FINANCIAL SECTOR REFORM PROGRAM

(JA-0049)

EXECUTIVE SUMMARY

Borrower:	The Government of Jamaica		
Guarantor:	The Government of Jamaica		
Executing agency:	The Ministry of Finance and Planning		
Amount and Source:	IDB: (OC)	US$	150,000,000
	Local:	US$	0
	Total:	US$	150,000,000
Financial terms and conditions:	Amortization Period:	20	Years
	Grace Period:	5	Years
	Disbursement Period:	24	Months
	Interest Rate:	variable	
	Supervision and Inspection:	1.00	%
	Credit Fee:	0.75	%
	Currency:	U.S. Dollars from the single currency facility	

Objectives: The financial sector reform program has two broad objectives: (i) resolution of the financial sector crisis, which came to a head in Jamaica in the mid 1990s, and (ii) reduction in the vulnerability of the financial system to future crises.

Description: The program will be carried out in conjunction with an IMF Staff Monitored Program (SMP), which will not provide any resources but will include specific targets for monetary and fiscal aggregates as well as structural benchmarks for public sector and financial sector reform. In the latter area the SMP and the goals of the present program will be coordinated. The program will (i) assist in the disposition of assets accumulated by FINSAC, the government agency charged with the work out of the financial institutions intervened during the crisis; (ii) support the containment of the debt incurred by FINSAC when it obtained

these assets; and (iii) contribute to the reduction in the vulnerability of the financial system to future crises by means of (a) support for improved bank and non-bank supervision, and (b) enhanced enforcement and adjudication capacity.

The program will be executed by the Ministry of Finance and Planning and is expected to be disbursed in two equal tranches of US$75 million each. The Caribbean Development Bank will provide US$25 million in financing for a parallel sector program which will share the conditionality of the proposed FSRP and will also be disbursed in two equal tranches. Furthermore, the CDB will finance a technical assistance program. The World Bank has committed to providing US$150 million in support of financial sector reform.

Bank's country and sector strategy:

The Bank strategy, as stated in the Country Paper (GN-2025), has two overriding objectives: (i) establishment of satisfactory macroeconomic conditions, characterized by sustainable fiscal and balance-of-payments equilibria, reduced interest rates and low inflation; and (ii) promotion of an improved environment for long-term private-sector-led growth and development. The proposed FSRP is fully consistent with and will be the means for implementing the Bank's country strategy in the financial sector and will contribute to achieving the broader macroeconomic objectives. As noted in the recent Programming Memorandum (June 2000), the FSRP initiative reflects a shift from the status quo scenario to a growth scenario for lending under the Bank's strategy. The program is also consistent with the Bank's Financial Market Strategy (GN-1948-3) approved last year in that it will be carried out in a context of macroeconomic stability and policy consistency, and it will improve the legal and regulatory environment.

Environmental/ social review:

The proposed program will have no direct environmental impact, because all initiatives will be limited to legal and institutional reforms affecting the financial sector. It should be noted that ancillary environmental issues are addressed in the supervisory procedures and in the sale of FINSAC non-core assets (see paragraph 2.21).

With respect to the social impact, it is expected that there may be some short run labor dislocation as a result of restructuring in the financial sector and expenditure restraint in the public sector. However, in the medium term, the social impact is expected to be positive, as a more stable and robust financial sector contributes to growth and helps to generate new jobs and social sector

improvements. To date the labor dislocation from the restructuring appears to have been minimal, given that unemployment rates have not been significantly affected. In addition, a number of safety net mechanisms exist which can alleviate some of the negative social effects of labor restructuring.

Benefits:

The first component of the program, in conjunction with the IMF Staff Monitored Program, will contribute substantially to the reduction and containment of the remaining government-backed (FINSAC) debt accumulated as a result of the financial crisis in the mid 1990s. Not only will this help to reverse the recent pattern of adverse debt dynamics thereby having a generally salutary effect at the macro-economic level; it will also provide a major impetus to the normalization of the financial sector. Payment of cash interest on the FINSAC paper will address the liquidity and solvency requirements of the two intervened domestic banks and enable them to be privatized; by the same token the remaining intervened insurance companies will be either closed or sold. The second major component of the program will reduce the vulnerability of the entire financial system to future crises not only by strengthening the legal and regulatory powers of the various supervisory bodies, but also by providing for their greater coordination particularly in times of impending financial crisis. Furthermore the system will benefit from strengthening the enforcement and adjudication capacity of the executive and judicial branches of government.

Risks:

In order to meet the objective of reducing and ultimately eliminating the FINSAC debt burden, the central government will have to maintain its primary surplus at the levels recently achieved of 10+ percent of GDP over the medium term. During this same period the government will have to follow policies conducive to a lowering of interest rates and increasing economic growth. These are ambitious goals and the means to achieve them have been developed in the context of the IMF Staff Monitored Program. It is worth noting that the country has achieved comparable primary surpluses in the past, has several important "shock absorbers" to a full-blown crisis, and is prepared to take additional expenditure reduction measures if needed.

In addition to the risks at the macro-economic level, there are certain risks with the sector-level initiatives that the program is undertaking. First, the largest domestically-owned bank, the National Commercial Bank, was intervened by the authorities during the financial crisis of the mid-1990s and is now to be brought to point of sale as one of the conditions for second tranche

release of the program. The steps involved are subject to legal challenge, which may delay but cannot reverse this process. The authorities expect to have completed these steps by early 2001, and second tranche release has been tentatively targeted for late in the third quarter. Thus there is some margin for delays in this case. A second and more general concern is the approval of the legal measures considered crucial for the program's success. These measures will be considered by Parliament and may be delayed or altered substantially, thus jeopardizing the second tranche release. However the Government has an adequate majority in Parliament and while favorable consideration cannot be assured, there is a reasonable likelihood that it will be forthcoming. A third area of concern is a consequence of one of the program's more important conditions, namely that the supervisory authorities be given authority, without prior approval from the political directorate, to take corrective enforcement actions and, when all other measures have failed, to seize management and take control of the offending institution. The risk is that the regulatory authorities may not exercise this power judiciously and expeditiously when the need arises. However this risk is mitigated by the relative maturity of the superintendency of banks and by the technical assistance which will be provided to all regulatory authorities in parallel with the program. Finally the institutional capacity of the new-non bank regulatory agency is a risk. In particular there is a shortage of skill and experience in Jamaica with setting up and running an integrated supervisory agency. To mitigate this risk the authorities have agreed to second a foreign expert to assist in the initial operation of the agency, if no such skill can be found in Jamaica

Special contractual clauses: The Policy Matrix (Annex I) and Policy Letter (Annex II) govern the conditions for the disbursement of each tranche.

Poverty-targeting and social sector classification: This operation does not qualify as a social equity-enhancing project, as described in the indicative targets mandated by the Bank's Eighth Replenishment (Document AB-1704). Furthermore this operations does not qualify as a Poverty Targeted Investment (PTI).

Exceptions to Bank policy: None.

I. FRAME OF REFERENCE

1.1 Jamaica is recovering from a financial crisis that began in the mid-1990s. Since then the measures taken both to reconstruct and reform the affected institutions and to lessen the financial system's vulnerability to future crises represent a fundamental change in the Jamaicans' management of the sector. The Government of Jamaica (GOJ) has sought assistance from the IMF, the IDB, the World Bank, and the Caribbean Development Bank (CDB) to further stabilize the macro-economic situation, to support the financial sector work-out effort, and to cement in place the prudential reforms needed to reduce susceptibility to future crises. The proposed Financial Sector Reform Program (FSRP) will be carried out in conjunction with an IMF Staff Monitored Program, which has been approved by management and presented to the IMF Board.[1] The CDB will provide US$25 million in financing for a parallel sector loan that will be substantively identical to the proposed FSRP. The CDB will also provide loan resources for a Technical Cooperation program that will fund all technical assistance activities to be carried out during and after the execution of the FSRP.

A. Socioeconomic framework

1. Significant developments of the 1970s and 1980s

1.2 After independence in 1962, Jamaica entered a period of sustained macroeconomic instability and volatility in the 1970s. This instability was reflected in fiscal and balance-of-payments deficits, high inflation, exchange-rate depreciation, the slide into a negative position of net international reserves, and economic stagnation. For example, output growth averaged *negative* 3.2 percent per year in 1973-1980 compared to 4.5 percent in 1960-70, inflation averaged 22.0 percent in 1975-80 compared to 3.9 percent in 1960-70 and the balance of payments showed an accumulated deficit of US$679.2 million in 1972-80 compared to a surplus of US$95 million in 1960-71.[2] Against the background of an interventionist Government stance, private net capital inflows turned sharply negative, aggravating the balance-of-payments difficulties. The deteriorating economic performance was accompanied by signs of social distress that included an upsurge in violent crime and emigration of skilled personnel.

1.3 **Macro-economic reform.** Responding to this instability, Jamaica entered into a succession of IMF-supported stabilization programs, starting in 1977 and

[1]. Jamaica had an EFF arrangement with the IMF between December 1992 and March 1996 after which there was strong domestic opposition to further Fund programs. Thus the authorities have elected a Staff Monitored Program (SMP) which does not provide loan resources and is presented to the IMF Board for information but does not require formal Board approval. The SMP and accompanying "Memorandum of Economic and Financial Policies of the Government of Jamaica for 2000/01-2001/02" was presented to the IMF Board of Executive Directors on July 21, 2000.

[2] See Desmond Thomas, Anatomy of a Stabilization Process: The Case of Jamaica, 1984 to the Present, *Canadian Journal of Development Studies*, Vol. XX, 1999.

culminating in the completion of an Extended Fund Facility program in 1996. Some major initiatives adopted in the 1980s under these programs included (i) import liberalization; (ii) income tax reform aimed at simplifying its administration and widening its coverage; (iii) adoption of a unified exchange rate following the practice of multiple exchange rate systems; (iv) divestment of Government-owned banks; and (v) deregulation of the financial sector allowing freer entry. These policy measures took place against a background of adverse terms of trade developments as international recession and the second oil price shock impacted and bauxite prices fell. Private capital inflows, which had declined sharply in the 1970s, failed to recover. Consequently, the balance of payments deteriorated and the national external debt burden escalated. However, toward the end of the 1980s there was some recovery of economic growth, which averaged 5.8 percent in 1987-90.

2. Policy responses in the 1990s and further developments

1.4 In the 1990s, stabilization efforts were intensified with a marked emphasis on tight monetary policy aimed at curbing inflation, which reached 80 percent in 1991. There was a shift from direct monetary policy interventions like credit controls to indirect monetary policy instruments such as open market operations and interest penalties on overdrafts at the Central Bank. [3] In addition, the foreign exchange regime was liberalized in 1990 with the adoption of a market-driven *inter-bank foreign exchange system* and the lifting of exchange controls in 1991.

1.5 At the same time, fiscal restraint was exercised leading to Central Government surpluses averaging 3.3 percent in the first half of the 1990s. These surpluses were the result of strong fiscal efforts, as indicated by primary surpluses averaging 13 percent per year during the same period. However, fiscal effort was subsequently relaxed in 1996/97-1998/99 as indicated by primary balances averaging 4 percent per year. Following the emergence of the financial sector crisis, Central Government fiscal deficits averaging 7 percent were recorded in the period 1996/97-1999/2000. The pattern of surpluses in the early 1990s turning to deficits in the late 1990s was also evident at the level of the overall public sector.

1.6 Tight monetary policy supported by tight fiscal policy in the first half of the 1990s, succeeded in reducing inflation from a peak of 80 percent in 1991 to seven percent by 1999. These policies also raised interest rates, with the weighted average loan interest rate reaching as high as 49 percent in 1994. This helped to stimulate private capital inflows, causing net international reserves to turn positive in 1993 and to grow to significant levels by 1997. The improved reserve position was also attributable to the continued growth of tourism, bauxite/alumina exports and unilateral transfers.

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[3] See David Marston, Jamaica's Experience with Indirect Instruments: Lessons for the Caribbean, *Social and Economic Studies*, Vol. 44, 1995.

1.7 After some reduction in nominal rates in recent years, the average real lending interest rate still exceeds 20 percent. A significant feature is high interest rate spreads between lending and deposit rates, which have been attributed to the high liquid asset and cash reserve requirements imposed as instruments of monetary tightening.

1.8 The nominal exchange rate depreciated from J$7/US$1 in 1990 to J$42/US$1 in 1999 but, for the most part, the real effective exchange rate appreciated during the 1990s. This undermined the competitiveness of the economy, encouraging import growth and a sluggish performance of exports.

1.9 **Costs of the public debt.** High interest payments, which fluctuated significantly during the decade, moving from 9 percent of GDP in 1990/91 to 14 percent in 1999/2000 have had a significant impact on the fiscal accounts. This has been due to rising interest payments on domestic debt, which rose from 4 percent of GDP to 12 percent during the same period, while interest payments on foreign debt declined from 5 percent to 2 percent. Overall, these payments have risen, as a proportion of GDP, despite a decline in the amount of debt relative to GDP. This is due to a change in the composition of the public sector indebtedness. External debt reduction has been accompanied by an escalation of domestic debt, which is subject to substantially higher interest rates.

1.10 Interest payments on public debt are pre-empting more than 50 percent of central government revenue. Meanwhile wages and salaries have increased from 9 percent to 11 percent of GDP over the decade of the 1990s. Thus, the effort to achieve fiscal balance has fallen mainly on capital expenditure, which was halved, from 6 percent to 3 percent of GDP, over the course of the decade. With capital expenditure already at low levels and debt service representing such a large portion of total expenditure, interest rate reductions would have a large impact in curbing total expenditure.

1.11 **Adverse debt dynamics.** The late 1990s witnessed an intensification of adverse debt dynamics involving growing upward pressures on interest rates, fiscal deficits and public debt accumulation. Interest rates have been forced up by a combination of high government borrowing requirements and a continuing need to mop up the excess liquidity generated by capital inflows. With interest payments absorbing more than half of total revenue, any increase in interest rates rapidly translates into substantial additional fiscal costs to the central government.

1.12 These adverse conditions have been aggravated by low economic performance as GDP growth averaged less than one percent annually and per capita income declined by one percent annually in 1991-96. Economic performance deteriorated further in the late 1990s, with output declining at an average rate of 1.1 percent per year in the 1996-99 period. This low performance was attributed, *inter alia*, to high real interest rates, declining international competitiveness especially in the apparel industry, a major setback in the bauxite/alumina industry and a slump in the agricultural sector induced by adverse weather conditions.

B. The Financial sector

1. Structure of the financial sector

1.13 The existing financial sector framework in Jamaica was essentially established with the enactment of the Banking Law (1960) for the regulation of banking in Jamaica, and the establishment of the Bank of Jamaica in the early 1960s. Up to this time, the commercial banks, which dominated the sector, were all foreign-owned and operated in accordance with the prudential regulations and standards of the countries in which their head offices were based. Consequently, the need for a strong regulatory and supervisory framework for the sector was not perceived as a priority, and the foreign banks resisted efforts to introduce regulations that would be administered by the Jamaican Authorities. Some local involvement in the commercial banking sector was initiated with the sale of 25 percent of its shares by the Bank of Nova Scotia to the Jamaican public in 1966, later to be followed up by the nationalization of Barclays Bank [4] in the 1970s.

1.14 Against a background of national economic growth averaging 5 percent in the 1960s and expansionary credit conditions that persisted into the 1970s, the financial sector expanded during this period in terms of the growth of assets and the establishment of new institutions.[5] This process was boosted in the 1980s by the deregulation of the sector allowing easier entry and the divestment of NCB and the Workers' Bank by the GOJ. The expansion of the financial sector continued into the 1990s, and its growth outpaced that of the overall economy, causing its value added contribution to double in the period of a decade, reaching 16 percent of GDP in 1995. The first half of the decade also saw the even faster growth of merchant banks, finance houses, and trust companies, which in part was driven by opportunities for regulatory arbitrage.

1.15 In the mid-1990s the tight anti-inflationary policies described above had an adverse impact on the financial sector as non-performing loans increased which was initially masked by extension of liquidity support from the Central Bank. In addition, the high interest rates and depressed economic conditions encouraged a shift from the traditional financial intermediation to trading in securities, mainly government securities issues for financing the deficits. This shift is reflected in falling shares of loans and advances relative to the proportions of assets held in the form of securities by financial institutions. In turn, these conditions were further exacerbated by the collapse of the financial sector that occurred, starting in 1996.

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[4]. Renamed the National Commercial Bank (NCB).

[5]. New institutions established included merchant banks, the Jamaica Investment Fund (trust company) (1970), the Jamaica Mortgage Bank (1972), the Jamaica Development Bank (1969) and the Jamaica Export Credit Insurance Corporation Limited (1971). See, Gail Lue Lim, *Jamaica's Financial System*, Bank of Jamaica, 1991.

2. The regulatory environment prior to 1996

1.16 Following the macro-economic reforms of the late 1980s (see paragraph 1.3), the Supervisory Authorities became increasingly aware of the deficiencies of the pre-liberalization legal framework, and initiated drafting of legislative revisions. However resistance to meaningful reforms by the financial sector lobby was strong and effective in the expansionary and inflationary environment of the early 1990s. Although new legislation was approved in 1992, the lobby influenced the outcome, resulting in provisions that gave inadequate powers of intervention, sanction and enforcement to the supervisory authorities. They could not implement their supervisory recommendations in a timely manner, which created a moral hazard by sending accommodative signals to the market. Having realized the inadequacies in the 1992 legislation, the authorities established a Task Force in 1995 to conduct a more comprehensive review of the laws. As noted below, the efforts of this Task Force, combined with the impact of the crisis in 1996/97, lead to several important amendments to the Banking Act and the Financial Institutions Act in 1997.

1.17 Not only did the authorities lack adequate powers in the early 1990s to take action in response to deteriorating conditions in the system; there were significant disparities between the prudential norms governing the various agents in the financial sector. While the deposit-taking entities under the supervision of the Central Bank became subject to increasingly stringent prudential norms, this supervisory approach was not replicated across the entire financial landscape, particularly as regards insurance companies. This, along with differential prudential requirements, encouraged regulatory arbitrage, which was used creatively by certain financial industry players to operate beyond the effective reach of the banking supervisors. Furthermore it is important to note that the institutional capacity for non-bank supervision was divided between various agencies, including the MOF, was very weak and continues to this day to be deficient compared not only to international best practice but also to bank supervision in Jamaica.

1.18 In addition, a significant contributor to the crisis was the weak financial industry practices, particularly the poor standard of corporate governance. The table below discusses these weak financial industry practices as well as the existing supervisory/regulatory framework that existed at the time.

Weaknesses in the Financial Sector	Supervisory/Regulatory Context
➢ Portfolio concentration (lending and investment in real estate, tourism project, etc.) without adequate provisions. ➢ Uncontrolled diversification into non-core businesses (insurance, merchant banking, trading companies, etc.)	➢ Supervision of different types of institutions remained separate and uncoordinated ➢ Less stringent investment limits in any one entity ➢ Lack of access to information on non- bank affiliates
➢ Excessive related-party lending and investment	➢ No regulations on total lending to and investment in connected persons/entities
➢ Mismanagement (unsecured lending, lack of focus on cash-flow analysis.)	➢ Inadequate credit classification/provisioning regulations
➢ Mismanagement of assets and liabilities in life insurance companies	➢ Weak insurance supervision ➢ No investment guidelines or restrictions in Insurance Act
➢ Breach of banking regulations ➢ Fraud	➢ Limited penalties for breaches of rules and regulations ➢ Limited supervisory enforcement powers for troubled banks
➢ Poor corporate governance	➢ Laws lacking definition of roles/responsibilities of Boards
➢ Insufficient capital, given risks taken	➢ Inadequate capital adequacy regulations
➢ Little disclosure requirements and weak accounting standards	➢ No regulation regarding financial information

1.19 As part of a previous IDB sponsored technical cooperation program (ATN/CD-CP 4917-JA) carried out from 1994 to 1996 attempts were made to strengthen the supervisory approach of the Bank of Jamaica. The focus of this project was to develop an examination manual, including procedures for supervising financial conglomerates; provide training in principles of supervision; implement an early warning system, develop a risk-based supervisory approach; and enhance the legal and regulatory framework. However the materials prepared only partially addressed the supervisory deficiencies, and for this and other reasons were not fully adopted by the staff at the BOJ.

3. The crisis of 1996/97

1.20 The Government's economic stabilisation policy has been identified as the villain that caused the financial services sector's problems. However, Government policy is general in its application and therefore, all things being equal, one would expect

all financial institutions to be affected at least to some degree. While the macroeconomic policies may have precipitated the insolvency of most domestic institutions, it is significant that in this period, the Bank of Nova Scotia Jamaica (BNS) continued to produce better results with each succeeding quarter, experiencing a slight dip in 1997, before continuing its record of increased profitability. Citibank, Canadian Imperial Bank of Commerce and other foreign banks also performed well during and after the crisis, as there was a "flight to quality" within Jamaica from indigenous to foreign-owned banks.

1.21 Rather than looking to macro stabilization policies, the causes of the crisis must therefore be sought at the institutional level, where abuses by the indigenous insurance companies in the first half of the 1990s precipitated major problems in the banking sector. Insurance companies were offering "equity and money market linked products" that were short term and paying high rates of interest. Insurance companies were gathering these short-term bank-like liabilities and investing in long-term assets, mainly real estate or linking them to stock market performance, all of which was encouraged by the burgeoning market performance. As the stock market and interest rates declined, people withdrew their money from the insurance companies, and in order to meet this demand the insurance companies accessed funds from their banking affiliates, thus creating a contagious drain on funds from the banks. Initially the Bank of Jamaica provided extensive liquidity support for the affected banks; however with continued drains, this BOJ support was insufficient and the insolvency of the banks was unavoidable.

4. Measures taken since the crisis

1.22 In the aftermath of the crisis, and once its full extent could no longer be ignored, the authorities responded with measures to restore the financial system to health and with initiatives to strengthen its legal and regulatory and supervision framework. Because the proposed Financial Sector Reform Program will build on this framework, these measures and initiative are presented in the following paragraphs.

a) FINSAC intervention

1.23 In late 1996, the authorities initiated a three-stage approach to manage the failed financial institutions, namely, intervention, reorganization/rehabilitation, and divestment. To carry out these tasks, the Ministry of Finance created in January 1997 the Financial Sector Adjustment Company (FINSAC), a limited life, special purpose entity wholly owned by the Government. In exchange for FINSAC bonds, the non-performing assets from all intervened institutions were hived off to a workout unit within FINSAC, thus setting up a "good bank/bad bank" structure. Furthermore FINSAC took an equity interest in several of the intervened institutions in exchange for FINSAC paper. Interest on this paper (at a rate of treasury bills plus 1 percent) is payable either in cash or with additional FINSAC paper (i.e. capitalized), and the government has chosen the latter form of payment

for all but a few issues. This has led to a substantial build-up in the stock of this debt. Following is a discussion of the key FINSAC assets.

1.24 **Union Bank** (UB) was created through the merger of four failed commercial banks, five merchant banks, and three building societies. The bank has been downsized, and the management structure, information technology and lending operations have been strengthened. FINSAC owns 99 percent of the shares, and the remaining one- percent is distributed among approximately 3000 small shareholders. FINSAC paper held by the UB currently amounts to J$17.8 billion (US$445 million) and accounts for approximately half of total assets of J$34 billion (US$ 810 million). The bank has a good branch network and a dormant license to operate an agency in Miami, which would have to be reactivated. As discussed in Chapter II, Royal Bank of Trinidad & Tobago is well along in negotiations to purchase the bank.

1.25 **National Commercial Bank** (NCB) and its holding company were intervened, but the existing management was left in place largely for political reasons, while FINSAC re-capitalized the institution. NCB has assets of around J$88 billion (US$ 2.1 billion), which makes it almost three times larger than Union Bank. More than half of the NCB assets are held in the form of FINSAC paper. Interest is being capitalized rather than being paid in cash, which is a primary reason for the bank's liquidity problems. However, as a result of new management in the treasury area and a "turnaround plan", including the sale of non-core assets, the bank's liquidity position at present is relatively stable. Also the bank has registered profits for the past three-quarters, attributable in part to a 9 percent financial margin on its treasury operations, and to cost cutting including the reduction in operating branches from 70 to 51. The bank has not been in overdraft with BOJ for almost one year, and currently is a net lender of funds in the market, although this position is very sensitive to market fluctuations.

1.26 FINSAC owns 67 percent of the equity of the combined bank and holding company. Since intervention, NCB has been downsized and its operations and organizational structure strengthened. The loan portfolio has declined from J$10.1 billion to J$8.4 billion through attrition as a result of a "Board Undertaking", agreed with the BOJ, which permits new lending only with 100 percent cash collateral. All non-performing loans are reported to be fully provisioned. There are 40 – 50 subsidiaries of the holding company, although only five are going concerns. The remainder are either dormant or in liquidation.

1.27 **The Insurance Industry.** The FINSAC intervention into the life insurance industry appears to have been successful in restructuring the industry. Cross ownership between insurance and banking has largely been eliminated among the domestic institutions. Re-capitalized with FINSAC bonds and by limited burden sharing with the "depositors", the industry is being privatized. Currently FINSAC has an equity interest in five insurance companies. Two are in process of liquidation; the third has been sold, and FINSAC's remaining interest is transitional, with a clear exit strategy. The policyholder liabilities and

corresponding assets of the fourth company have been sold and pending resolution of several legal issues, FINSAC expects to sell the remainder of the business by December 2000.

1.28 FINSAC continues to own 26.5% of the common stock of the fifth company, Life of Jamaica Ltd. (LOJ), and owns 100% of the preferred shares. The company is undercapitalized and FINSAC is currently negotiating to inject a further J$1.9 to 2.8 billion in return for which FINSAC would gain a controlling interest in the company (at least 75% plus one share). As discussed in Chapter II, FINSAC plans to sell its interests in LOJ by mid 2001.

1.29 **Non-core assets and Non-performing Loans**. In addition to the banks and insurance companies, FINSAC has other non-core assets consisting of real estate investments in hotels, commercial, industrial and residential properties, and in non-performing loans (NPLs) acquired from intervened banks and insurance companies. The current value to FINSAC is way below their original purchase price. Since the intervention, FINSAC has restructured its operations and established the capacity within two separate units to concentrate on the sale of the real estate and the NPLs. While the sale of residential properties has moved at an appreciable rate since commencement of the divestment program, disposal of commercial properties has been slow. As part of the existing MIF Technical Corporation (ATN/MT-5735-JA) FINSAC conducted a detailed inventory analysis of the hotel properties and obtained the services of an international hotel expert to advance the sale of four major properties. For the NPLs, a financial management company was recently hired to conduct an analysis of the entire portfolio and prepare an integrated marketing plan.

1.30 **Summary of FINSAC position.** As of March 31, 2000 (end of FY 99/00) FINSAC had liabilities of about J$ 107 billion (US$ 2.6 billion) in bonds outstanding, while its assets included equity interests in Union Bank, National Commercial Bank, and some insurance companies, unsold properties, and non-performing loans (NPLs). The estimated total value of these assets is roughly J$15 billion, which when sold will be used to partially retire the FINSAC debt. A major feature of the proposed sector reform program will be to implement a plan to retire a portion of the FINSAC debt and pay interest in cash on the remainder. (See paragraphs 2.9 – 2.17).

b) Strengthened oversight of the financial sector

1.31 As noted above, prior to the crisis the authorities had initiated several measures to improve the oversight of the financial system; however the crisis precipitated the political consensus necessary to bring these and further, more far-reaching reforms to fruition. These developments are described in detail in documentation available in the project files and are summarized below.

(i) Reforms in bank supervision

1.32 Bank supervision improvements over the past several years can be categorized into four principal areas: 1) developing supervisory tools for early *detection* of problems arising in individual banks and in the sector; 2) strengthening the *legal and regulatory* framework, including regulations to address weak banking practices and amendments to provide for greater *enforcement* capabilities; and 3) introducing standards of *self governance* to engender prudent practice.

1.33 *Detection:* In order to improve the regulators' ability to detect weaknesses early on in the financial cycle, the authorities have strengthened their supervisory processes, including on- and off-site supervision. Quarterly performance targets have been developed for the banking system and a Financial Stability Monitoring Committee was established to analyze the systemic risks in the system.

1.34 *Legal and regulatory framework:* The legal and regulatory framework was strengthened and important progress was achieved in the area of reform of legislation pertaining to banks (commercial banks, merchant banks, building societies and provident funds). Amendments to financial sector legislation approved in 1997 included: tightened prudential limits on connected lending; introduction of Basle capital requirements to be set at 10% of risk-based assets (more conservative than the standard 8%); a broader, more exacting definition of what constitutes "fit and proper" in respect to managers, directors and major shareholders of banks.

1.35 *Enforcement*: has been enhanced by the introduction of a ladder approach to prompt corrective action (undertakings, directives, and "cease and desist" orders) which clearly advise the industry regarding sanctions/supervisory actions the supervisor will take depending on the severity of the problems detected.

1.36 While these legislative reforms in the banking area represent important progress; the challenge remains effective implementation of the norms and regulations. The BOJ has tested some of these powers by requiring "Board Undertakings" as noted above in the case of NCB (see paragraph 1.26) and issuing Cease and Desist Orders (which previously could only be done by the Minister). However, the supervisor still does not have authority to directly impose fines for the majority of breaches to regulations due to a perceived constitutional requirement that fines must be imposed through the court system. Only fines for non-compliance with cash/liquidity reserve requirements can be imposed, as these predate the Jamaican Constitution.

1.37 Furthermore, the 1997 legislation and the prudential norms continue to vest significant power in the Minister of Finance to grant exemptions to legislation and to prudential requirements and to exercise final decisions on bank intervention and exit. The potential arbitrariness of the Minister's powers cause uncertainty in the application of prudential rules, leading to improper expectations on the part of both the bank and its customers. This ministerial discretion over the financial

sector weakens the ability of the BOJ to supervise the industry, because institutions are inclined to seek exemptions (or delays) as opposed to complying with particular requirements of the supervisor. These deficiencies will be addressed by the proposed FSRP.

1.38 *Self governance:* The supervisory authorities responded to the dilution of management skills in the financial system by introducing "Standards of Best Practices" to the industry in the following areas: credit risk management, focusing on cash flow analysis; asset and liability management, including liquidity, interest rate and foreign exchange risk. The industry is in the process of adopting these standards.

1.39 *Financial information:* Measures were also taken to improve financial information. Authorities introduced a requirement that the banks to attest to truth and fairness representations contained in quarterly un-audited balance sheets. Accounting standards have been brought more in line with US GAAP standards

(ii) Reforms in non-bank supervision

1.40 *Insurance Supervision:* The Office of the Superintendent of Insurance (OSI) is responsible for the regulation of a) insurance companies and b) unit trusts, but not mutual funds or other collective investment schemes. Under an existing IDB-MIF project (TC-97-03-25) efforts have been made to strengthen insurance supervision by developing a stronger financial sector infrastructure by managing FINSAC's investments in the insurance sector, by building institutional capacity and by establishing the regulation of pension funds.

1.41 A significant number of insurance supervision strengthening components of the TC program have been completed, including a supervisory manual for insurance companies, a draft Insurance Act and supporting regulations, solvency standards for life and general insurance companies, accounting standards for auditors, and early warning indicators. Furthermore, on-the-job training was provided during on-site inspections.

1.42 *Private Pension Supervision:* The existing IDB-MIF project noted above also addressed strengthening the supervision of private pension plans. However, several of the initiatives to be taken under this project have been put off to a later date given the other priority initiatives of FINSAC and the government efforts to reform the pension system on a much broader scale. The Ministry of Finance and Planning published a policy background document (*Green Paper*) entitled "Reform of the Pensions System in Jamaica" in 1999. To date the supervision of private pension plans is non-existent, with some cursory compliance reviews performed by the tax authorities. Therefore, a significant amount of reforms will be required in the future both in the legal and regulatory framework as well as in the area of institutional building.

1.43 *Securities Commission (SC):* The SC officially came into existence on December 6, 1993 with the gazetting of the Securities Act of 1993. As a practical matter, however, the SC did not commence operations until June 1, 1994. Thus, the SC has a relatively short history. At the present time, the securities industry regulatory system is fragmented and the SC lacks powers to carry out the broad regulatory mandate in such areas as; enforcement of on-going risk-based capital adequacy standards for securities brokers and dealers, delineation of fit and proper standards, supervision of unit trusts, mutual funds and other collective investment schemes in a uniform manner, and determination of initial and periodic disclosure requirements for listed companies.

(iii) Deposit insurance

1.44 The Jamaica Deposit Insurance Corporation (JDIC) commenced operations in August 1998, with all institutions supervised by the Bank of Jamaica legally required to be members. Coverage is purposely limited to the relatively small amount of J$200,000 (approximately US$5,000) to protect small depositors and force large depositors to monitor the condition of their bank. The JDIC has no independent oversight capacity and by law has access to BOJ information on the financial status of its members. Thus the JDIC operates largely as a passive insurance fund, which given the size of the sector, the relative strength of the BOJ, and the scarcity of supervisory resources, is an acceptable mechanism for the present time.

c) Implications for the structure of the financial system

1.45 **Structure.** The FINSAC intervention has reduced the number of financial intermediaries in the system and simplified the ownership structure. The number of supervised institutions (commercial banks, other financial institutions and building societies) fell sharply from 51 in 1996 to 26 by July 1999. The size of the system in terms of total assets was J$247 billion (US$ 5.9 billion) as of January 31, 2000, including banks, Financial Institution Act licensees and building societies. Commercial banks represent roughly 80 percent of this total. The NCB Group and Bank of Nova Scotia (BNS) Group are of roughly equal size and together represent approximately 60 percent of the financial system (and 70 percent of commercial banks) in terms of total assets. The remaining 40 percent includes: Union Bank Group 14.2 percent; CIBC Group 6.1 percent; Citibank Group 2.4 percent; TCB Group (domestic) .4 percent; other merchant banks 1.9 percent, and other building societies 14.4 percent. The assets of the remaining seven life insurance companies totaled J$ 24 billion (US$ 570 million) at year-end 1999. Of the large banks, BNS has by far the greatest loan portfolio, while the assets of NCB and Union Bank are primarily tied up in FINSAC paper.

1.46 **Liquidity.** As noted in a recent IMF report[6], commercial bank liquidity averaged 52 percent for the three-year period ending 1998, against a required ratio of 46

[6] IMF Staff Report: 1999 Article IV Consultation; Selected Issues and Statistical Appendix (Dec. 1999).

percent. At end-July 1999 however, 28 percent (up from 16 percent in 1998) of commercial bank assets were held in non-cash earning FINSAC paper, reflecting the situation in NCB and Union Bank noted above. For the financial system as a whole, claims on FINSAC as a ratio of total assets rose sharply from 9 percent in 1998 to 23 percent at end-July 1999. Thus liquidity remains a pressing challenge for the banking system, particularly the intervened banks.

1.47 **Asset quality.** A comparison of asset quality in the pre- and post-FINSAC period shows that, compared to the BOJ maximum benchmark of 10 percent, the ratio of non-performing loans (three months or more in arrears) to total loans for the banking system as a whole first deteriorated from 14 percent in 1996 to 27 percent in 1997. Then the ratio improved to 13 percent by July 1999 after a substantial volume of non-performing assets was exchanged for FINSAC paper. The ratio continued to improve to 12 percent by June 2000. The number of institutions above the 10 percent ratio benchmark declined from 31 in the pre-FINSAC period to 15 by July 1999. The number further declined to 12 by June 2000. These improvements reflect the combined impact of FINSAC's rehabilitation policies, internal measures adopted by the banking institutions to improve risk management in line with the BOJ's supervisory norms, and the general tightening of supervision and monitoring of institutions against specified targets.

1.48 With respect to provisioning for non-performing loans, the banking system moved from 24 percent in 1996 to 64 percent by July 1999. Provisioning for non-performing loans moved more rapidly in the commercial banking sector, from 28 percent in the pre-FINSAC phase to 74 percent by July 1999. By year-end 1999 the ratio of provisions for loan losses to loans 3 or more months in arrears had grown to 88 percent for all commercial banks, with the two major banks remaining under FINSAC intervention, NCB and Union Bank, at 93 percent and 97 percent respectively.

1.49 **Capital.** The banking system as a whole has been moving toward the BOJ's 10 percent minimum capital/risk-weighted asset ratio with the average ratio rising from 2 percent in 1997 (reflecting the highly negative values of the intervened banks) to 15 percent by July 1999. This ratio further improved to 19 percent by June 2000. However FINSAC paper issued for capital injections accounted a large portion of the capital and as of end-July 1999 represented 57 percent of the capital base of the banking system, and 17 percent of the total assets were held in other FINSAC securities, considered as zero risk weighted instruments.

1.50 **Profitability.** For the banking system as a whole, the ratio of gross pre-tax profits to revenue moved from a loss of 16 percent in 1997 to a positive 10 percent by mid-year 1999. For the quarter ending June 2000 the ratio had improved to 15 percent. Across subgroups, the performance was uneven, with some banks posting healthy profits and other continued losses. An important caveat is that not all profits represent cash profits, owing to the high ratio of FINSAC paper in the asset portfolio of the intervened banks. By mid-year 1999, of the banks supervised by the BOJ that reported profits, only one (NCB, which represents 38 percent of

total assets) showed non-cash profits. The return on average assets ratio recorded a turnaround from a deficit of 3 percent in 1997 to a positive 0.4 percent by mid 1999, reflecting some signs of increasing efficiency, but also the favorable impact of bank rationalization.

1.51 **Summary.** Although the financial system in Jamaica has undergone significant improvements since 1996/97 and asset quality has improved thanks largely to the FINSAC initiatives, the problem of inadequate liquidity continues. This reflects the illiquid nature of the FINSAC support to the failed financial institutions. While there are signs of an easing of the liquidity constraint in some instances, as banks take concrete steps to improve efficiency and generate income, the underlying situation remains tight. This in turn impedes the divestment phase of the restructuring of the intervened bank and insurance institutions. As described below, the proposed FSRP addresses these issues.

C. Jamaica's financial sector strategy

1.52 As stated in the Memorandum of Economic and Financial Policies recently agreed between the IMF and the GOJ (presented to the IMF Board, July 21,2000), "...the government recognizes the need for a long-term comprehensive solution to address the mounting debt burden associated with the FINSAC liabilities. The strategy for FINSAC debt resolution involves six key measures:"[7] (i) write off of debt to the central government; (ii) offset debt to other public sector entities (notably the BOJ); (iii) sale of Union Bank, (iv) recovery of non-core assets; (v) use proceeds from possible MDB financing to reduce the stock of FINSAC debt; and (vi) government to explicitly assume, and make full cash interest payments on, all remaining FINSAC liabilities outstanding as of end 2000/01. Furthermore the strategy calls for (a) rapid preparation of NCB for privatization; and (b) enhanced financial sector supervision and regulation, including strengthening the regulatory and supervisory framework for non-deposit-taking financial institutions. The objectives of the proposed FSRP are entirely consistent with Jamaica's country sector strategy. The authorities view the FSRP as a significant tool with which to achieve their financial sector reform strategy.

D. Bank Strategy and Rationale for Bank Involvement

1.53 The Bank strategy, as stated in the Country Paper (GN-2025), has two overriding objectives: (i) establishment of satisfactory macroeconomic conditions, characterized by sustainable fiscal and balance-of-payments equilibria, reduced interest rates and low inflation, and (ii) promotion of an improved environment for long-term private-sector-led growth and development. The proposed FSRP is fully consistent with and will be the means for implementing the Bank's country

[7] As these measures are an integral part of the proposed FSRP they are only summarized here and are discussed in detail in Chapter II.

strategy in the financial sector and will contribute to achieving the broader macroeconomic objectives. As noted in the recent Programming Memorandum (June 2000), the FSRP initiative reflects a shift from the status quo scenario to a growth scenario for lending under the Bank's strategy. The program is also consistent with the Bank's Financial Market Strategy (GN-1948-3) approved last year in that it will be carried out in a context of macroeconomic stability and policy consistency, and it will improve the legal and regulatory environment.

E. Previous Bank experience

1.54 **A MIF Program** (TC-97-03-25), with FINSAC as the executing agency, was approved in 1997 and is scheduled to expire in January 2001. The objective is to strengthen the financial system by providing assistance to FINSAC in three main areas: 1) to improve insurance supervision (as noted above); 2) to create capacity to dispose of the assets FINSAC receives as a result of its intervention activity; and 3) to execute financial and economic studies that will recommend changes in the legal and regulatory infrastructure. This program has contributed significantly to FINSAC's institutional capacity in the areas indicated.

1.55 **Previous sector loan.** The Bank approved a Trade, Finance and Investment Sector Loan for Jamaica in September 1991 (contract signature October 4, 1991 - LO-630/OC-JA). The loan called for improvement of the regulatory norms for bank supervision, movement to market rates of interest on loans from the development banks, a diagnosis of conditions needed to establish a secondary market in GOJ paper, creation of a securities market oversight agency (the Securities Commission – SC), the elimination of the 50% liquid assets ratio, and a gradual reduction in the reserve requirement. The first two objectives were partially met during the disbursement period of the program (December 1991 to July 1993), while the latter three were not. Since then the reserve and liquid asset requirements have been lowered, and the SC was created. The program did not achieve all its objectives during execution, and in particular did not establish a sufficiently robust regulatory framework to counteract the subsequent abuses in the financial system.

II. THE PROGRAM

A. Objectives and description

2.1 **Objectives.** The financial sector reform program has two broad objectives: (i) resolution of the past crisis, and (ii) reducing vulnerability to future crises. As noted, the program will be carried out in conjunction with an IMF Staff Monitored Program, which will not provide any resources but will include specific targets for monetary and fiscal aggregates as well as structural benchmarks for public sector and financial sector reform. In the latter area the SMP and the goals of the present program will be coordinated. The policy matrix (Annex I) proposes several sector-specific conditions which will help achieve the broad objectives of the program. Related initiatives are described in the Letter of Sector Policy (Annex II), and the parallel CDB Technical Assistance loan will support the necessary legal and regulatory reform, training, and institutional strengthening.

2.2 **Description.** The following paragraphs first describe the macroeconomic and sectoral framework and the main elements of the IMF Staff Monitored Program that provide the context for the proposed Financial Sector Reform Program. Subsequently the two major components of the FSRP itself are described in sections 2 and 3. The complementary technical assistance activities, to be carried out under to auspices of the CDB, are described in the text and summarized in tabular form in Annex III.

1. FINSAC debt containment and the macro-economic context

2.3 **GDP growth.** Based on the analysis carried out for the SMP, the IMF projects real rates of growth in output to rise from –0.5 percent in FY 1998/99.[8], and 0.0 percent in 1999/00, to +3.5 percent by 2004/05. Notable is the service sector, which accounts for close to 60 percent of GDP, and is expected to grow at an increasing rate ranging from 1.55 percent in 2000 to 4.0 percent in 2005. There are already growing signs of private sector optimism, reflected in a dramatic 49 percent rise in the Jamaican Stock Exchange index in January to May 2000 compared to a 7 percent rise in the whole of 1999.

2.4 **Fiscal and monetary policies.** The IMF Staff Monitored Program (SMP) calls for "measures to reduce the public sector deficit, maintain an appropriate monetary policy stance and accelerate structural reforms to improve efficiency and effectiveness."[9] On the fiscal side, the main features of the SMP include: (i) partial reduction of the FINSAC debt, and payment of interest in cash on the remainder, starting in FY 2001/02; (ii) continued expenditure restraint – including

[8] The fiscal year runs from April 1 to March 31.

[9] The Jamaica—Staff Monitored Program was sent to the IMF Board of Executive Directors on July 21, 2000 (document EBS/00/152) and is available on the IMF web site. The following discussion is drawn from the Memorandum of Economic and Financial Policy (MEFP) annexed to the SMP.

on wages, recurrent provisions (other goods and services), and capital outlays; (iii) an increase in the withholding tax rate on interest from the current 15 percent to the maximum personal income tax rate of 25 percent and new fees and charges; and (iv) legislation to expand coverage of the General Consumption Tax (GCT). Based on these policies the public sector primary surplus is projected to be high but declining while the overall public sector deficit will be reduced sharply and be eliminated by 2002/03.

2.5 It should be noted that the projected primary balances, while high by international standards, are not uncommon in Jamaica. During much of the first half of the 1990s, the central government ran a primary surplus at or above the levels projected for the medium term.

2.6 As regards monetary policy, the program will focus on ensuring a reduction in inflation through targeting base money. In the context of the fiscal adjustments just noted, lowering interest rates will be possible without triggering inflation. Interest rates are expected to continue on their recent downward trend due to (i) a reduction in the cash reserve and liquid asset and requirements (from 15 and 33 percent respectively to 9 and 27 percent by end FY 2001/02); and (ii) a lower overall public sector deficit. Net claims on banking system by public sector will be reduced by 3 and 4 percent respectively in FY 2000/01 and 2001/02, allowing for a corresponding increase in real growth in private sector credit, thereby supporting the incipient economic recovery during these years. Interest rates are expected to continue on the recent downward trend mainly because of credible policies that are being adopted, including a lower overall public sector deficit; a plan to resolve the liquidity problem facing the financial sector from the significant holdings of effectively non-marketable FINSAC paper. [10]

2.7 The main aims of exchange rate and monetary policies over the medium term will be to contain domestic inflation and maintain official international reserves at relatively comfortable levels. In principle, the government believes that economic policies should seek to avoid loss of competitiveness as measured by the real effective exchange rate for the Jamaica dollar, which should not appreciate in the current medium-term macroeconomic framework. Efforts to improve external competitiveness will concentrate on structural reforms—including through labor market reforms—to increase productivity and through wage restraint. Therefore, the government will continue to allow the exchange rate to reflect underlying market forces, and the central bank's intervention in the foreign exchange market will be limited only to deal with temporary pressures on the exchange rate. It is expected that the nominal exchange rate will decline mildly and the real rate will remain relatively stable. The analysis carried out by the IMF found this to be fully consistent with the projected domestic interest rate path noted above.

[10] Although the banks' portfolios include a large amount of floating rate government securities, the high cost of funds for FINSAC-owned entities arises from their short-term deposits paying interest rates that are linked to the central bank's reverse-repurchase rates.

2.8 Official reserves are expected to rise appreciably in the initial years from US$ 800 million to about US1.2 billion between FY 1999/00 to 2001/02 (about twice the projected short-term external liabilities and about half the projected money supply), which would place the country in good stead to meet large external amortizations in the mid 2000s. In any event, the SMP has established quarterly targets for net official reserves that will be monitored closely to determine if any policy response is required to deviations with respect to the target path. Furthermore, the government is committed to avoid the accumulation of external payment arrears and will not impose exchange restrictions. During this same period, external debt is expected to rise slightly from 46 percent of GDP to 47.6 after which the IMF projections call for a decline to 38.5 percent by FY 2004/05. The decline in foreign indebtedness and large reserves represent further support for the projected relatively stability in the foreign exchange rate.

2.9 **Containment of the FINSAC debt.** The strategy for managing the FINSAC debt calls for reducing the stock of debt over two years, FY 2000/01 and FY2001/02 and paying cash interest starting in FY2001/02. In the first year (a) all debt owed to other central government agencies will be written off; (b) approximately J$12 billion (US$300 million) of the debt owed to the Bank of Jamaica will be offset against an equal amount of deposits of the central government at the BOJ and the remaining J$14 billion will be managed in a manner which will not jeopardize the profitability of the BOJ nor impede its ability to conduct open-market operations or other central banking activity. (The GOJ will make cash payments to the BOJ in lieu of interest on the remaining debt sufficient to assure that the latter does not incur a loss on its operations); and (c) a portion of the remaining debt, held by the private sector, will be amortized (i) with revenues from the sale of FINSAC assets (Union Bank and non-core assets); and (ii) through government repurchase of the equivalent of approximately US$162.5 million in outstanding FINSAC debt. In FY 2001/02 the government will dedicate at least an additional US$87.5 million in fiscal resources to the repurchase of a like amount of FINSAC debt. (The FY 2001/02 resources will total US$162.5 million if the "second installment" of US$75 million from the World Bank is approved and disbursed.) The timing and amount of revenue from the sale of other FINSAC assets, and from claims against former owners and other miscreants, are difficult to determine and have not been factored into the calculations.[11]

2.10 The following table shows the effect of this strategy. It is based on projections of GDP made by the IMF, and projections of the interest rate path made by the IMF and IDB during the preparation of the Staff Monitored Program. Subsequent to that exercise the amount of fiscal resources for debt reduction was revised upward to take into account more recent information on the external funding commitments from the MDBs. The projected size of the debt and the associated cash interest costs take this recent information into account and are shown both in

[11] FINSAC has pending civil suits against eight parties, which if successful could result in recoveries of J$4.9 billion. (US$122.5 million).

absolute terms and as a percentage of GDP over the medium term period through FY 2004/05. The major holders of FINSAC paper as of end FY 1999/00 are listed in the memo item. As the exact allocation of reductions of FINSAC paper will depend on the negotiations surrounding the sale of respective FINSAC assets (Union Bank, NCB, the Life Insurance Companies, etc.), no attempt has been made to project the distribution of debt reduction by owner.

Amount of Actual and Projected FINSAC Debt and Associated Cash Interest Costs

(US$ millions)

	1999/00 Actual	2000/01 Projected	2001/02 Projected	2002/03 Projected	2003/04 Projected	2004/05 Projected
Public Sector						
Total	902.6	-0-	-0-	-0-	-0-	-0-
Central Gvt	291.6					
BOJ	611.0					
Private Sector						
Total *	1,773.2	1,789.8	1,617.0	1,617.0	1,617.0	1,617.0
Grand Total	2,675.8	1,789.8	1,617.0	1,617.0	1,617.0	1,617.0
as % GDP	37.0	22.9	19.6	18.1	16.8	15.5
Int. Payments			245.5	217.8	201.7	183.9
as % GDP			3.0	2.4	2.1	1.8

Source: FINSAC and IMF Staff Projections.
Exchange rate used for FY 1999/00 and FY2000/01 J$40 = US$1. For remaining out years J$42 = US$1.

*Note: Composition of debt held by private sector as of end FY 1999/00 (in US$ millions): Union Bank $370.8, NCB $1,001.2. Others $401.2 – including insurance companies.

2.11 It is important to note that consistent with the government's objective of closing FINSAC, management of the debt will shift from FINSAC to the Ministry of Finance and Planning as a part of this debt containment strategy. At the present time FINSAC has an internal unit which administers the "FINSAC bonds" in terms of tracking, reconciliation and general monitoring. This unit will collaborate closely with the MOF on the reduction of the outstanding debt as outlined above. Starting on April 1, 2001, the remaining debt will be transferred to the MOF and converted into obligations of the central government essentially no different from their normal Local Registered Stock (LRS), i.e. the medium-term bonds of the government of Jamaica. According to an assessment of the IMF, Jamaica's debt management capacity has been strengthened considerably in recent years with the establishment of a special Debt Management Unit in the MOF.

2.12 **Feasibility of the strategy.** As noted in the preceding table these domestic interest payments decline from 3.0 to 1.8 percent of GDP over the period FY 2001/02 and 2004/05. It bears repeating that these payments have been factored into the overall public sector balance discussed above. As noted there, the

government's fiscal effort, including cash interest payments on the FINSAC debt will be sufficient to begin to yield a surplus in FY 2003/04. This surplus could then be used to pay down the remaining principle amount of the FINSAC (or any other government) debt.

2.13 **Downside scenario.** The MEFP notes that, while the government believes that its budget is consistent with generating the targeted primary surplus and reductions in the overall deficit, there are downside risks. First domestic interest rates may not fall as fast as assumed and, second, the real GDP growth may not grow as fast as anticipated. During the analysis alternative projections were developed based on an assumption of more sluggish GDP growth (1 - 2 percent per year) and slower reductions in interest rates (down to only 13 percent) over the medium term. Under this downside scenario, the FINSAC debt resolution strategy would result in cash interest payments on FINSAC debt that are about 0.4 percentage points of GDP higher each year. By the same token, the overall public sector balance would be lower, by 0.3 to 0.1 percentage points, than in the base case and would turn positive one year later in FY 2003/04. Even under this downside scenario, the overall public debt as a percentage of GDP would still decline to a level of around 125 percent of GDP by the end of the medium term period.

2.14 **Corrective measures.** The SMP will monitor the budget indicators closely and if they are found to be falling short of the targeted levels, the government is committed to taking measures to counteract these shortfalls. While the contingency plans have not been fully developed, they would most likely include further cuts in expenditures. Capital outlays would be reviewed to determine which projects could be postponed or scaled back. Also the government would bring forward into 2000/01 contemplated new measures to tighten tax administration, including a broadening of the tax base to cover a greater portion of the informal sector. Finally, if necessary, quick-yielding revenue measures would be introduced. Essentially, any additional outlays -- including from higher-than-projected interest rates or shortfalls in revenues -- will be offset by expenditure cuts elsewhere or by new revenue measures.

2.15 Jamaica also has several important shock absorbers, which have helped cushion the economy's vulnerability. These include the relatively large proportion of bank deposits held in foreign-owned institutions (46 percent); the willingness of financial institutions to roll over a significant portion of government domestic debt; large and stable inflows from tourism and private remittances; the high level of official international reserves relative to base money and short-term public external debt; and the large informal sector.

2.16 Barring a major unforeseen event, the government is convinced that these policies will contribute importantly to reversing the adverse debt dynamics of recent years, where debt as a proportion of GDP grew from 102 to 144 percent of GDP in the four-year period from end FY 1995/96 to end FY 1999/00. The payment of interest in cash on the FINSAC debt and the reduction in borrowing by the central

government is expected to lower this total public debt to about 95 percent of GDP by 2004/05.

2. FSRP component A: Resolution of the past crisis

2.17 Since the crisis came to a head roughly four years ago, the government has taken the measures previously noted to contain the crisis and subsequently to resolve it. These measures were taken despite the macro-economic context of high unemployment and negative real rates of growth. The Bank program to resolve the past crisis will build on these measures and will be carried out in a macro-economic context that should be more conducive to their implementation.

a) Disposition of assets

2.18 **Sale of Union Bank.** Royal Bank of Trinidad & Tobago holding (RBTT), the second largest bank in that country, has expressed interest in purchasing Union Bank and discussions are well advanced. A memorandum of Understanding has been signed and the transaction is expected to close in late August. The sale price was established as net asset value as of June 30, 2000, to be determined by independent auditors. (At December 31, 1999 the net asset value was J$3.1 billion -- approximately US$77.5 million). The proceeds from the sale will be used to buy back a portion of the FINSAC paper which Union Bank holds, currently valued at about J$19.4 billion (US$485 million) due to capitalization of interest. The program calls for the sale of Union Bank by first tranche.

2.19 **Preparation for sale of National Commercial Bank.** NCB suffers from weak senior management, illiquidity, and a complex ownership structure. FINSAC has begun to replace personnel in key management positions (CEO, CFO, and General Manager Information Technology). Payment of cash interest on the FINSAC paper, which constitutes a large portion of NCB assets, will resolve the liquidity issue and will be a key element in bringing the bank to point of sale. In the meantime, provisions have been by the Minister of Finance for assuring liquidity and solvency during the remainder of FY 2000/01. Prior to bringing NCB to point of sale, the NCB Group holding company will be eliminated and all shareholder interest will be folded into the bank. The essential financial subsidiaries will be incorporated into the bank, while the non-financial subsidiaries will be sold or closed. The board of directors of the newly consolidated bank will then approve initiation of a judicial process, called a "scheme of arrangement", by which FINSAC can gain a controlling interest of 75 percent plus one share.

2.20 This process is expected to take several months and could be delayed, although not reversed by court challenges. Prior to first tranche release the authorities will reorganize the NCB and file a "scheme of arrangement" petition with the registrar of the Supreme Court. NCB will be brought to point of sale prior to second tranche as evidenced by a signed MOU between FINSAC and an acceptable and qualified buyer of at least 51 percent of the total outstanding equity. These

initiatives will be complemented by the World Bank sector adjustment program, which is in preparation.

2.21 **Sale of non-core assets and NPLs.** It has been difficult for FINSAC to sell the bulk of the non-performing loans in its portfolio given local market conditions. Therefore FINSAC will package all remaining loans to privately owned firms[12] and sell them to an international Asset Management Company (collection agency). A Consulting firm is already undertaking a diagnostic of the NPLs and will develop alternative disposition strategies as the basis for an integrated marketing plan. Portfolio packaging to point of sale and market distribution is scheduled for January 2001. FINSAC expects to fully dispose of its non-performing loans to private-sector entities by June 2001. In addition to its non-performing loans, FINSAC still has unsold real estate properties in its portfolio. While the hotel properties have the most value, they may be more difficult to sell due to market conditions and the legal (e.g. management contract) and ownership issues that still have to be resolved. FINSAC in the sale of its assets will require appraisals, where appropriate, that follow standards of best practices for real estate appraisals, and include environmental hazard liabilities. Prior to second tranche the authorities expect to sell at least 90 percent (by value) of the residential and 40 percent of the commercial real estate properties and will agree with the Bank on a plan for disposition of the remaining properties.

2.22 **Life of Jamaica.** The Minister of Finance has proposed in a Cabinet submission that public funds be injected into LOJ to make up the solvency deficit of approximately J$1.9 billion (US$47.5 million). In return the Government will increase its ownership from 26.5% to a controlling interest of at least 75% plus one share of the ordinary shares (common stock). This holding will then be sold to a private sector buyer in exchange for a further capital injection. This plan has been discussed with LOJ's current owners who have confirmed that they are unable to provide fresh capital of their own. This plan to eliminate the solvency deficit will be formalized prior to first tranche release, and FINSAC will sell its equity interest in LOJ to the private sector prior to second tranche release.

b) Liquidity support for Union Bank and NCB

2.23 Having written off or amortized the FINSAC debt to the maximum extent possible, the government will then replace the balance of FINSAC paper, held essentially by Union Bank and NCB, with fully negotiable, cash interest bearing securities of the GOJ starting April 1, 2001. These cash payments will provide the two banks with essential liquidity for servicing their deposits and making new loans. Furthermore, as the ex-FINSAC paper would now be fully negotiable, the

[12] During the economic downturn in the late 1990s the government took control of selected failing sugar and coffee business and one tourism-related operation. These businesses had defaulted on loans to banks that were subsequently intervened by FINSAC. These loans account for less than 15 percent of the FINSAC portfolio of NPLs. Rather than including theses loans in the package to be sold to a collection agency, they will be disposed of in the context of the re-privatization or liquidation of these firms.

owners of the banks would be in a position to sell a portion of it in the secondary market according to their business plans for asset allocation.

3. FSRP component B: Reduction in vulnerability in the financial system to future crises

2.24 Equally as important as the resolution of the past crisis is reducing the vulnerability of the system to future crises. This component of the program will address this concern by strengthening both bank and non-bank supervision as well as enhancing the capacity of the judicial system to enforce the financial statutes and adjudicate disputes arising therefrom. As the initiatives to strengthen supervision and regulation are quite extensive, they are summarized here, with more detailed information available in the project files.

a) Improvements needed in bank supervision

2.25 The supervisory authorities have recently conducted a self-assessment of their compliance with the 25 Basle Core Principles for Effective Bank Supervision following the standardized BIS methodology. The results indicate that the authorities are compliant or largely compliant with the majority of the Core Principles, however several areas continue to need strengthening and will be addressed by the FSRP as follows: a) The BOJ will be given the power, without prior ministerial approval, to take corrective enforcement actions and seize management and take control of (intervene in) licensees when there is continual non-compliance with supervisory instructions and disregard for prudent banking practices. The BOJ will also be given the power to assess fines[13]. b) Coordination with other supervisors will be formalized via the establishment of a joint Regulatory Policy Council (RPC) where issues relating to lead regulator and crisis management will be discussed[14]. The Council will produce semi-annual progress reports that will provide policy and technical advice to regulatory bodies. Legislation will also be required to allow for the exchange of information among supervisors. c) An up-to-date supervisory ladder of enforcement coupled with crisis intervention procedures that reflect the current legal framework will be prepared and this framework will be fully communicated to the industry. d) The BOJ will obtain authority to ensure that corporate affiliates and structures do not hinder effective supervision, either by prohibiting commercial banking and industrial activities in the same group or segregating within a financial group/holding company all financial services activities and isolating deposit/lending activities by requiring capital market activities to be carried out in

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[13] Jamaican law permits only the courts to levy fines. The authorities plan to introduce legislation that will permit the BOJ and FSC to "assess" fines on their respective regulated entities when in breach of certain directives. The entity would have the option of paying the fine immediately, or if not, court proceeding would be initiated. If found guilty, the court would levy the appropriate fine. This approach has precedent in the prosecution of traffic violations.

[14] The RCP will be comprised of the Supervisor of Banks and/or nominee, the chief Executive Officer of the JDIC, the CEO of the FSC and the Financial Secretary of the MOF and /or nominee.

a separate sub/affiliate. e) The supervisors' ability to evaluate market risk will be enhanced andf) A framework for supervision of credit unions will be developed.

2.26 The program contains provisions for statutory and regulatory reform to address these issues, and the critical ones are dealt with in the policy matrix (see Annex I). Related issues are addressed in the letter of sector policy (see Annex II). Technical assistance will be provided through the parallel CDB TA loan to support the BOJ in the implementation of many of these measures (see Annex III). The program also calls for an independent, outside assessment of compliance with the Basle core principles and agreement between the Bank and borrower prior to second tranche release on corrective measures to rectify any remaining deficiencies.

b) Improvements needed in non-bank supervision

2.27 **Creation of a non-bank financial-services commission.** In December 1998 an international consulting firm recommended that Jamaica begin preparing to move toward a single, unified, regulatory agency. Rather than embarking on this path immediately, the Minister of Finance announced in his annual budget speech, in April 2000, the merger of the Office of the Superintendent of Insurance (OSI) with the Securities Commission (SC) into a unified successor agency tentatively called the Financial Services Commission (FSC). This agency will also be responsible for supervision of private pension plans. The new supervisory entity will report via a Board to the Minister of Finance. The proposed Financial Sector Reform Program will support a strong independent FSC by requiring that (i) board members be selected according to fit and proper criteria and not serve simultaneously on the boards of entities regulated by the FSC; (ii) fees are charged to enable the FSC to be self-funding after an initial start-up period; (iii) staff compensation is market-competitive; and (iv) the FSC has independent enforcement powers and rulemaking capabilities comparable to those of the BOJ. Given the importance of quality management at the start up of the FSC, the Bank will approve the job descriptions, including the qualifications, of its CEO and senior management. With respect to the three component parts of the new agency, namely; SC, OSI, and private pensions supervision, the program will (i) strengthen securities market regulation and surveillance, including timely and proper risk identification; (ii) improve insurance analysis and supervision (life and non-life); and (iii) build a foundation of supervision for the effective oversight of private pension plans.

2.28 **Insurance Supervision:** An independent assessment of the OSI, compared to IAIS (International Association of Insurance Supervisors) best-practice principles, was carried out during program preparation, and it revealed significant deficiencies in the legal and regulatory framework. The following issues were raised and are addressed by the program either in the policy matrix or policy letter: a) the passage of the New Insurance Act with provisions on corporate governance, rulemaking and prompt corrective action; b) the development of supporting regulations regarding, solvency requirements, investment guidelines,

market conduct rules and actuarial standards; c) the development of a "supervisory ladder of enforcement" for insurance companies given the powers under the new act; and d) the development of risk-focused on-site examinations. Furthermore, technical assistance will be required in the development of a formal training program and software for financial analysis.

2.29 **Private Pension Supervision:** In order to implement the reforms recommended in the "Green Paper", a new Private Pensions Act will need to be drafted and include topics such as registration, licensing, investment limits, minimum solvency standards and information disclosure. It is also envisioned that certain amendments to the Income Tax Act will need to be drafted. Prior to the introduction of this legislation the government will seek to build further consensus on this issue by means of obtaining comment from Parliament and the public on a more elaborated policy document termed a "White Paper". In addition, institutional strengthening will be required in the following areas, as detailed in the action plan developed by the authorities with the IDB and CDB assistance; a) the design and preparation of policy and procedural manuals; b) the development of a proper information systems and supervisory reporting; and c) the development of a staff training program with emphasis on analysis of pension plan investing and funding. The above issues are addressed in the policy letter.

2.30 **Securities Commission:** The SC has prepared an action plan to address their legislative agenda as well as their needs in institutional strengthening. The SC's legislative agenda includes: a) augmenting the regulatory and enforcement powers of the SC; b) enabling the SC to impose risk-based capital standards to engender investor protection; c) enhancing disclosure practices for listed and other public companies;d) improving regulation related to "fit and proper" standards; and e) creating a level playing field for collective investment funds offered to public investors in the form of unit trusts, mutual funds or similar products. Improvements will also be needed in the area of enhancing the staff's capabilities to conduct market surveillance. During project preparation a detailed review was conducted of the securities industry and included a review of several of the important principles stipulated by IOSCO. These principles included the adequacy of powers and rulemaking capabilities of the SC. A further review of the IOSCO principles would be more appropriate after the SC has had time to implement the recommendations made during project preparation; particularly the experience in implementing its new regulatory powers as proposed by the legislative amendments.

2.31 Expeditious clearance and reliable settlement of securities transactions are fundamental to any well functioning capital market. Currently in Jamaica, some securities continue to be issued in bearer form rather than registered form. In order to reduce the potential for systemic risk, all securities—both listed and unlisted—should be "immobilized" in a single national depository. The elimination of bearer securities would reduce the potential for lost or stolen certificates, or for the improper use of such securities, particularly in repo transactions. As a first step the program calls for a feasibility study on the

immobilization and registration of government securities. Prior to second tranche release, the GOJ will commit to implement the agreed recommendations of the study.

2.32 A related area is the governance of the Jamaican Stock Exchange and the Jamaica Central Securities Depository (JCSD). At present it is wholly owned by the Jamaica Stock Exchange (JSE). If it were to serve the broader securities market, including trades taking place off the exchange, its ownership would logically be expanded to represent a broader cross section of capital market participants. Such an expansion of ownership would raise the issue of treating the JCSD as a self-regulatory organization (SRO). At present, only one SRO is recognized in the Securities Act, namely the Jamaican Stock Exchange. In the event that the ownership of JCSD is broadened in the future to accommodate the inclusion of government securities, consideration should be given to recognizing it as an SRO as well.

c) Enhanced enforcement and adjudication capacity

2.33 A. Bank-sponsored diagnostic study undertaken in early July 2000 confirmed that the Jamaican justice system currently lacks the ability to speedily investigate and resolve cases related to complex commercial litigation, on the civil side, and financial crimes, on the criminal side. This inhibits prudent commercial lending and investment, and it contributes to the perception that financial crimes can be committed with impunity. The Program will support the establishment of a Commercial Court and a Financial Crimes Unit to address each of these shortcomings, along with associated training in each area. Both can be established administratively, without the need for new legislation.

(i) Commercial court

2.34 Judges in Jamaica generally come from a background of practice in criminal law; few have substantial training in commercial/financial matters. Insufficient legal research facilities prevent the courts from keeping up to date with developments in other common law jurisdictions with regard to such matters, and databases for tracking the courts' own cases are inadequate. Also, current court rules do not give judges much control over their own case management, allowing for extensive delaying tactics by litigants.

2.35 The Government of Jamaica will create a Commercial Court, as an administrative unit of the Supreme Court, in order to address these problems. Draft court rules for the Commercial Court were tabled in Parliament in June of 1999, and are currently being finalized by the Rules Committee of the Supreme Court. The proposed new unit would have jurisdiction over a wide variety of commercial and finance-related actions. The new Court rules will allow for a judge-managed court calendar, greatly expediting case clearance, and a court-annexed alternative dispute resolution system should further streamline case resolution. Enhanced legal research and information technology for the Commercial Court will be

financed in part by a supplementary court filing fee to be approved by Parliament, and the GOJ is exploring the best way to scale this fee to allow equitable access to the court.

2.36 The Program design includes technical cooperation to be funded by the CDB, which will train the Commercial Court judges and ancillary court staff. Training will be conducted with the assistance of notable local jurists and widely respected international legal training institutions, particularly those with experience in other Commonwealth countries that have similar legal systems. Judicial training will focus on the mandate of the Commercial Court itself; the judicial administration of commercial and other civil cases; alternative dispute resolution mechanisms; substantive changes in relevant civil law; the use of information technology, including computerized legal research resources; intellectual property rights; and the assessment of damages. Ancillary court staff will receive training in computerized case management applications; alternative dispute resolution profiles and tracking; and court staff management.

(ii) Financial crimes unit

2.37 The Office of the Director of Public Prosecutions (DPP) carries out criminal investigations and prosecutions, including those related to financial crime such as securities fraud and money laundering. While there are currently DPP staff with a certain level of experience in this complex area, the volume of staff caseloads tends to restrict prosecution of financial crimes, and impede any great degree of specialization by DPP staff in the area.

2.38 Administrative provisions have been made within the DPP for the creation of a new Financial Crimes Unit (FCU), which will include financial analysis capability. The FCU will be staffed with six experienced prosecutors; six additional prosecutors will be hired to replace them. Four analysts and a small number of computer data entry persons will staff the analysis unit within the FCU, which will be responsible for tracking possible violations of Jamaica's Money Laundering Act of 1996 (as amended), and other irregular bank transactions.

2.39 CDB-funded training of FCU staff will prioritize financial institutional safeguards and principles (e.g., the Basle principles), and effective prosecution techniques of breaches of relevant laws, including money-laundering laws. Further training would be carried out, primarily overseas, in related areas. The Program will also seek to build local ongoing training capacity via the Justice Training Institute, which was established by the Ministry of National Security and Justice (MNSJ) in July of 1997. These initiatives will be coordinated with other technical support that may be provided to the MNSJ and/or the Office of the Chief Justice.

4. Contribution of the operation to the solvency of the system.

2.40 As noted in Chapter I, the FINSAC intervention and the initiatives taken in 1997 to improve the supervisory framework addressed the immediate problems of the crisis and started the process of improving the soundness of the financial system. However also noted there was the continuing drag on liquidity and profits attributable to the FINSAC paper held in the system. In fact the impact of the FINSAC paper has been growing as interest has been capitalized rather than paid in cash. This paper has also been used to capitalize both insurance companies and banks, and much of it is effectively non-negotiable or, to the extent that a secondary market exists at all, can only be sold at a deep discount. Thus many of the affected institutions are technically insolvent. The auditors of NCB, the largest holder of FINSAC paper, have indicated as much, unless the market value of the paper can be demonstrated to be worth its face value.

2.41 The program will address this solvency issue directly. As discussed above, a centerpiece of the program is the conversion of the outstanding FINSAC debt held by the private sector into cash interest bearing, fully negotiable government bonds. This will address the liquidity, cash profitability, and solvency needs of the affected institutions. Because these institutions are such an important part of the system as a whole, the conversion of the FINSAC paper will similarly impact the system as a whole.

2.42 Meanwhile the proposed changes to the regulatory environment will increase the resilience of the system to future threats to its solvency. Insurance companies will have to bide by more stringent solvency and investment guidelines. The supervisory agencies will have increased power to take early corrective actions and assess fines when directives have not been met. Crisis intervention procedures will be more fully defined and carefully coordinated respectively by a functioning joint Regulatory Policy Council (RPC) and by an updated supervisory ladder of enforcement. Threats of mixed conglomerate structures will be lessened by measures that would require greater separation between financial services and non-financial activities.

B. Cost and financing

2.43 The total cost of the Financial Sector Reform Program is estimated to be US$175 million, which will provide general budget support. Of this amount the IDB will provide financing in the amount of US$150 million from the Ordinary Capital resources. The Caribbean Development Bank (CDB) will provide financing in the amount of US$25 million. As is the normal practice for sector reform operations, there will be no formal government counterpart funding.

C. Complementary CDB and World Bank operations

2.44 **CDB technical assistance loan.** In addition to their sector loan, the CDB will provide funding for a parallel technical assistance program, which will support the

legal, regulatory, and institutional reforms proposed by the FSRP. The elements of this program are described in the text and are summarized in Annex III. This amount of this TA loan has not been determined yet but is expected to be in the range of US$2-5 million.

2.45 **World Bank sector adjustment program.** The World Bank has announced that it will provide US$150 million in fast disbursing funding to Jamaica to assist with the resolution of liabilities accumulated in the wake of the 1996-97 financial sector crisis, as well as to support reforms aimed at ensuring the long-term sustainability and competitiveness of the financial sector and guarding against any recurrence of crisis. . The WB program will focus on (i) the sale of Union Bank; (ii) the new management and restructuring of the NCB with the objective of bringing NCB to point of sale; (iii) the sale of the Life of Jamaica insurance company; and (iv) will closely support the IDB initiatives in the supervision and regulation area. The WB program will also call for the same budgetary adjustment measures as have been agreed in the context of the IMF Staff Monitored Program. The WB is currently appraising its program and expects to present it to its Board in mid November 2000.

III. PROGRAM EXECUTION

A. The borrower, guarantor and executing

3.1 The guarantor will be the Government of Jamaica. The Ministry of Finance and Planning will be the executing agency for both the CDB and IDB programs. The major sub-executing units will be FINSAC, the BOJ, the new non-bank supervision agency (FSC) including the OSI and the SC, the Ministry of National Security and Justice (MNSJ), and the Office of the Chief Justice.

B. Program execution and administration

3.2 As noted above the sector reform program will disburse in two equal tranches. The authorities will have complied with all policy conditions precedent to first disbursement before presentation of the operation to the Board of Executive directors. Thus the country will be eligible for first disbursement upon contract signature and compliance with other standard requirements.

3.3 The CDB will fund a full range of technical assistance activities, which will be designed not only to assist in achieving the specific second tranche conditions of the ISRP but also to support the institutional and technical strengthening of the counterpart agencies more generally. The size of the CDB TA program will depend upon the cost of the approximately 20 separate activities to be funded. Terms of reference and budgets are currently being prepared. The TA program will extend beyond the period of the FSRP which will be disbursed in two tranches of equal size over an approximately 12 to 18 month period.

C. Procurement of goods and services

3.4 There are no procurement issues, as this is a fast-disbursing operation with no formal restrictions on the use of the resources.

D. Execution and disbursement schedule

3.5 Disbursements will be in two equal tranches of US$75 million from the IDB and $12.5 million from the CDB respectively. The first tranches of the respective bank loans are expected to be disbursed shortly after the corresponding contract signatures. The second tranches are expected to be disbursed approximately 12 months later.

E. Monitoring and evaluation

3.6 An inspection and supervision fee for the IDB operation of US$1,500,000 – equivalent to 1 percent of the Bank financing – will be deposited in the Bank's accounts to cover general inspection and supervision expenses. In addition to the supervision missions undertaken by the project team and the permanent contact and technical support to be provided by the Country Office, the Bank will

establish procedures to ensure that the program is implemented in a satisfactory manner, and the borrower is expected to cooperate accordingly.

3.7 After consultation with the Bank, the borrower has elected not to conduct a formal ex-post evaluation of the program.

IV. VIABILITY AND RISKS

A. Environmental impact

4.1 The proposed program will have no direct environmental impact, because all initiatives will be limited to legal and institutional reforms affecting the financial sector. It should be noted that ancillary environmental issues are addressed in the supervisory procedures and in the sale of FINSAC non-core assets (see paragraph 2.21).

4.2 With respect to the social impact, it is expected that there may be some short run labor dislocation as a result of restructuring in the financial sector and expenditure restraint in the public sector. However, in the medium term, the social impact is expected to be positive, as a more stable and robust financial sector contributes to growth and helps to generate new jobs and social sector improvements. To date the labor dislocation from the restructuring appears to have been minimal, given that unemployment rates have not been significantly affected. In addition, a number of safety net mechanisms exist which can alleviate some of the negative social effects of labor restructuring.

B. Risks

4.3 **Macroeconomic framework.** In order to meet the objective of reducing and ultimately eliminating the FINSAC debt burden, the central government will have to maintain its primary surplus at the levels recently achieved of 10+ percent of GDP over the medium term. During this same period the government will have to follow policies conducive to a lowering of interest rates and increasing economic growth. These are ambitious goals and the means to achieve them have been developed in the context of the IMF Staff Monitored Program. This program is risky in that there are factors beyond the control of the authorities that could adversely affect its implementation. However, it is worth noting that the country has achieved comparable primary surpluses in the past, has several important "shock absorbers" to a full-blown crisis, and is prepared to take additional expenditure reduction measures if needed. In the same vein, no country is immune to exchange rate risk and domestic interest rates are one factor that can influence the exchange rate. In the case of Jamaica, this relationship has been fully analyzed and taken into account in the terms of the potential impact that the projected decline in domestic interest rates could have on the exchange rate. The IMF analysis concludes that given the expected fiscal stance of the country over the medium term, the declining interest rate path is fully consistent with a mildly declining nominal -- and stable real – foreign exchange rate. Furthermore during this period the overall foreign debt is projected to be trending downward and official reserves to be increasing, which should further bolster the stability of the exchange rate.

4.4 **Amortization of intra-governmental debt.** About 36 percent of the FINSAC debt is owed to other government agencies, of which 25 percent is owed to the

Bank of Jamaica. Approximately half of this will be offset against deposits that the central government has at the BOJ. The MOF has agreed with the BOJ on a plan for managing the remaining FINSAC held by the BOJwhich calls for the central government to make cash payments to the BOJ so as to assure that the latter does not incur losses. While this plan guarantees the profitability of the BOJ, it postpones rather than resolves the issue of the outstanding FINSAC debt held by the BOJ.

4.5 **Sale of NCB.** The government's lack of a controlling stake in NCB could impede bringing the bank to point of sale. The authorities are pursuing a "scheme of arrangement" approach to achieve the necessary ownership majority of 75 percent plus one share such that existing shareholders cannot block the sale of NCB. This process may be challenged in court; however such challenges could only delay but would not stop the process.

4.6 **Legal framework.** In addition to the legal and regulatory reforms enacted since the crisis, the program calls for approval of measures to provide effective supervision powers for the regulatory agencies, the authority for them to assess fines, and a clear system to manage potential future crises. The authorities are preparing legislation in support of these initiatives and the government has an adequate majority in Parliament; thus approval of these measures in a form acceptable to the Bank is likely. However given Parliament's independence, approval cannot be assured.

4.7 **Regulatory authorities' power to intervene failing institutions.** In the past the regulatory authorities have not had the autonomy to act effectively and expeditiously when confronted with banks or other financial institutions that have failed to comply with supervisory instructions and/or that have disregarded prudent banking practices and, as a result, may be on the brink of insolvency or are already insolvent. In the past Jamaica's regulatory structure has been subordinated to the political directorate, and if continued, this pattern could threaten the stability of the financial system in the future. The FSRP includes measures to provide the regulatory authorities with the power, without approval from political directorate, to take corrective enforcement actions against specified unsafe and unsound practices and, when all other measures have failed, to seize management and take control of the offending institution. By endowing the regulatory authorities with these independent powers of enforcement and intervention, Jamaica will be adhering to international best practice and strengthening its capacity to forestall future financial crises. However there is a risk that the regulatory authorities may not exercise their new powers effectively. This risk is mitigated by the technical assistance that will be provided in parallel with the program. Also as a result of the restructuring and downsizing in the wake of the mid 1990s crisis, the institutional structure of financial sector is relatively uncomplicated and more transparent compared to the pre-crisis period.

4.8 **Institutional capacity.** Non-bank supervision is to be consolidated into one agency, the FSC, which will become operational by April 1, 2001. A strong leader

with the relevant skills and experience will be necessary in order for this new entity to be effective in carrying out its responsibilities. The risk to building this institutional capacity is that few persons in Jamaica have experience in creating and operating an integrated supervisory entity. In addition, there are few individuals in country with strong insurance supervisory skills. Given this situation, the government authorities have agreed to second a foreign expert to assist in the initial operation of the FSC. The IDB will approve the qualifications of the CEO and senior management of the FSC prior to release of the first tranche.

JAMAICA: Financial Sector Reform Program (FSRP)
(JA-0049)

POLICY MATRIX

	Objective	First Tranche	Second Tranche
-economic Framework			
ility	Maintain sound economic policy framework	IMF Staff Monitored Program (SMP) in place. (including policies consistent with government making cash interest payments on FINSAC debt according to agreed schedule).	- Maintenance of policy framework consistent objectives of the program (Continued complia targets).
ution of Existing Financial-system Crisis			
ebt	Reduce debt and pay interest in cash on remaining stock	- Plan agreed to cancel/offset portion of FINSAC debt owed to other government agencies.	- Intra GOJ debt cancellation plan effective & reached. - Government making regular cash payments a remaining FINSAC debt held by private sector - FINSAC paper fully negotiable.
of le. k	Maximize banks' attractiveness to potential buyers	Union Bank: Conclude sale NCB Bank/Group: Restructuring underway (including); - Board approval of reorganization plan to eliminate Group & merge all holdings into Bank - "Scheme of arrangement" to raise FINSAC ownership to 75%+1 share filed with Supreme Court - Contracts of key new outside senior managers signed. - Plan to address liquidity needs agreed by MOF	- At least 51% of outstanding ordinary shares o point of sale (as evidenced by signed MOU wi acceptable buyer) - Plan agreed to dispose of remaining GOJ equ any, in NCB.
of n-	Early disposition of other FINSAC assets	Agree on plans for disposition of FINSAC non-core assets.	Conclude sale of: - portfolio of non-performing loans to private-e - at least 90% of residential and 40 % of comm properties Plan agreed for disposition of remaining prope
	Prepare undercapitalized insurance company for sale	Cabinet approved plan to eliminate LOJ solvency deficit (limited FINSAC financial injection in return for control over company prior to sale).	Government equity interest in LOJ sold to priv interests

	Objective	First Tranche	Second Tranche
ction in Vulnerability of Financial System to Future Crises			
1	BOJ adopt international best practices, particularly regarding autonomy & supervision of complex groups	Measures proposed to (a) provide BOJ and FSC with power to take corrective actions and in specified circumstances seize management and take control of its licensees without ministerial approval, (b) provide all regulatory bodies power to assess fines, and (c) clarify bank secrecy provisions and permit information exchange between supervisors	- Measures in effect regarding (a) powers of int fines, & (c) bank secrecy and information exch - Independent assessment completed of BOJ co with Basle core principles and action plan agreed to resolve remaining deficie - Provisions in effect to (a) enhance regulatory complex groups and (b) separate deposit/lendi capital market activities via separate subs/affili
on-	Entity established and component parts strengthened	- Job descriptions for FSC CEO & senior management approved, including professional qualifications. - Measures proposed to (a) establish autonomous FSC and (b) empower component parts, *to wit:* - Insurance: i) repeal & replace Insurance Act including provisions on corporate governance, rule making, & prompt corrective actions - Securities: (a) grant FSC i) power to implement uniform risk-based capital standards for licensed securities brokers & dealers, ii) mandate to regulate prospectuses & disclosure standards, (b) broaden definition of mutual funds to include all collective investment schemes, (c) TORs agreed for immobilization/registration feasibility study.	- FSC in full operation, umbrella legislation in CEO & senior management in place. - Insurance: (a) provisions in effect on corpora governance, rule making & prompt corrective a regulations in effect including i) solvency requ investment guidelines, iii) market conduct, & i standards; (c) completion of supervisory ladder completion of at least one on-site risk-based ex - Securities: (a) measures in effect on i) unifor standards for brokers/dealers, ii) prospectuses & standards, (b) repeal/amend Unit Trust Act, and commitment to implement agreed action plan o immobilization/registration of government secu single national depository.
1 J,	Formalized coordination & full crisis mgt capability	Ministry papers tabled in Parliament formally announcing - establishment of Regulatory Policy Council (RPC) - agreed Crisis Intervention Policy and lead regulator provisions - MOU signed by interested parties.	- RPC semi-annual progress report issued - Crisis intervention & lead regulator policies i
t 1	Enhance enforcement capabilities against fraud and abuse	- Financial Crimes Unit (FCU) established and staff identified with budget allocations - Commercial Court (CC) established & judges appointed. - Measures proposed on supplementary court filing fee - TC/Training program agreed	- FCU & CC fully staffed & budgeted - Supplementary court filing fee in effect for C

MINISTRY OF FINANCE AND PLANNING
30 NATIONAL HEROES CIRCLE
P.O. BOX 512
KINGSTON
JAMAICA

ANY REPLY OR SUBSEQUENT REFERENCE SHOULD BE ADDRESSED TO THE FINANCIAL SECRETARY AND THE FOLLOWING REFERENCE NUMBER QUOTED:-

Telephone No. 92-28600-16

August 31, 2000

Mr. Enrique V. Iglesias
President
The Inter-American Development Bank

Dear Mr. Iglesias:

FINANCIAL SECTOR POLICY

1. The Government of Jamaica is undertaking a broad set of macro-economic and financial sector reforms which together will restore the sector to health and reduce its vulnerability to future shocks, should they occur. At the macro-economic level, these reforms will reverse the adverse debt dynamics which have plagued our country for the past several years. At the sector level, these reforms will either return all major financial intermediaries to the private sector, or if they are not viable, close them or merge them. The reforms will also strengthen and consolidate our regulatory framework. We intend not only to raise each component part of the framework closer to international standards, but also to establish a capacity for coordinated crisis management which will help foretell and forestall crises before they occur, and deal expediently with them if and when they do occur. In support of these initiatives, the government requests funding for a financial sector reform program in the amount of US$150 million from the Inter-American Development Bank.

2. In support of this request, this letter describes:

   a. The government's macroeconomic policy framework recently presented to the management of the International Monetary Fund and its Executive Board as a Staff-Monitored Program. This framework covers fiscal, monetary, trade, and exchange rate policies.

b. The objectives of the financial sector reform both in terms of dealing with the FINSAC debt and restoring the system to health and in terms of the specific initiatives to consolidate and coordinate the capacity of the agencies charged with oversight of the financial sector.

I. Background

3. Jamaica made considerable progress in stabilizing the economy and undertaking needed structural adjustments during the decade from the mid-1980s to mid-1990s. The liberalization of the financial system that occurred, however, was not accompanied by a sufficiently robust prudential and supervisory infrastructure. As a consequence, a wide range of intricately related financial institutions emerged, with substantial lending to connected parties. Some financial institutions began to show signs of liquidity problems in 1995, which were initially met through greater resort to the overdraft facility of the central bank. At the same time, the earlier fiscal consolidation was reversed, as public sector domestic borrowing increased significantly, with central government's efforts to eliminate the losses of the central bank and public sector wage settlements which outpaced inflation. Despite these developments, inflationary pressures were reduced and relative stability was maintained in the foreign exchange market although private sector economic activity remained weak.

II. Macroeconomic Framework

4. Economic performance in the recent period of 1998/99–1999/2000 was characterized mainly by weak output performance and high real interest rates. The output decline of ½ percent in 1998/99 represents the third consecutive year of contraction and output is estimated to have stagnated in 1999/2000, as high interest rates continued to hinder investment to some extent. Inflation rose from 6 percent in 1998/99 to about 8½ percent in 1999/2000, owing to higher prices for oil imports and the effects of new fiscal measures. Unemployment is estimated to have remained high at about 15½ percent during the period, with some new entrants into the labor force being engaged in the informal sector (reportedly about one-fourth the size of the measured economy). The real effective exchange rate for the Jamaica dollar—based on relative CPI indices—which had appreciated significantly in the earlier years, appreciated only slightly in 1998/99 and then depreciated by 4 percent in 1999/2000.

5. Significant efforts at fiscal consolidation were undertaken during 1998/99—1999/2000. The public sector primary surplus was raised by 6½ percentage points of GDP to 7 percent in 1998/99, mainly through strengthened tax administration and efficiency gains in the operation of the public enterprises. However, the growing interest bill on the large public sector debt (including that on FINSAC liabilities) more than offset this gain, and the overall public sector deficit widened from 11 percent of GDP in 1997/98 to 12 percent of GDP in 1998/99. Further consolidation efforts in 1999/2000—relying mainly on expenditure cuts and some revenue measures, including the introduction of a withholding tax on interest—raised the public sector primary surplus by about 5½ percentage points to 12½ percent of GDP. However, the overall public sector deficit dropped by only 3 percentage points of GDP because of further increases in

the interest bill. Consequently, the stock of public debt rose from about 124 percent of GDP at end-1997/98 to about 144 percent of GDP at end-1999/2000.

6. Monetary policy was aimed at reducing inflation in a base-money targeting framework. Despite a reduction in the unremunerated statutory cash reserve requirement and a steady decline in the central bank repurchase rate—monetary policy remained tight during 1998/99–1999/2000. Base money is estimated to have decreased by an average of 3 percent a year during the period. Real interest rates (weighted average lending rates) declined from about 21½ percent at end-1997/98 to just below 15 percent at end-1999/2000.

7. The focus of structural reforms during 1998/99–1999/2000 was on the financial sector and trade. The rationalization of the financial sector involved the merger of four FINSAC-acquired banks and several other financial institutions into one—the Union Bank; advances in the financial restructuring of the state-owned National Commercial Bank including solvency support through the provision of FINSAC securities; and the sale of five of the six intervened insurance companies. Also, the supervision and regulation of commercial and merchant banks, building societies, were strengthened. The process of trade liberalization under the aegis of CARICOM was completed with the reduction of the maximum common external tariff on nonagricultural products to 20 percent in January 1999.

8. The Staff-Monitored Programme (SMP) which has been agreed with the International Monetary Fund sets out the macro-economic programme and targets which the Government intends to pursue over the medium term. The objectives of the program are to consolidate recent gains in economic stablilisation and adjustment, advance the resolution of the problems facing the financial sector following the intervention by the public sector in the latter part of the 1990's, and lay the foundation for strong economic growth that would help address poverty on a sustained basis. The informal monitoring under a staff-monitored program (SMP) would serve as a vehicle for maintaining a close dialogue with the Fund to convey a signal (to official creditors, donors and financial markets) of Jamaica's commitment to a credible and consistent policy package. The SMP therefore sets out the economic framework within which the Financial Sector Reform will be executed.

III. Resolution of the Existing Financial System Crisis

9. In the financial sector, the government recognizes the need for a long-term comprehensive solution to address the mounting debt burden associated with the FINSAC liabilities. The strategy for FINSAC debt resolution involves implementing six key measures: (i) FINSAC's debt to the central government (the Ministry of Finance and Planning) will be written off. (ii) FINSAC's debt to public sector entities (Bank of Jamaica, and other government entities) will be offset against those entities' liabilities to the government. In the case of the Bank of Jamaica, the liabilities to the government (i.e. central government deposits at the BOJ) are insufficient to offset the FINSAC debt held by the BOJ. The remaining debt will be converted to cash-yielding government securities in a way that does not jeopardize the continued profitability of the BOJ. (iii) The sale of Union Bank will be completed in 2000/01, and proceeds from the sale will be used towards reducing the stock of FINSAC debt held by the Union Bank. (iv) Efforts to recover value on FINSAC's non-core assets—including the sale of property and the portfolio of non-

performing loans (NPLs) to a third party—will be intensified during 2000/01 and the proceeds used towards a reduction in the FINSAC debt held by the private sector. (v) The government will use all proceeds from possible World Bank, IDB, and CDB loans supporting its financial sector to reduce the stock of FINSAC debt during 2000/01–2001/02. (vi) All remaining FINSAC liabilities outstanding as of end-2000/01 will be assumed explicitly by the government, and full interest payments will be made on FINSAC paper in cash beginning in 2001/02.

10. Preliminary calculations indicate that this strategy would require additional cash interest payments by the central government of about 3 percent of GDP in 2001/02, trending downwards over the medium term to about 2 percent of GDP in 2004/05. At this level of effort, and taking into account the reductions in the stock of debt through the measures outlined above to J$73.6 billion, the stock of FINSAC debt relative to GDP would decline from 37 percent at end-1999/2000 to 23½ percent in 2000/01 and 17 percent by end-2004/05.

11. The following discussion provides details on the strategy for disposition of the major FINSAC assets:

12. **Union Bank of Jamaica** was created through the merger of four failed commercial banks, five merchant banks, and three building societies. The bank has been downsized, and the management structure, information technology and lending operations have been strengthened. FINSAC owns 99 percent of the shares, and the remaining one- percent is widely distributed.

13. Royal Bank of Trinidad & Tobago Holding (RBTT), owner of the second largest bank in that country, has signed a Memorandum of Understanding, dated June 30, 2000, to purchase the bank and the transaction is expected to close in early September. The sale price was established at net asset value of J$3.1 billion (approximately US$77.5 million). The proceeds from the sale will be used to buy back a portion of the FINSAC paper held by Union Bank.

14. **National Commercial Bank** (NCB) has assets of around J$88 billion. FINSAC owns 67 percent of the equity of the combined bank and holding company. Since intervention, NCB has been downsized and its operations and organizational structure strengthened.

15a In accordance with the supervisory requirements for strengthening and deepening of management expertise, the Board is in the process of replacing personnel in key management positions. The CFO has been replaced, a new CEO will commence in September and arrangements are well advanced for the engagement of a General Manager Information Technology. A draft rehabilitation plan will be prepared which will address issues of liquidity management, information technology, cost reduction, increased revenues, customer service, credit policies and risk management and the hiring of a General Manager for Credit. Payment of cash interest on the FINSAC paper, which constitutes a large portion of NCB assets, will provide liquidity starting in FY 2001/02 and will be a key element in bringing the bank to the point of sale. In the meantime, provisions have been made for assuring liquidity and solvency during the remainder of the current fiscal year. Prior to bringing NCB to the point of sale, there will be further rationalization in respect of the essential financial subsidiaries and the non-financial subsidiaries.

15b Prior to first tranche release a "Scheme of Arrangement" document will be filed in court in order for FINSAC to obtain the necessary controlling interest in NCB. NCB will be brought to the point of sale soon thereafter.

16. **The Insurance Industry.** Currently FINSAC has an equity interest in five insurance companies. Crown Eagle and Jamaica Mutual are in the process of liquidation; Island Life has been sold, and FINSAC's remaining interest is transitional with a clear exit strategy. The policyholder liabilities and corresponding assets of Dyoll Life have been sold and pending resolution of several legal issues, FINSAC expects to sell the remainder of its interest in Dyoll by December 2000.

17. FINSAC continues to own 26.5% of the common stock of the fifth company, Life of Jamaica Ltd. (LOJ) and owns 100% of the preferred shares. The company is undercapitalized and the government has taken measures to eliminate the solvency deficit and in return FINSAC will obtain a controlling interest in the company. This plan for the elimination of the deficit will be formalized prior to first disbursement, and FINSAC will then sell its holdings of Ordinary Shares soon thereafter.

18. **Non-core assets and Non Performing Loans.** In addition to the banks and insurance companies, FINSAC has other non-core assets consisting of real estate investments in hotels, commercial, industrial and residential properties, and in non-performing loans (NPLs) acquired from intervened banks and insurance companies. Since the intervention, FINSAC has restructured its operations and established the capacity within two separate units to concentrate on the sale of the real estate and the NPLs. FINSAC will package the remaining loans and sell them. A Consulting firm is already undertaking a diagnostic study of the NPLs and will develop alternative disposition strategies as the basis for an integrated marketing plan. Packaging the NPLs and market distribution is scheduled for January 2001. FINSAC expects to dispose of approximately 85% of its non-performing loans by June 2001. In addition, FINSAC still has unsold real estate properties in its portfolio. An action plan has been prepared which calls for the disposal of non-core assets and non-performing loans prior to second tranche release.

IV. Reduction in Vulnerability of Financial System to Future Crises

A. Bank Supervision Strengthening

19. The government has taken continuing actions over the past few years to enhance the soundness of the banking system through improvement of the legal and regulatory framework and the supervisory capabilities of the Financial Institutions Supervisory Division (FISD) within the Bank of Jamaica (BOJ). Amendments to the legislation enacted in 1997 enhanced the supervisor's powers to take certain corrective measures such as the power to require a "Board Undertaking", give "Directions" and issue "Cease and Desist Orders" (which previously could only be done by the Minister). Additional amendments included: tightened prudential limits on connected lending; introduction of Basle capital requirements to be set at 10% of risk-based assets (more conservative than the standard 8%); a broader, more exacting definition of what constitutes "fit and proper" in respect to managers, directors and major shareholders of banks;

tightened investment limits and greater powers to allow for the examination of accounts of holding companies.

20. In 1995 the supervisory authorities sought to strengthen management skills in the financial system by introducing "Standards of Best Practice" to the industry in the following areas: Credit Risk Management, including focus on Cashflow Analysis, Liquidity Management, Capital Management, Interest Rate Risk Management, Foreign Exchange Risk Management, Internal Controls, Securities Portfolio Management and Real Estate Appraisal. These standards are in line with international best practice and since that time form the yardstick by which the adequacy of licensees' policies and procedures are measured. Considerable improvements have been seen in this regard.

21. Supervisory processes, including on- and off-site supervision have been strengthened in order to better facilitate the early detection of problems and timely implementation of corrective action. Quarterly performance targets have been developed for the banking system and a Financial Stability Monitoring Committee was established to analyze systemic risks in the system.

22. To further strengthen its autonomy, the bank supervisor will be provided with the power, with respect to its licensees, without Ministerial approval, (a) to take corrective enforcement actions against specified unsafe and unsound practices and (b) to seize management and control of such entities when there is continual non-compliance with supervisory instructions and where there is disregard for prudent banking practices. The supervisory authorities will continue to improve the transparency of the system of enforcement and intervention which will include the update of the ladder of enforcement originally issued to the industry in 1996 in accordance with recent legislative amendments. This will allow the market to have a clear statement of what actions may be taken by the regulators, when these actions are likely to be taken, and the consequences of failing to rectify problems, expeditiously. As agreed an interagency crisis intervention policy, which addresses the above issues and is signed by participating parties, will be tabled in Parliament with provisions for lead regulator concept. The provisions for lead regulator will be codified in legislation by second tranche. In order to better enforce these and other provisions, arrangements will be made to grant Bank of Jamaica the authority to assess fines according to a pre-established schedule when infractions have been detected.

23. To facilitate the transfer of responsibilities for supervisory oversight to BOJ, credit unions were recently designated as specified financial institutions under the Bank of Jamaica Act. Additionally, draft regulations governing key prudential areas have been formulated and are currently under review in conjunction with the industry. These measures, along with consequential amendments to the Cooperative Societies Act, will provide the requisite legislative framework to allow for effective regulation of credit unions. The capabilities of the BOJ's Supervisory Division will also be strengthened to handle this new responsibility with support from the parallel technical assistance program to be funded by the CDB.

24. This year, Bank of Jamaica's Supervisory Division, acting in consonance with procedures agreed by bank supervisors internationally and using the Basel Core Principles Methodology completed a self-assessment of Jamaica's compliance with the Basel Core Principles. An action plan has also been developed to address the areas where full compliance has not been achieved.

Self-assessment is preliminary to an independent assessment to be conducted by Supervisory experts using the Basel Core Principles Methodology and the Bank of Jamaica has agreed to have such independent assessment conducted by second quarter of year 2001. In particular, this assessment would review progress made in the evaluation of market risk and consolidated supervision, including the supervision of financial conglomerates.

B. Strengthening Non-bank Supervision

25. In the context of strengthening financial sector reform, the Government has announced its intention to establish a new non-bank (non-deposit-taking) supervisory authority, referred to as the FSC (Financial Services Commission). This entity, due to begin operations on April 1, 2001, will be responsible for the regulation and supervision of entities dealing in securities, collective investment funds (e.g. unit trusts and mutual funds); investment advisors, insurance industry (companies, brokers, agents and sales persons) and private pension funds.

26. The Government understands the importance of having an autonomous supervisory entity. Therefore, it will ensure that the entity has adequate enforcement powers, including the power to assess fines and seize management and take control of licensees, without Ministerial approval. In the interest of greater transparency and accountability, public comment will be sought prior to the enactment of new rules, regulations, guidelines or amendments. Fees and commissions will be set such that after an initial start-up period the entity will become self-funding. In addition, the members of the governing board of the FSC shall not simultaneously serve on the Board of Directors of the Stock Exchange, other self-regulatory organizations, members of which fall under the aegis of the FSC, or any supervised entity. Furthermore the FSC Board members shall not hold any beneficial ownership or other proprietary interest exceeding 5% of any class of shares or any managerial position of any kind in any insurance company or broker or any securities dealer, investment adviser, unit trust or unit trust manager supervised by the FSC.

27. The Government intends to recruit staff, including the CEO, of the highest caliber in terms of technical ability, judgment and aptitude. In order to ensure that the new entity achieves full effectiveness in the shortest possible time, the Government will seek to recruit a CEO with knowledge of local financial sector conditions and demonstrated capacity to successfully manage the various stakeholders in the Jamaican financial sector. The Government will consider it advantageous if this individual also had experience in setting up or managing an integrated supervisory authority. In the event that the individual does not have such experience a suitable high-level consultant with experience in setting up and managing an integrated supervisory authority will be retained as a direct advisor to the CEO. The Government will, whenever necessary, employ additional advisors with the required technical expertise to act as advisors in other key positions in the new organization. These persons would provide and facilitate on the job training for senior officers in the organization. The staff of the FSC will be paid competitive salaries which shall be consistent with wage policy as set out in Cabinet Decision No. 13/90 dated March 1990, and/or any subsequent Government wage policy.

Securities Supervision

28. An important component of the program is to strengthen the supervision of non-banking activities. The legislative agenda in respect of the supervision of the securities industry has been expedited. This agenda includes granting the FSC the power to: i) introduce risk-based capital standards to engender investor protection; ii) enhance disclosure practices for listed and other public companies; iii) improve regulation related to "fit and proper" standards; and iv) create a level playing field for collective investment funds offered to public investors in the form of unit trusts, mutual funds or similar products. This would involve the amendment of the Unit Trust Act. The regulatory authorities have also committed to enhance staff skills to conduct market surveillance. In 2000/01 the SC will undertake a self-assessment of its compliance with IOSCO principles.

29. In order to minimize systemic risk in the securities market the BOJ is in the process of finalizing with primary dealers a "master agreement" to govern reverse purchase transactions. Currently there is in place a standardized repurchase agreement between the BOJ and the primary dealers/counter-parties. The standardized master agreement will govern transactions among primary dealers or between a primary dealer and third party.

30. Government will examine the feasibility of issuing Treasury Bills in registered form. Government will undertake a feasibility study of the immobilization and registration of all securities issued by the Government. The Government will implement the agreed recommendations of the study set out in an agreed action plan.

Insurance Supervision

31. The Government will also improve insurance supervision by developing a legal and regulatory framework and building institutional capacity within the FSC. In doing so the Government will repeal and replace the Insurance Act with a new Act to include measures to strengthen corporate governance, the rulemaking process and establish prompt corrective action. Regulations will be in effect with regards to solvency requirements, investment guidelines, market conduct rules and actuarial standards. As part of the preparation for incorporation into the FSC, the Superintendent of Insurance will undertake a self-assessment in compliance with IAIS standards of insurance supervision.

32. The FSC will begin to put in the necessary infrastructure to conduct effective supervision of the insurance industry. This will include: i) developing a risk-focused approach toward examinations ii) enhancing the registration and licensing process; and iii) improving the reporting of financial information and conducting relevant analyses.

Private Pension Supervision

33. Efforts are underway to reform the pension system in Jamaica. A Green Paper was prepared in January 1999 and industry comment was obtained. The Government realizes that in order to implement the reforms recommended in the Green Paper, a new Private Pensions Act will need

to be drafted and include topics such as registration, licensing, investment limits, minimum solvency standards and information disclosure. It is also envisioned that certain amendments to the Income Tax Act will need to be drafted. Prior to the introduction of this legislation the Government will seek to build further consensus on this issue by means of obtaining comments from the public by the tabling of a White Paper in Parliament.

34. The government is also committed to strengthen institutional capacity within the FSC by i) the design and preparation of policy and procedural manuals; ii) the development of a proper information systems and supervisory reporting; and iii) the development of a staff training program with emphasis on analysis of pension plan investing and funding.

C. Strengthening the Overall Supervisory Framework of the Financial Sector

35. One of the primary causes of the crisis of 1996/1997 was the co-mingling of financial and non-financial activities within the same corporate group. The government has recognized this by enacting legislation that begins to deal with this potential problem such as the tightening of investment limits and restrictions on connected lending. However, significant work still needs to be conducted in this area to limit the risk of contagion from non-banking businesses to the bank. The authorities have committed to research the following issues: i) separating financial and non-financial activities of banking groups on a phased basis; ii) providing the regulatory authorities with the power to require the establishment of a separate financial group/holding company in the instance of a mixed conglomerate or where there are significant changes in corporate structure arising from involvement in non-banking activities with a view to determining the appropriate structure to achieve the desired objectives. Furthermore, the authorities have committed to strengthen legislation by requiring deposit-taking institutions to establish a separate affiliate or subsidiary to conduct the business of broker or dealer in securities.

36. To further enhance financial sector supervision, the government considers that the coordination of the activities of the different supervisory agencies and the timely sharing of information among them is essential to reduce the risks associated with the activities of financial conglomerates. In this area the BOJ, JDIC (Jamaica Deposit Insurance Corporation) and, once formally established, the FSC (a new non-bank supervisory entity-Financial Services Commission) are proceeding to strengthen formal institutional mechanisms, through the establishment of a Regulatory Policy Council, for consultation and the systematic sharing of information, which will help to ensure the consistency of prudential norms, facilitate consolidated supervision, minimize the risks of contagion and facilitate timely discussion on policy for the financial sector. The Regulatory Policy Council will issue a semi-annual report to the Minister on technical guidance provided to the respective regulatory bodies. The government is aware that amendments to existing legislation will be required to ensure the exchange of information among supervisors. Measures will be effected to allow for this exchange prior to second tranche release.

37. The Regulatory Policy Council will consider the following issues a priority i) the harmonization of risk-based capital 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 in respect to financial companies and the development of specific rules relating to transactions within a financial group, dividends and other distributions, and the ownership and management of the group.

38. An important element of supervisory coordination is the development of a Memorandum of Understanding amongst the regulators. This Memorandum of Understanding will address such issues as the coordination and conduct of examinations for dually licensed entities.

D. Strengthening the Enforcement and Adjudication Process

39. The Jamaican justice system currently lacks the ability to speedily investigate and resolve cases related to complex commercial litigation, on the civil side, and financial crimes, on the criminal side. This inhibits prudent commercial lending and investment, and contributes to the perception that financial crimes can be committed with impunity. The Program will support the establishment of a Commercial Court and a Financial Crimes Unit to address each of these shortcomings, along with associated training in each area. Both can be established administratively, without the need for new legislation.

40. Commercial Court. The Government of Jamaica will create a Commercial Court, as an administrative unit of the Supreme Court, in order to address these problems. Draft court rules for the Commercial Court were tabled in Parliament in June of 1999, and are currently being finalized by the Rules Committee of the Supreme Court. The proposed new unit will have jurisdiction over a wide variety of commercial and finance-related actions. The new Court rules will allow for a judge-managed court calendar, greatly expediting case clearance, and a court-annexed alternative dispute resolution system should further streamline case resolution. Enhanced legal research and information technology for the Commercial Court will be financed in part by a supplementary court filing fee to be approved by Parliament, and it is expected that the best way to allow equitable access to the court would be to structure the scale of fees.

41. Training of the Commercial Court judges and ancillary court staff will be conducted with the assistance of notable local jurists and widely respected international legal training institutions, particularly those with experience in other Commonwealth countries that have similar legal systems. Judicial training will focus on the mandate of the Commercial Court itself; the judicial administration of commercial and other civil cases; alternative dispute resolution mechanisms; substantive changes in relevant civil law; the use of information technology, including computerized legal research resources; intellectual property rights; and the assessment of damages. Ancillary court staff will receive training in computerized case management applications; alternative dispute resolution profiles and tracking; and court staff management.

42. Financial crimes unit. The Office of the Director of Public Prosecutions (DPP) carries out criminal investigations and prosecutions, including those related to financial crime such as securities fraud and money laundering. While there are currently DPP staff with a certain level of experience in this complex area, the volume of staff caseloads tends to restrict prosecution. Administrative provisions have been made for the creation of a new Financial Crimes Unit (FCU) within the DPP. The FCU will be staffed with experienced prosecutors forensic

investigators, forensic examiners, analysts and a small number of computer data entry persons, which will be responsible for tracking possible violations of Jamaica's Money Laundering Act of 1996 (as amended), and other irregular bank transactions.

43. Training of FCU staff will prioritize financial institutional safeguards and principles (e.g., the Basle core principles), and effective prosecution techniques of breaches of relevant laws, including money-laundering laws. Further training will be carried out, primarily overseas, in related areas. The Program will also seek to build local ongoing training capacity via the Justice Training Institute, which was established by the Ministry of National Justice and Security in July of 1997 and the Regional Drug Training Centre which was also established by the Ministry.

44. Training for both the Commercial Court judges and staff and the FCU staff will run in parallel with the launching of the financial sector reform program and will accomplish agreed benchmarks prior to disbursement of the second tranche of the sector loan. The training will continue on an on-going basis after final disbursement of the sector loan, with support from a parallel technical assistance loan from the Caribbean Development Bank.

V. Conclusion

45. Jamaica has made progress in addressing the issues of the financial crisis of the mid 1990s and in initiating reforms of the sector. As described in this letter, the government is committed to making substantial progress in these areas. The policies to be implemented during the next two years should strengthen the soundness of our financial sector. Accordingly the Jamaican government hopes that our request for a new financial sector reform program will be approved, and we look forward to collaborating with the IDB in carrying out the program to a successful conclusion.

Sincerely yours,

Omar Davies

Minister of Finance and Planning

FSRP Technical Assistance Activities:
Both in Support of Meeting Policy Conditions and for Other Related Purposes
(Funding sources indicated in Parenthesis)

	Objective	Tranche Related Activities	Other Technical Assistance
o-economic Framework			
	Maintain sound policy framework	- None Required.	- None Required.
ution of Existing Financial-system Crisis			
ebt	Reduce debt and pay cash interest	- None Required.	- None Required.
of ale.	Maximize banks' attractiveness	- None Required.	- None Required.
t of on-	Early disposition of other FINSAC assets	- Funding provided to FINSAC via IDB-MIF.	- None Required.
	Prepare insurance company for sale	- Technical assistance provided by MIF: resident insurance specialist.	- None Required.
uction in Vulnerability of Financial System to Future Crises			
n	BOJ adopt international best practices, particularly regarding autonomy & supervision of complex groups	- Complete an independent assessment of Basle Core Principles (CDB funds) - Draft legal measures for the effective supervision of complex groups and merchant banks (CDB funds) - Draft legal measures for effective powers of intervention and ability to levy fines (GOJ/BOJ own funds) - Draft legal measures requiring the sharing of information amongst supervisors (amend bank secrecy provisions) (GOJ/BOJ own funds)	- Develop and implement supervisory fra credit unions (CDB funds) - Develop and implement framework to e market risk for financial institutions (CI

	Objective	Tranche Related Activities	Other Technical Assistance
y	Entity established and component parts strengthened	- Institutional strengthening of FSC- technical advisor, implementation of strategy; the development of processes and systems; information technology; and training (CDB funds) - Preparation/passage of insurance regulations which include i) solvency requirements; ii) investment guidelines; iii) market conduct and iv) actuarial standards (CDB funds) - Completion of supervisory ladder and risk-based modules for insurance industry (CDB funds) - Development of risk based capital standards for securities industry (CDB funds) - Development of supervisory framework for Unit Trusts/Collective Investment Schemes (CDB funds) - Immobilization of securities/Securities in registered form (CDB funds) - Prospectuses and Disclosure standards (SC/FSC own funds)	- Institutional strengthening of SC– mar surveillance capabilities (CDB funds) - Development of Securities Industry Be Manual, including guidelines for deali distressed companies (CDB funds) - Institutional strengthening – insurance use of early warning system; developn reporting forms for life and general co procedural manual for general insuran companies; actuarial training (CDB fu - Institutional strengthening – pensions: policies/procedures; enabling legislati training on analysis of pension plan in funding (CDB funds)
y on OJ,	Formalized coordination & full crisis mgt capability	- Semi-annual report – RPC; Crisis intervention policy (BOJ/FSC/JDIC own funds) - Memorandum of Understanding (BOJ/FSC/JDIC own funds)	
nt n	Enhance enforcement capabilities against fraud and abuse	- Commercial Court- training for judges, prosecutors, and investigators (CDB funds) - FCU- training (CDB funds)	

PROPOSED RESOLUTION

JAMAICA. LOAN ____/OC-JA TO THE GOVERNMENT OF JAMAICA

(Financial Sector Reform Program)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Government of Jamaica, as Borrower, for the purpose of granting it a financing to cooperate in the execution of the Financial Sector Reform Program. Such financing will be for the amount of up to US$150,000,000, from the Single Currency Facility of the Ordinary Capital resources of the Bank, and will be subject to the "Financial Terms and Conditions" and the "Special Contractual Clauses" indicated in the Executive Summary of the Loan Proposal contained in Document PR-____.