the population; five life insurance companies accounted for over ninety per cent of premium income in the business; one-third of all merchant banks and several building societies have been found to be insolvent and closed. In 1996 and 1997 there was a run on two commercial banks triggered by rumours of their insolvency. Depositors feared a repetition of the experience of late 1995, when depositors were initially unable to access their funds in a bank that was put under temporary management and later closed. By March 1997, the Bank of Jamaica had to provide about J\$18 billion of special support to commercial banks to help them meet withdrawals by depositors in the banks themselves and in affiliated insurance companies. The financial sector was in a crisis and this constituted **a storm in our teacup**.

## THE BACKGROUND

### *Developments in the Financial Sector*

Jamaica's financial sector grew rapidly between 1987 and 1994. Growth of the Financing and Insurance Services sector rose from 9 per cent in 1987 to a peak of 50 per cent in 1994, averaging 17 per cent per year in the interim. In the years since 1994, Finance and Insurance Services sector growth has been negative. The sector's contribution to total GDP rose from under 7 per cent in 1987 to nearly 16 per cent in 1994, but has since fallen to 12 per cent.



This growth was partly associated with an increasing number of financial institutions (banking entities and insurance companies) from 67 in 1989 to 105 in 1995 with the major increases being among building societies and merchant banks. (There was one additional commercial bank during this period). By September 1998, the number of institutions had fallen to 71.

Deposit liabilities of commercial banks increased from J\$10.5 billion at the beginning of 1990 to J\$89 billion by the end of 1995. Thereafter, growth slowed but continued to a peak of J\$110.5 billion at the beginning of 1998. Loans and advances of commercial banks also expanded, moving from just under J\$8 billion to J\$46 billion during the corresponding period and thence to a peak of almost J\$69 billion in May 1997, but then falling back to J\$46 billion by May 1998.

During the late 1980s and early 1990s, there were significant structural changes in the financial sector. Most noteworthy was the rising importance of groups comprising several types of financial institutions. Indeed, each group sought to include a commercial bank, merchant bank, building society, life and general insurance, investment trust, and leasing company. This form of business structure was designed to take advantage of opportunities for minimizing the impact of regulations, supervision and taxation upon the group. It was therefore a structural change that was partly a response to opportunities for arbitrage.

Domestic entrepreneurs gained increasing importance in the ownership and control of the sector. The privatization of some government-owned institutions that had been acquired from foreign interests during the 1970s favoured indigenous investors (51 per cent of shares in National Commercial Bank, formerly Barclays Bank, were offered to the public in 1986). In addition, liberalization

of controls over entry into the financial sector made it easier to start up businesses in the sector.

The early 1990s were marked by a profound change in the financial policy environment away from direct controls toward a system of rules and a strengthened regulatory framework for monitoring and enforcing these rules. In 1991, Jamaica began to relax controls over the borrowing, dealing, and surrendering of foreign exchange. Controls on capital investment (direct and portfolio) by non-residents were also relaxed. Whereas previously commercial banks were restricted in meeting the domestic currency requirements of customers as a means of preventing illegal outflows, these were also gradually liberalized and then eliminated. In August 1992 the Exchange Control Act was repealed, effectively ending controls on capital transactions between residents of Jamaica and residents of other countries. However, some features of the Act regulating trading in foreign currency were retained in revised financial legislation.

Revisions in financial legislation sought to update and strengthen the regulatory environment within which the financial sector had to operate. The new measures included:-

- The Bank of Jamaica (Amendment) Act, 1992, with provisions to make monetary policy more effective; to rationalize the treatment of BOJ losses; to regulate the management of foreign exchange; and to give statutory recognition to the Department of Bank Inspection.
- The Banking Act, 1992, which, along with the Financial Institutions Act, 1992, provided for stricter licensing of banks, minimum levels of capital, stricter prudential controls, provisioning for loan losses,

strengthening supervision and regulation, and mechanisms for identifying and punishing the culpable in troubled institutions.

- The Financial Institutions Act, 1992, to regulate the operations of merchant banks and other near banks which take deposits from the public.

While this legislation was timely, the necessary institutional complements took longer to be developed. The supervision of insurance did not undergo strengthening paralleled with the supervision of banks. Significantly, deposit insurance was not part of these efforts to secure the integrity of the financial sector. This was to be subject to detailed study only in 1995/96, by which time problems were becoming apparent.

Almost as soon as the ink was dry on the 1992 legislation it was recognized that further changes were necessary. This gave rise to six new pieces of financial sector legislation in 1997 designed to enhance the power of the Minister of Finance to intervene in troubled institutions and increase the menu of sanctions available to the supervisory agencies. However, these more recent changes were too late to prevent the deterioration that occurred during the economic slowdown, especially after 1992.

### *Developments in the Economy as a Whole*

Real economic growth (1986 prices) slowed from 6.8 per cent in 1989 to an average of 1.2 per cent during 1991-1994, then declined and became negative during 1996 and 1997. The strong growth at the beginning of the period reflected largely the tail of a construction boom and rapid expansion of the financial sector. After a high growth of 18 per cent in 1989, the construction and installation sector essentially ceased to grow, and except for

1995 declined every year during the last five years ending in 1997. Growth of the financial sector was the major contributor to positive growth in 1994. The other significant economic development was in the annual rate of inflation (point to point) which increased from 17 per cent in 1989 to 80 per cent in 1991. Thereafter inflation was brought under control through monetary and fiscal policy, gradually reducing to 9 per cent in 1997.

## **CRISIS AND THE GOVERNMENT'S RESPONSE**

Against this background, in 1995 Century National Bank, which could not meet its obligations, was initially provided relief through a J\$4 billion overdraft at the Bank of Jamaica. Later on it was put under temporary management by the Minister of Finance and was closed in early 1996. The terms of reference of the Financial Institutions Services company established to sort out the problems of Blaise Trust in 1994 were extended to include the winding up of Century National Bank.

By April/May 1996, a group of CEOs of several life insurance companies (representing financial groups) approached the government to discuss assistance in dealing with their liquidity problems. In August 1996, the Government appointed a small working group assisted by a noted international financial consulting firm to look into the problems and advised troubled institutions to prepare work-out plans on the basis of which support could be considered. Several did so with the help of other international financial consulting firms. The Government also sought assistance from the IMF, the World Bank and the Inter-American Development Bank. These institutions sent a combined team to study the situation. The report of this team set out the macroeconomic conditionality that would attach to a financial package to support the rehabilitation of the financial sector; the report also contained the outline of an intervention and reform

programme including fast-track legislation to provide the authorities with the requisite powers and flexibility of action.

During the next few months, preliminary analysis showed that what was described as a liquidity problem due to mismatch of assets and liabilities was in fact a problem of insolvency - potential, borderline and in some cases substantial. This finding argued for more thorough analysis of the problems on a case by case basis, which required several months of additional work both by the government's group and by the institutions. It also became clear that whereas insurance companies had made the approach to government, several commercial banks had been contaminated through their inclusion in groups with troubled insurance companies and other institutions. This was the case with Eagle Commercial Bank, National Commercial Bank and Workers Savings and Loan Bank, which had lent considerable sums to members of their groups. Both Workers Savings and Loan Bank and Eagle Commercial Bank slipped into an overdraft position of about J\$6 billion with the Bank of Jamaica, which was covered by drawing on government's balances which had been sterilized in the interest of monetary policy.

### *Enter FINSAC*

Toward the end of 1996, the Government decided to adopt a comprehensive approach to the problems of institutions in the sector rather than to deal piecemeal with individual cases. In January 1997, FINSAC - the Financial Sector Adjustment Company (similar to the Resolution Trust Corporation set up by the US Government to deal with the savings and loan crisis in 1989) - was set up to deal with the troubled institutions. This was followed by an announcement in Parliament on February 7, 1997 by the Prime Minister that government would guarantee depositors' funds in licensed deposit-taking institutions, pension funds managed

by authorized institutions and policy-holders' funds in insurance companies.

The work of FINSAC was planned to be executed in three phases and to be completed over a five to seven-year period.

- The first phase would be one of intervention during which there would be negotiation with owners/managers leading to FINSAC's provision of re-capitalization support based on an agreed rehabilitation plan. Where rehabilitation did not seem a feasible option there would be acquisition or closure. A sector overview study was also to be completed during this phase.
- The second phase would consist of the rehabilitation of institutions (including re-structuring of their portfolio of investments and work-out of their non-performing loans, rationalization of branch networks to avoid overlapping, and the improvement of management and control) and the strengthening of the regulatory and supervisory framework of the sector.
- The third phase would be to complete the divestment of assets acquired in the process of liquidating entities for which deposit guarantees were called, review of the legislative framework, recover capital support through the sale of investments in assisted institutions, and the winding down of FINSAC operations.

## **OUTLINE OF THE REHABILITATION PROCESS**

### ***Rehabilitation Objectives***

The immediate objective of FINSAC's efforts was to resolve the problems of the institutions by assisting in an orderly adjustment through re-capitalization and re-structuring in accordance with an agreed work-out plan, or by assisting in the winding up of entities that could not be restored to viability. Another objective was to strengthen the sector by reducing the number of institutions and by merging small units into more economic and viable ones. Recognizing that viable institutions require viable customers, another objective was to adjust the debt obligations of customers to help productive enterprises to recover.

An intermediate objective was to prevent a repetition - by attending to regulations, supervision, deposit insurance and other security systems, and by helping firms reduce their vulnerability to instability in the macroeconomic environment. The ultimate objective was to reduce short-term systemic risk without the moral hazard associated with dependence on government guarantees.

### ***Diagnostic and Overview Studies of the Financial Sector and Troubled Institutions***

The main findings of the diagnostic and overview studies done during 1997 were the following:

- (a) There were too many small banks and insurance companies.
- (b) The troubled banks were all domestically owned and controlled; all the domestically owned and controlled banks were troubled.

- (c) Domestic banks suffered from poor credit management and an inadequate control environment, as well as portfolio diversification into areas where they had no comparative advantage.
- (d) Banks were inefficient, requiring large spreads between overall lending and deposit rates (average weighted). Jamaican spreads were 14-15 per cent during 1992/94 rising to 21-22 per cent in 1995/97, compared with spreads of 7-8 per cent in Barbados, Guyana, and Trinidad/Tobago (T/T) during 1992/97. However, larger spreads in Jamaica were said to be needed to compensate for the higher reserve requirements averaging about 48 per cent of total deposit liabilities compared with less than half this percentage in the case of Guyana, the OECS and T/T, and with 39 per cent in Barbados during 1993/97. But high reserve requirements are not new in Jamaica; and though affecting rates charged on loans it cannot be said to have brought about the recent crisis.
- (e) Domestic banks have negative return on assets compared with positive (ranging from just under 2 per cent to almost 3.5 per cent) though slightly declining return on assets in the case of foreign banks. Return on assets for T/T banks during 1993-96 averaged 2.7 per cent.
- (f) Insurance companies suffered from poor portfolio management: a mismatch of assets and liabilities reflected in too much investment in real estate especially overbuilding of head offices; high operational cost due to excessive commissions to agents and small size leading to high overheads.



## ***Intervention***

Intervention involved the negotiation of agreements with troubled institutions with the aim of either closing, supporting or acquiring them. Since the negotiation was with troubled groups, the closure applied only to some institutions within the group. Where institutions were to be closed, FINSAC provided for the transfer of deposit liabilities to a commercial bank under its control. Usually the agreement to support was based on an agreed rehabilitation plan produced by consultants for the institution and reviewed by FINSAC staff and consultants. In some cases, the intervention involved the Minister of Finance who would put the institution under temporary management under the powers provided him in banking laws. In one or two cases intervention involved the negotiated acquisition of the group for a token amount, FINSAC thereafter assuming its assets and liabilities.

The extent of intervention is reflected in the fact that FINSAC now has investments in over 150 companies, including:

- 15 banks (5 of which are commercial, other merchant banks and building societies)
- 21 insurance companies (including all the major life companies with over 95 per cent of premium income)
- 34 securities firms
- 15 hotels.

## ***Rehabilitation***

Rehabilitation is a process made up of the following stages:

- (a) ***Evaluation of recovery possibilities.***
- (b) ***Refinancing or closing institutions*** - FINSAC used its bonds to purchase preference shares and a modicum of ordinary shares in some cases in order to eliminate the solvency deficit.
- (c) ***Forensic audit of acquired institutions*** - FINSAC has employed international audit firms to conduct forensic audits to determine whether financial problems arose from illegal actions of owners and/or management, and to help prepare for legal action against such parties.
- (d) ***Asset management and disposal*** - unit set up with grant support from the Inter-American Development Bank (IDB) to arrange for consultants to identify, value and sell assets in a transparent and expeditious manner.
- (e) ***Workout of non-performing loans*** - non-performing loans bought from intervened banks with FINSAC bonds; workout unit set up to collect, restructure (including partial write off) and reschedule loans.
- (f) ***Sector and institutional re-development*** - holding company being set up for FINSAC controlled banks, to explore rationalization of operations including mergers. Similarly, arrangements for combining the small insurance companies are being studied.
- (g) ***Re-privatization*** - sale of components and institutions to the private sector through a transparent

process involving closed bids evaluated by an international audit/accounting firm using previously announced criteria (Eagle Unit Trust, First Equity Corporation, etc.); or sale through another GOJ institution e.g. Jamaica National Investment Bank in the case of cement company shares.

### ***Regulatory Reform***

Overview sector studies have identified regulatory weaknesses among the important contributory factors to the crisis. Special attention has been paid to the need to strengthen the Office of the Superintendent of Insurance, but the need for more effective coordination of the three main regulatory functions affecting banks and deposit-taking institutions, insurance companies, investment management and securities trading was also recognized. Under an IDB grant a special project to strengthen the regulation of insurance has been established initially within FINSAC. A committee set up by the Minister of Finance on regulatory reform is spearheading the design of more effective coordination. A team of consultants hired by FINSAC is assisting this committee.

### ***Winding Down Rehabilitation Agency***

FINSAC was set up as a temporary agency to last five to seven years. Winding down will involve liquidating all investments in supported institutions, i.e. selling ordinary and preference shares. Residual functions will be transferred to a successor organization to be identified.

## **ACCOMPLISHMENTS TO DATE**

During the first year, FINSAC intervened in the Eagle Financial Group, Life of Jamaica Insurance Company, Island Life

Insurance Company, Dyoll Life Insurance Group, Jamaica Mutual Life Assurance Society, Workers Savings and Loan Bank, The Horizon Group, and Fidelity Merchant Bank. FINSAC acquired the Eagle Financial Group for J\$1. It re-capitalized Life of Jamaica, Island Life and Dyoll Life through the purchase of newly issued preference shares and through the purchase of 26.5 per cent of the ordinary shares of each company, together totalling about J\$2 billion. It purchased the ordinary shares in order to prevent the companies from undertaking changes, which could compromise the agreed rehabilitation plan. FINSAC required Mutual Life and Life of Jamaica to divest to it their shareholdings in commercial banks, National Commercial Bank (NCB) and Citizens Bank of Jamaica respectively, and to concentrate on their core insurance business. FINSAC thus acquired control of Citizens and Eagle commercial banks and majority control of NCB and has re-capitalized them and bought their non-performing loan portfolios.

The intervention phase overlapped with the rehabilitation phase. Supported by an IDB grant, FINSAC started work on the re-development of the Office of the Superintendent of Insurance and on the divestment of assets. Several entities in the Eagle Group were either closed or sold; the merchant bank was wound down to a skeleton; the commercial bank was re-structured and reduced in size; and Crown Eagle Life was assisted in gaining control of Ciboney tourist development in respect of the claims of Eagle against Ciboney.

## **FACTORS CONTRIBUTING TO THE CRISIS**

There is much controversy regarding the main cause of the problems in the financial sector. While it may be impossible to reach a consensus on this, there is an ample menu of contributing factors about which most persons would agree. Here is a partial

list: the content and ordering admittedly reflect my own perception and biases.

### *Mindset of Domestic Entrepreneurs*

Here are some predominant characteristics of the indigenous entrepreneur that were responsible for the rapid expansion of the financial sector over the last decade and a half:

- Too eager to get rich.
- Too bullish in risking other people's money.
- Too eager to start at the top.
- Too competitive with one another in demonstrating the trappings of success - reflected in the rush to form larger and more complex groups; the penchant to build large high-rise head office buildings - *the edifice complex*;
- Too prone to bend prudential norms and regulations.

On the positive side, these were dynamic risk takers who explored possibilities for businesses that were beyond the vision of most. This attribute, no doubt, contributed to initial success in mobilizing savings both in Jamaica and from the Jamaican diaspora, reflected in the rapid sectoral GDP growth. But lacking the conservatism and patience appropriate for longer-term success in the sector, they directed their attention and energies as well as investment portfolios toward expansion of the tourism infrastructure and construction of office buildings and shopping malls. How can a society screen potential investors in order to identify those with

attitudes incompatible with our traditional views as to what may be best for a sector's development and stability?

### ***Management of Financial Institutions***

The quality of indigenous management of the troubled institutions must be regarded as a contributing factor in the crisis in the financial sector. Foreign-owned and controlled institutions operating in the same environment using indigenous managers did not experience the same problems. Higher incidence of fraud and irregularities in indigenous institutions is indicative of weakness in the control environment. Poor portfolio performance - euphemistically referred to by managers as a "mismatch between assets and liabilities" in the case of insurance companies and a high ratio of non-performing loans in the indigenous banks - may have been due partly to the quality of management and partly to their inability/unwillingness to resist political and other pressures to lend or invest in response to objectives besides the viability of their institutions. Another failing of management was that product design reflected too many and too complex products which often lacked transparency.

No doubt the rapid growth of the sector in the face of supply constraints on the availability of high quality managers was partly responsible for the quality of management. However, better internal controls and prudential guidance of overseas head offices seem to have been a factor in the better performance of the management of foreign-owned banks.

### ***Macroeconomic Policy***

Managers/owners cite the macroeconomic policy environment, particularly the high interest rates and high reserve requirements associated with the tight monetary policy aimed at

winding down the inflation of the early nineties, as an important factor undermining the viability of their institutions. Again, it must be observed that foreign-owned banks operating in the same macroeconomic environment fared much better, enjoying positive net income and return on assets of between 1.5 per cent and 3 per cent compared to the negative net income and return on assets of indigenous banks. While the macroeconomic situation might have contributed to the rise in the ratio of non-performing loans in all banks, it does not explain the much larger deterioration of the ratio for indigenous banks.

Some blame the macroeconomic policy environment for the collapse of the real estate market and argue that the said collapse has been the main cause of their insolvency. This is only partly true. There was evidence of over-building and the construction sector cooled off by 1990 (as evidenced by commercial bank loans and advances and by sectoral GDP growth) before the contractionary (tight money) stance beginning in 1992 to contain the high inflation after its peak of 80 per cent in 1991. But it is true that with the contractionary policies in place, market conditions ceased to validate overly optimistic re-valuation of real estate assets (especially hotels, due to over-building in the tourism sector by 1994; and life insurance companies' lavish head office buildings which remained partially unoccupied for lack of tenants). In the case of banks, real estate comprised a large share of the collateral or loans. This collateral became inadequate to support the growing stock of loans when real estate prices slowed as inflation was brought under control.

### ***Deficiencies in the Regulatory Environment***

Government's failure to adequately regulate and supervise institutions was a contributory factor to the debacle in the financial sector. Specifically, there was tardiness in updating prudential

regulations and in putting adequate supervisory agencies in place. The Office of the Superintendent of Insurance especially was not adequately staffed and as a department within the Ministry of Finance did not appear to have the stature needed to deal at eye level with the moguls of the insurance industry. Bank inspection at the Bank of Jamaica fared better, but was still late in being upgraded to deal with the increasing complexity of the groups within which the banks and other deposit-taking institutions were located.

For some time the government had been concerned with the need to upgrade the legal/ regulatory framework of the sector, and had introduced major revisions of financial legislation in 1992. However, further revisions as well as the complementary institutional development could not be put in place quickly enough to avoid the deterioration that quickly developed after 1994.

### *Liberalization of the Capital Account*

Some blame capital account liberalization for financial sector problems and argue that re-imposition of some controls ought to be part of the solution. As will be shown in the next two paragraphs, on balance, liberalization does not seem to have been an important contributor to the problems of financial institutions. The return to control does not seem to be a requirement for the solution to recent problems of the financial sector.

Capital account liberalization in Jamaica emphasized the lifting of controls on outflows. Controls on inflows were never the object of attention. Jamaica's experience suggests that controls on outflows did not effectively block capital that really wanted to flow out, with the result that relaxation of controls on outflow was not followed by any noticeable capital flight. The removal of controls eliminated a nuisance to businessmen and the population and the



likely disincentive effects on foreign investment inflows. Liberalization also reduced the need for a large exchange control bureaucracy of skilled professionals whose talents could be better employed elsewhere.

There seems to have been some increase in inflows, possibly in response to liberalization of outflows and possibly in response to high interest rates and a virtually stable nominal exchange rate. Some of the increase may have been the repatriation of earlier capital outflows provoked by controls. Short-term interest-sensitive inflows can be a source of instability, (as the Chilean experience showed) and their increase is not an undiluted advantage. Jamaica experienced large inflows (some capital but mostly transfers) especially during 1994. The Bank of Jamaica had to buy up foreign exchange in order to restrain the appreciation of the Jamaican dollar, which had the effect of injecting domestic currency into the system, tending to compromise the effort to reduce aggregate demand and inflation. On the positive side, the inflows allowed the central bank to increase net international reserves, which was not an undesirable objective.

### *Deficiencies in Information Flows*

Lack of information on customers/borrowers - no credit bureau - makes it difficult for managers of institutions to assess the risk associated with their loan portfolios. The laws have traditionally been skewed toward preserving the secrecy of customers' relations with each institution, with the result that institutions do not share information. FINSAC found that very frequently, customers were simultaneously indebted to several institutions. Add to this the failure of institutions to insist on adequate documentation on collateral, and the result is that many customers got more credit than would be justified by their wealth and income

situation if the relevant information was centralized and available to each lender.

Lack of timely information flow on financial institutions to the public made it difficult for the depositor to assess the relative risk attached to dealing with one institution rather than another. The same is true of insurance companies and other non-banking entities. This problem extends to the information provided on instruments such as certificates of deposit and promissory notes, which sometimes made it impossible for the public to determine who was custodian of their funds, the manner in which the funds would be invested, and who was obligated to repay.

## **REHABILITATION ISSUES**

### ***Should Jamaica Have Attempted Financial Sector Rehabilitation?***

Perhaps the most important rehabilitation issue concerns whether the Government of Jamaica should have attempted it. The resolution of this issue turns on the answer to two questions. First, could a responsible government risk not doing it? Second, can Jamaica afford it? Whether a country can take the risk of not intervening depends on the size of the sector and the extent to which it is troubled. Jamaica's financial sector was such an important part of the economy, and the share of deposits and insurance business accounted for by sick institutions was so large, that the risk of disruption of the intermediation function in the economy was considered too large to be acceptable. This was so because of the likely retardation of an already stagnating productive sector. The overwhelmingly clear examples emanating from other countries have been that the risk to their economies has not been considered acceptable. Most countries that intervened to resolve financial sector crises have concluded that

while the cost has been in every case more than anticipated, rehabilitation has been worth the cost.

The reality is that no one knows the true cost beforehand. Initially, it was not expected to be costly. The fact that problems in the financial sector were not due to or accompanied with a balance of payments crisis or depletion of international reserves suggested that the problem was internal to domestic institutions. There was a flight from weak to strong institutions rather than to overseas. Intervention and re-capitalization mainly required Jamaican dollars. These could be provided internally, albeit with possible negative economic effects requiring judicious macroeconomic management.

### *The Issue of Moral Hazard*

Once some form of government guarantee is in place, some savers take risky decisions - paying inadequate attention to the quality of the institutions in which they put their savings - in response to the attraction of the promise of high rates of interest. In Jamaica's case, the decision to give a blanket guarantee to deposits, insurance policy-holders' funds, and pension funds may have led to the conversion of some liabilities by business managers to the categories guaranteed by government. In future, savers will have to be educated to the fact that banks and other financial institutions will never be wholly safe.

Similarly, investment managers make riskier loans and investments if they feel the government will bail them out. Once the financial condition of the institution deteriorates they also delay going to FINSAC for assistance. This invariably results in greater insolvency and imposes greater burden on the government. One must also suspect that in the interim some entrepreneurs/managers

make special arrangements in favour of themselves and to the advantage of connected parties.

One problem faced in the decision to intervene in the crisis was how to balance concerns about moral hazard against the risk of breakdown in the financial system and the potentially devastating economic effects flowing therefrom, due to failure to assist. To curtail moral hazard, deposit insurance will replace blanket guarantee by government; however, recovery of deposits will be less than full.

The problem of moral hazard is still with us, but will be reduced through the deposit insurance scheme that has recently been instituted. Under this scheme the government's blanket, 100 per cent guarantee of deposits of any amount is being replaced by a guarantee up to a fixed nominal amount per account. There are no more banks earmarked for intervention by FINSAC so that the present 100 per cent guarantee on deposits of any amount will become irrelevant.

### ***Issue of Domestic versus Foreign Ownership of Financial Institutions***

The relative importance of domestic versus foreign ownership is an important political issue. Because the troubled financial institutions are all indigenous, and because domestic entrepreneurs lack the resources to re-capitalize insolvent institutions, there is the chance that in the future a sizeable part of the ownership may be held by foreigners. But how much of a shift to foreign ownership is acceptable to the community? The government has said that the future strength of the financial sector lies in foreign rather than domestic ownership. At the same time there is a strong sentiment that it is undesirable and potentially risky to have foreign ownership and control of all the important

institutions in the financial sector. This sentiment has been strong enough to ensure that the national airline keeps flying even though substantial public subsidy has had to be provided. Obviously, there is a limit to what the government can subsidize, and that limit has been reached and probably exceeded.

### *Issue of Groups*

Whether or not stand-alone specialized financial institutions are to be preferred over integrated financial service institutions in the future development of Jamaica's financial sector is a question that is being examined. Current thinking is that given the lack of coordination among the regulatory agencies and the present inability to monitor complex institutions, initially integrated financial service institutions should not be encouraged before improvements in regulatory/supervisory systems are in place.

This initial response was not based on theory but on the practical observation that certain parts of financial groups were contaminating other parts. They were contaminating each other due to inadequacies in Jamaica's capacity to regulate and supervise these complex structures. One could find that a group was being supervised/regulated by one or more of the three agencies - Bank of Jamaica, the Office of the Superintendent of Insurance, and the Securities Commission - and that there was no coordination of their efforts. FINSAC is trying to break up the groups into their component financial institutions, especially the separation of banking from insurance institutions, until Jamaica has built up the ability to supervise and regulate complex organizations. Being aware that the trend in other parts of the world is towards integrated financial systems, the intention is not to go against this trend, but to allow the development of the regulatory/supervisory framework to determine the pace of evolution of complex structures.

### ***Relative Emphasis on Punishment versus Rehabilitation***

Incidents of fraud and malpractice have come to light in the process of intervention failed institutions. Clearly, the financial relations among institutions within groups have been less than at arm's length; and lending to connected parties has not been rare.<sup>1</sup> These raise the issue of relative emphasis on establishing culpability and the punishment of the culpable and on the rehabilitation of the institutions. Given scarce managerial talent and the expense of litigation, rehabilitation can be slowed by too much emphasis on determining blame and punishing the culpable. While provision should be made for punishment of those whose excesses are responsible for or contributed to present problems, immediate emphasis has been on rehabilitation. This has been necessary to stop panic and stave off a run on other institutions.

Justice has not been ignored. In each intervened institution where FINSAC has acquired control, a forensic audit is done. It is possible that unless an example is made of the culpable, another financial sector crisis will become more likely and could even be worse than this last. However, how much should be spent on forensic audits should be justifiable in terms of what can be recovered. FINSAC's intention is to recover as much of the funds as possible, and where there is evidence of criminal wrongdoing, to refer the information to the Director of Public Prosecutions for his action. But the marshalling of evidence has to wait on painstaking forensic audits, which by nature are time-

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<sup>1</sup>In the case of the Workers Bank, owned and controlled by the Corporate Group, over 60 per cent of loans were to the Corporate Group and its component institutions and another 10 per cent were to staff of the bank.

consuming and expensive. The prosecutions represent an additional burden on the DPP's office and with staffing constraints, the process takes a long time.

### *The Replacement of Management*

The public has been concerned about the failure to replace management at the problem institutions. In some cases where there was evidence of incompetence of hired management, the approach has been to replace them if more suitable ones can be found. This has been done in only a few cases so far. Unfortunately, there is not a reserve of unemployed better managers domestically which can be tapped to provide replacements. In the current economic climate, it has been difficult to attract foreign managers even at premium levels of pay. Increasing effort will have to be dedicated to the re-indoctrination and re-training of managers, some re-deployment within institutions and the upgrading of the control environment. It is also the intention to introduce changes in pay structures to include an incentive component responsive to verifiable performance requirements and standards.

### *Viability of Life Insurance Business*

In the case of life insurance, because agents' commissions amount to nearly double the premium income payable in the first two years and are payable up front, the expansion of sales created a cash flow problem. In addition, this system favoured the writing of new business rather than the maintenance of business beyond two years old. Clearly, new commission arrangements or better still, new approaches to sales involving direct sales over the counter and by mail to lower sales cost, will be indispensable for survival of this type of business.

The life insurance sector has developed in an atmosphere of freedom from overseas competition for the Jamaica market. This has been due to the nature of the business and the legal requirements and taxation. Recently, the Jamaica market has become attractive to foreign underwriters who, operating informally under the guise of being tourists, sell insurance from their hotel rooms to Jamaican clients without paying the taxes and stamp duties that Jamaican companies have to pay. This has been tantamount to trade liberalization since the government has not acted to prevent it.

It is difficult to determine how important a problem this could be for the future viability of the industry. Foreign competition probably increases the range of products and lowers the cost to Jamaicans. Whether the appropriate response would be to bar purchase of foreign insurance products, or to level the field by abolishing or lowering the charges on the domestic industry, is a matter that will have to be studied.

### *The Issue of Competing Priorities - Stability versus Growth*

Trying to rehabilitate a sick financial sector in an economic environment in which you are trying to wind down inflation and in which growth is stagnant - zero or negative, - presents a real problem, requiring a delicate balancing of priorities and measures. Financial sector rehabilitation involving liquidity and solvency support to problem institutions can complicate efforts to curb inflation. Reduction of inflation requires the correction of excess liquidity in the economic system. In the Jamaican situation, priority was given to the reduction of inflation.

Consistent with the inflation reduction priority, FINSAC intervened on the basis of a special instrument, guaranteed by the



Government, but with restricted liquidity in that the Bank of Jamaica did not accept the instrument for discounting. FINSAC bonds addressed the solvency problem but not the liquidity problem of the institutions being rehabilitated. Gradually, the instrument became usable in addressing, to a limited extent, the liquidity problem in that other institutions became willing to lend against the FINSAC paper on the basis of repurchase agreements.

The rehabilitation of the financial sector will also depend critically on the restoration of the viability of clients, especially of borrowers. This viability will depend on the return to positive growth in the Jamaican economy. This presents a sort of conundrum, in that stimulation of growth requires a solution of the problem of how to mobilize more savings despite the high percentage of defective intermediaries. FINSAC has to do even more than it has been doing to restore confidence in the financial institutions, which means it has to speed up rehabilitation and divestment of institutions to suitable new owners.

The return to positive growth also depends on the relative emphasis of policy either in terms of growth or on the curbing of inflation. Now that substantial progress has been made in achieving the latter objective, higher priority can now be given to promoting growth. The inflation rate has been brought down from 80 per cent in 1992 to 9 per cent in 1997. With inflation falling to 9 per cent and interest rates declining much more slowly, down from 50 per cent to 40 per cent, real interest rates, which were negative, when you had 50 per cent nominal rate and 80 per cent inflation, are now very positive. The effect of the drastic reduction in inflation and a large rise in real interest rates has further depressed investment and economic activity. Drastic reduction in inflation without significant reduction in money wage adjustments has resulted in rising real wage levels not justified by productivity change. Rising real wages and higher real interest rates reduce

businessmen's expectations of positive profit. Those in the export business can expect no relief through exchange rate adjustment. Getting the economy to grow will require the happy confluence of revised priorities, policies and circumstances. All of these policies will involve a delicate balancing act, for the possible resurgence of inflation must continue to be watched.

### *Financing Rehabilitation*

No country has fiscal surpluses adequate to deal with a crisis in the financial sector without obtaining additional financing. The choices are foreign borrowing, financing by the central bank (money creation), financing by central government, borrowing from the private sector, and financing through government guaranteed bonds issued by the rehabilitation agency. The criteria for guiding the choice among these are the nature of the crisis, cost, convenience, and macro-economic impact.

In Jamaica's case, the problems did not involve foreign debt in the financial sector and the problems were not accompanied by a crisis in the external accounts. Hence there was no necessity to borrow abroad. The decision to finance FINSAC's intervention through government guaranteed bonds was made on the basis of convenience in that the bonds could be issued quickly without going immediately to Parliament to raise government debt ceilings to provide headroom since the government was only the guarantor. Borrowing by the government for FINSAC would have put further pressure on the already high interest rates, increasing the cost of financing the budget and generating cost-push inflationary pressures.

The choice of financing method does not alter the fact that the ultimate burden will be on the central government's budget. While part of the cost will be defrayed from the proceeds from the sale of assets of intervened institutions, given the degree of

insolvency, significant residual burden will fall on the public purse. Financial sector rehabilitation must inevitably compete (either now or later) with investment in social and economic infrastructure for limited fiscal resources. Fiscal policy must ultimately be geared to meet the increase in debt burden as the guarantee of FINSAC bonds will be called on at least in part. There is unlikely to be an income flow enough to allow FINSAC to pay interest on its bonds. Provision has to be made for the orderly servicing and liquidation of FINSAC bonds.

### *Liquidation of the Resulting Debt*

In its two recent budget presentations, the Government ignored the debt service obligations of FINSAC; however, the deficit in FINSAC in the remainder of the budget would have to be covered. In a growing economy the burden of rehabilitation of the financial sector could be borne out of increased taxation in the future. This is ultimately what is expected to happen in Jamaica. In the meantime the debt has to be managed. It has to be serviced. What are the prospects for cutting expenditure? What are the prospects that tax revenues can be increased? What are the prospects for greater borrowing by government from foreign sources? What are the prospects for greater borrowing by government in the domestic market?

From casual observation, expenditures cannot be cut to any significant extent. About 50 per cent of the expenditure budget is debt service, and the remainder is predominantly for security, health and education. Jamaica, already failing to provide assured income sources to 25 per cent of the people, is nearing the flashpoint for social disorder and a cut in social programmes would exacerbate potential problems. A large part of the resources absorbed in providing these programmes consist in the labour of civil servants and other employees, the expenditure being their

wages and salaries. The reduction of these programmes and the dismissal of workers would aggravate the unemployment situation. (Severance obligations would tend to increase expenditure in the short-term). Cutting of expenditure tends to fall more heavily on capital rather than on recurrent items. The capital items include improvement in infrastructure through new projects and maintenance of existing ones. Jamaica is already on the preferred list of host countries for private foreign investment because of the low quality of infrastructure. Reduction in capital expenditure is likely to involve a sacrifice of future growth; and should be avoided. The prospect for increasing tax revenue in the face of continued negative growth of the economy is not good. Indeed, the attempt to do so would further depress opportunities for economic recovery.

Borrowing more overseas is likely to be difficult in the face of recently increasing aversion to emerging economies' paper as reflected in the fall in the price of Jamaica's bonds overseas and the resulting increase in yield to 18 per cent of bonds with a coupon rate of 9 per cent. This means that any new issue of bonds would need to promise at least this yield. Perception overseas of Jamaica's creditworthiness for foreign borrowing will be adversely affected by recent and projected performance of exports. The present exchange rate policy may be seen by some as having an anti-export bias.

Further public sector borrowing in the domestic market, in the face of the current tight monetary stance, runs the risk of causing interest rates to rise or at least not fall. It could also tend to crowd out the private sector from access to funds needed for a higher level of economic activity. Yet domestic borrowing may be the only way out available to deal with the government deficit in the near term. To avoid the potential adverse effect on growth, it should be recognized that FINSAC's obligations have to be

provided for. When the government allowed FINSAC to issue J\$65 to J\$70 billion of FINSAC paper, it in fact created money, if not directly, something that is potentially money that sooner or later will be monetized. Government could avoid the ill-effects of further domestic borrowing by monetizing part of the FINSAC paper by having the Bank of Jamaica discount it. By so doing, the Financial Secretary would mop up part of the liquidity to cover the deficit, while leaving enough to meet the liquidity needs of financial institutions and put a little downward pressure on interest rates. Clearly, there is risk of some spillover into the demand for foreign exchange, which could be met by running down reserves a bit or by letting the exchange rate adjust. This in turn could lead to a slightly higher inflation target than had been announced but this would be associated with real interest rates and real wages more consistent with the needs of growth.

The main argument against this sort of delicate balancing is, “Yes, but what if inflation gets out of hand?” The answer is that this is unlikely. First, the recommendation is not one of “untrammelled” printing, but is precisely limited by the amount of near money assets already issued by FINSAC. The Bank of Jamaica does not have to invite people to cash in their whole stock of FINSAC paper at one fell swoop, but can discount them on a phased basis, month by month, while monitoring the pressure developing on the exchange rate and on the inflation rate. Future interest payable on FINSAC paper would accrue to the Bank of Jamaica, and would not involve the injection of this source of liquidity into the private sector. FINSAC paper held by the Bank of Jamaica could be returned to the Ministry of Finance in lieu of cash as and when BOJ has profits to be remitted to the Ministry. This is not a substitute for careful and judicious management of the monetary system. It will require even more careful monitoring to make sure that the revised inflation targets are not exceeded, for if they are, there may be a tendency to slam on the brakes.

The burden of FINSAC rehabilitation has to fall on the Jamaican people somewhere, sometime. Given the present growth outlook, it is unlikely that it can fall on them as additional taxation. It can fall on the real value of money balances without damage to future growth. I am concerned that many economists have given inflation a bad name, like salt in the diet. Doctors used to say if you are hypertensive cut out the salt in the diet, meaning you should not have too much salt, but be aware that some is essential to the electrolytic balance of the body. I am not suggesting that inflation should be allowed to go out of control again. Jamaica cannot maintain the lower inflation now targeted without eroding the possibilities for growth in income and employment. If the wage adjustments resulting from the tradition of competitive, political trade unionism remain in the order of 15 per cent to 20 per cent, and if the difference between inflation and wage rates is not compensated by growth in productivity, growth in income and employment may be stagnated. The society could be better off with 15 per cent inflation while liquidating the FINSAC debt than the present policy stance suggests.

## LESSONS

Here is a short list of lessons from the Jamaican experience:

- Entry barriers should be high and entry criteria should effectively screen out the unfit.
- Financial regulations should pay greater attention to the investment portfolio of institutions, and specifically ensure greater transparency of the risks being taken by investment managers. Institutions often gambled with savers' funds.

- Regulators should pay attention to whether leverage is excessive.
- Particular attention should be paid to transactions off the balance sheet. Foremost among these is the implicit guaranteeing of transactions in commercial paper for a fee. Regulators should require fuller and more timely data on such transactions.
- Now that the foreign exchange market has been liberalized, banks and other institutions should be required to provide timely and complete data on their foreign exchange reserve positions and on forward transactions which could affect their short-term debt.
- Regulations in future must trigger exit of weak institutions before a point of insolvency is reached.
- Troubled institutions are usually sicker than management is willing to reveal. Hence the financial and other costs of rehabilitation are usually greater than purported to be.

## **SOME RECOMMENDATIONS**

I recommend that:

- Caribbean Centre for Monetary Studies or ISER do a case study of the Jamaican experience.
- CARICOM regulatory agencies and central banks intensify their collaboration in bringing about greater uniformity in the coverage, quality, and frequency of

statistical data on their financial sectors in order to facilitate research and policy coordination within the area.