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Report No. P7527-JM

REPORT AND RECOMMENDATION

OF THE PRESIDENT

OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A PROPOSED

SECOND BANK RESTRUCTURING & DEBT MANAGEMENT PROGRAM

ADJUSTMENT LOAN

IN THE AMOUNT OF US$75 MILLION

TO

JAMAICA

September 17, 2002

Finance Private Sector and Infrastructure Sector Management Unit
Caribbean Country Management Unit
Latin America and the Caribbean Regional Office

CURRENCY EQUIVALENTS

(as of July 31, 2002)
48.65 Jamaican Dollars = US$1.00

JAMAICAN FISCAL YEAR

April 1 - March 31

ABBREVIATIONS AND ACRONYMS

BCP	Basle Core Principles
BNS	Bank of Nova Scotia
BOJ	Bank of Jamaica (Jamaica's Central Bank)
BRDP	Bank Restructuring and Debt Management Program
CAN	Country Assistance Note
CAR	Capital Asset Ratio
CAS	Country Assistance Strategy
CAS PR	Country Assistance Strategy Progress Report
FINSAC	Financial Sector Adjustment Company Limited
FIS	Financial Institutions Services
FSC	Financial Services Commission
FY	Fiscal Year
GAAP	Generally Accepted Accounting Practices
GDP	Gross Domestic Product
IDB	Inter-American Development Bank
IFI	International Financial Institution
IMF	International Monetary Fund
JDB	Jamaican Development Bank
JDIC	Jamaica Deposit Insurance Company
LAR	Liquid Asset Ratio
LOJ	Life of Jamaica
LRS	Locally Registered Stock (Treasury bonds)
MOF	Ministry of Finance & Planning
MOU	Memorandum of Understanding
NCB	National Commercial Bank
NIBJ	National Investment Bank of Jamaica
NPLs	Non Performing Loans
OSI	Office of the Superintendent of Insurance
PDL	Past Due Loans
PIOJ	Planning Institute of Jamaica
RBTT	Royal Bank of Trinidad & Tobago
S&P	Standard and Poor's
SC	Securities Commission
SMP	Staff Monitored Program

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JAMAICA
PROPOSED SECOND BANK RESTRUCTURING & DEBT MANAGEMENT PROGRAM
ADJUSTMENT LOAN

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JAMAICA

SECOND BANK RESTRUCTURING & DEBT MANAGEMENT PROGRAM (BRDP II) ADJUSTMENT LOAN

PROPOSED LOAN AND PROGRAM SUMMARY

BORROWER: Jamaica

AMOUNT AND TERMS: US$75 million. The loan will be a fixed-spread US dollar loan repayable in 16 years including 6 years of grace. The loan will carry the Bank's standard terms on interest rates, front-end fees, and commitment charges for fixed-spread loans.

DESCRIPTION: The operation will support the second phase of the Government's Bank Restructuring and Debt Management Program (BRDP), which includes:

Resolution of financial institutions. The Bank's first loan supported the sale of one large commercial bank in which the Government had a majority equity stake. At the time, the Government continued to have majority equity stakes in two other financial institutions –Life of Jamaica, the largest insurance company and, National Commercial Bank, the largest domestic commercial bank in Jamaica. Since the first loan, the entire equity stakes of the Government in both these institutions have been sold. The proposed second loan supports the sale of these two financial institutions. Bank funds will be used to retire part of the government bonds held by these financial institutions and it will complement other sources of funds available to the Government such as fiscal resources, proceeds from asset disposal, and loans from other international financial institutions (IFIs).

Phase-out of the crisis management agency. FINSAC –the Government's crisis management agency– which was established in 1997, has completed all of its assigned operational functions and has ceased operations as of July 2002. The proposed second loan supports the operational closure of the crisis management agency upon the successful completion of its responsibilities. FINSAC intervened, rehabilitated, and divested several financial institutions. The Government no longer has majority equity stakes in any intervened financial institution in Jamaica. FINSAC also acquired a large portfolio of NPLs from intervened financial institutions. It has since packaged and disposed of this entire portfolio to private investors. The Government also acquired a large portfolio of non-core assets (hotels, real estate, etc.) as part of the intervention process. Most of these assets have been sold and the Financial Institution Services (FIS, an institution established prior to FINSAC) has been given the responsibilities for management and disposal of remaining repossessed assets. Management and disposal of minority Government stakes in the remaining few financial institutions and completion of certain legal formalities of the intervention process will also be undertaken by FIS.

Restructuring and management of the public debt arising from the resolution of the financial crisis. The Bank's first loan supported the Government's actions for restructuring FINSAC's liabilities and the conversion of all outstanding FINSAC liabilities into negotiable government bonds, and servicing them in cash. Although there have been some delays, the Government has subsequently implemented all its commitments in this area. The proposed second loan supports: (i) the Government's efforts to continue servicing in cash all government bonds that replaced FINSAC's liabilities with the private sector, and (ii) the Government's actions to improve BOJ's profitability (beyond the replacement of FINSAC debt supported under the first loan).

Regulatory and supervisory reforms in the financial sector. In order to reduce the vulnerability of Jamaica's financial system to future crises, the proposed second loan supports continuing efforts by the Government to strengthen the legal, regulatory, and supervisory environment of the financial sector. In the banking sector, since the approval of the first Bank loan, the BOJ undertook an independent assessment of the Basle Core Principles of bank regulation and supervision. The BOJ and the Government have also taken steps to address areas of weakness identified in the independent assessment. Necessary legislative measures have been approved and capacity building at the BOJ is proceeding. Significant strengthening of the legislative, regulatory, and supervisory framework for the non-bank financial sector has been undertaken since the approval of the first Bank loan. A new Insurance Act – in line with international best practice - has been approved and several implementing regulations have been issued. The Financial Services Commission (FSC), a new integrated regulator and supervisor for institutions in the insurance, securities, and pension industries is operating satisfactorily and its capacity is being strengthened.

Improving the financial infrastructure for renewed bank lending. Since the onset of the crisis in the mid-1990s, there has been little new bank lending in Jamaica. With the resolution of all major financial institutions, the banking sector has just resumed more prudent lending operations. These are essential to restart economic growth. The proposed second loan supports the Government's actions in strengthening the financial infrastructure in Jamaica by creating the regulatory environment for establishing credit bureaus, which is a crucial, but currently missing, element in the financial infrastructure of Jamaica.

PROJECT RATIONALE: The Government of Jamaica recognizes that the two major challenges to restarting economic growth in Jamaica and thereby contributing to poverty reduction are the creation of a sound financial sector after the crisis of the mid-1990s and managing the debt burden resulting from Government interventions during the crisis. The proposed loan will support Government actions aimed at tackling these challenges. Jamaica is moving from a stage where the Government had become the effective owner of almost the entire domestically owned financial sector to one where almost the entire financial sector is foreign owned. There is also an ongoing transition from an environment of a poor legal, regulatory, and supervisory framework to one where it is much more in line with international best practices.

The Government's intervention and restructuring of financial institutions affected by the crisis through the provision of special FINSAC securities that capitalized interest in exchange for impaired assets contributed to the creation of adverse debt dynamics. The intervention generated a stock of public sector liabilities (FINSAC debt) of about 42.4 percent of GDP as of March 2001, over and above an already high pre-crisis public debt level of over 100 percent of GDP, which has since remained largely stable. The Government has explicitly recognized the financial cost of the intervention by converting all FINSAC liabilities into tradeable Government securities. On all such securities held by private financial institutions, the government is making interest payments in cash.

The Government has committed itself to a program of macroeconomic stability monitored by the staff of the IMF. As part of this program, the Government is committed to generating large primary surpluses through revenue mobilization measures and restraint on expenditures. For instance, in FY2000/01, Jamaica achieved a primary surplus of 12.2 percent of GDP. The Government's program has had to be modified since the first Staff Monitored Program, (SMP, formulated in April 2000) largely as result of (i) external shocks such as the events of September 11, 2001 in the US; (ii) natural disasters such as floods from Hurricane Michelle in November 2001; (iii) violence in parts of Kingston in July 2001; and (iv) closure of the bauxite refinery due to a labor dispute, which impacted negatively on fiscal revenues, foreign exchange inflows, and GDP growth. All these have adversely affected the Government's fiscal position. The Bank supported the Government's economic rehabilitation program in response to the events of September 11, 2001 through an Emergency Rehabilitation Loan of US$75 million. The Government's revised macroeconomic program, though facing significant risks, is credible, and has strong Government commitment.

Within the context of this strong Government commitment, the Bank has been assisting Jamaica in resolving the financial sector crisis. In order to minimize risks to the Bank and retain flexibility to respond to changing circumstances, a programmatic approach to lending in support of the Government's BRDP was adopted which called for two separate single-tranche loans each of US$75 million. The Bank's first BRDP loan, approved in November 2000, supported the first phase of the financial sector crisis resolution. The proposed loan supports the second phase of this process. As in the first loan, the proposed second loan also supports specific actions taken by the Government prior to Board consideration.

BENEFITS:

The proposed second loan would have several benefits. First, it would contribute to moving the resolution of the financial crisis toward completion by supporting the disposal of majority equity stakes in the last two remaining major financial institutions in Government hands to foreign investors. Second, the loan would contribute to enabling the Government to continue its efforts at servicing the liabilities generated during the crisis in cash. This, in turn, would support the provision of greater liquidity to the banking system. Strong and well-capitalized financial institutions with adequate liquidity would be in better position to provide prudent lending to the private sector, with the attendant beneficial effects on growth, wider access, and employment. Third, the Bank's loan would have a strong positive signaling impact through supporting the closure of the crisis resolution agency upon the completion of its responsibilities. Fourth, the loan would support the continued strengthening of the regulatory and supervisory framework for the financial sector in Jamaica. This is expected to reduce the vulnerability of the financial system to future shocks. It would also contribute to improving the environment for better lending practices through the creation of credit bureaus. Fifth, it would support the Government's program of debt management by contributing to the lengthening of maturities of the public debt and replacement of the stock of relatively expensive, shorter-term, domestic debt with relatively cheaper international debt (assuming only modest depreciation of the Jamaican currency). This would modestly ease the Government's fiscal burden and reduce the pressure on domestic interest rates. Sixth, it is expected that the Bank's support, together with that of the other IFIs, will further increase confidence of the domestic and foreign private sector regarding the Government's commitment to the final resolution of the financial sector crisis, and thereby contribute to greater economic activity. Finally, resolution of the financial sector crisis is key if Jamaica is to put its economy back on a sustained positive growth path. If the Government's program supported by the proposed loan is successful, a major benefit would be the resumption of higher economic growth.

RISKS:

Both the Government's program as well as the Bank's operations in supporting it face several, significant, risks. Recent exogenous shocks suffered by the economy have also highlighted the risks faced by the program. However, actions taken by the Government since the beginning of the crisis and subsequent to the approval of the first Bank loan have simultaneously changed the nature of the risks and contributed to increase confidence that risks are manageable. As was the case with the first loan, the Bank recognizes these risks, as well as the fact that it is not realistically possible for the proposed operation to address all risks and mitigate them completely. Despite the risks, the Bank believes it is worth supporting the Government's program, in order to move the process of resolution of the financial sector crisis towards completion and attempt to maintain higher growth in Jamaica.

The main risks facing the operation are the following: First, arguably the single biggest risk is that of potential macroeconomic instability. The Government has thus far been largely successful in stabilizing and lowering interest rates as well as generating significant primary surpluses broadly in line with the targets set out in the SMP. These have enabled it to service its large stock of debt. However, going forward, there is a risk that servicing the public debt could become much more challenging. The events of September 11 in the US and natural disasters such as floods had major negative implications for the Jamaican economy resulting in large revenue shortfalls. The economy has low capacity to absorb more large exogenous shocks. The Government has already approached the IFIs and received emergency assistance after the events of September 11. Additional resources may be harder to mobilize in the event of further difficulties. The Government's tax collections are already quite efficient and spending is already on an extremely tight leash. There is little room for improvement in revenues or contraction in spending. If fresh exogenous events cause further fiscal pressures, which are addressed through additional borrowings, it is unlikely that the Government will be able to meet SMP targets in terms of putting its public debt on a sustainable path.

Second, the program faces significant political risk. Elections are due in Jamaica by March 2003 and are likely to be held before the end of 2002. While the Government has thus far shown a strong commitment to a credible macroeconomic program, it is not difficult to visualize a scenario where political pressures might lead to higher than planned public expenditures in the short to medium term resulting in greater fiscal pressures.

Third, there is a risk that the extremely tight fiscal discipline required to make the proposed program successful may not be sustainable in the medium term. Although the tight discipline has not been the cause of the recent social tensions in Jamaica, such outcomes remain a risk if rapid economic growth does not resume.

Fourth, the Government's financial sector restructuring program has been largely successful in placing the sector on a path to recovery. However, this has been achieved by placing a large amount of Government debt in the sector, raising its exposure to Government credit risk. Government bonds form the majority of bank asset portfolios, both because of the replacement of FINSAC debt with government bonds, as well as through their own investment operations. As long as the Government continues to service its obligations, the banking sector is likely to remain relatively sound. However, if the Government has difficulty servicing its debt, the quality of bank assets will almost certainly rapidly erode, with concomitant adverse impact on banking system soundness.

Fifth, although banking sector and non-bank financial institutions' regulation and supervision have been significantly strengthened, continuous vigilance will be necessary to ensure that there are no lapses in supervision, which could expose the financial system to additional risks. The FSC is a new entity and continued support to strengthen it and enhance its autonomy are necessary to ensure that it successfully performs its functions. Jamaica now has a largely sound legal framework for the financial sector. It needs to ensure that its implementation and enforcement continue.

SCHEDULE OF DISBURSEMENTS: The full amount of the loan is expected to be disbursed in a single tranche upon loan effectiveness.

CLOSING DATE: December 31, 2002

PROJECT ID NUMBER: P073756

REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED SECOND BANK RESTRUCTURING & DEBT MANAGEMENT PROGRAM (BRDP II) ADJUSTMENT LOAN TO JAMAICA

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1. I submit for your approval the following Report and Recommendation on a proposed loan to Jamaica in the amount of US$75 million to support the second phase of the Government's Bank Restructuring and Debt Management Program (BRDP II). The program focuses on completing the financial resolution of the crisis that occurred in the mid-1990s and involves the following components: (i) sale of the National Commercial Bank (NCB, currently the second largest commercial bank) and Life of Jamaica (LOJ, the largest insurance company); (ii) sale of NPL portfolio; (iii) disposal of a significant portion of the real estate asset portfolio; (iv) closure of operations of the crisis management agency; (v) restructuring and management of the public debt arising from the resolution of the financial sector crisis; (vi) regulatory and supervisory reforms in the financial sector; and (vii) improving the financial infrastructure. The loan will be a fixed-spread US dollar loan repayable in 16 years including 6 years of grace. The loan will carry the Bank's standard terms on interest rates, front-end fees, and commitment charges for fixed-spread loans.

I. MACROECONOMIC CONTEXT AND RECENT PERFORMANCE

A. The Context

2. As discussed in the Board document for the first BRDP loan (Report No. P7397-JM)[1], a severe financial sector crisis occurred in Jamaica in the mid-1990s. The crisis was largely attributable to rapid financial sector liberalization that was not complemented by a sufficiently robust prudential and regulatory infrastructure and strong enforcement. A large number and variety of financial institutions emerged, enabling regulatory arbitrage. By late 1996, there were compelling signs of systemic liquidity and solvency problems in several financial institutions and inflationary pressures built up. The Government's response focused on reducing inflation through tight monetary policy, maintaining a stable nominal exchange rate, intervening in the financial sector through a full guarantee for all depositors, strengthening the regulatory and supervisory framework of the financial sector, and re-capitalizing weak institutions using Government-backed debt issued by a newly created failure resolution agency – the Financial Sector Adjustment Company Limited (FINSAC). This institution was established in 1997 with the objectives of intervention, rehabilitation and divestment of troubled financial institutions. Through the interventions of FINSAC, the Government largely avoided a meltdown of the financial sector.

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[1] The loan was approved by the Bank on November 30, 2000.

3. However, the stabilization of the financial sector came at a substantial cost. Since the Government did not have the resources to service all FINSAC notes in cash, it resorted to capitalizing interest on FINSAC paper (largely at market interest rates that peaked at about 20 percent per year) through the issue of more FINSAC paper. While this postponed the financial recognition of the costs of the crisis, the compounding effect of interest capitalization resulted in an extremely rapid growth of FINSAC paper – reaching a level of about J$142.7 billion (about US$3 billion, or about 42.4 percent of GDP) as of March 2001, without resolving the banks' cash flow problems. Taking into account the already high (non-FINSAC) public debt that existed before the crisis (over 100 percent of GDP in 1995, which has largely remained stable since then), Jamaica faces a severe debt sustainability and fiscal problem.

4. The Government recognized that resolution of the financial sector crisis and reversing the adverse debt dynamics was essential for the economy to achieve significant recovery. Since early 2000, the Government has undertaken several promising initiatives, including a significant clean up and restructuring of the financial sector, maintaining an extremely tight fiscal stance in which large primary surpluses were targeted and largely achieved, and signing of agreements with the IMF for two Staff-Monitored Programs (SMPs) covering the years 2000-2002 and 2002-03. On the basis of these actions, the Government approached the Bank, the IDB, and the CDB for support to resolve the crisis in the financial sector. The Bank approved a US$75 million in November 2000 and disbursed it in full in December 2000 to support the first phase of the Government's program. The loan was part of a programmatic approach in which the Bank envisioned providing a second loan of an equivalent amount to support the second phase of the Government's program. The IDB approved a two-tranche loan for US$150 million in September 2000 and disbursed the first tranche shortly thereafter. Faced with the shocks of late 2001, the IDB responded to the Government's request for funds by formally splitting the second tranche into two components of US$40 and $35 million each. The first component of the second tranche for US$40 million was disbursed in March 2002. The CDB approved a US$25 million loan, of which $5.9 million remains to be disbursed. The CDB also approved an additional US$4 million for ongoing technical assistance.

B. Recent Economic Developments and Prospects[2]

5. Since the last CAS for Jamaica was discussed at the Board in November 2000, the Jamaican economy has been continuing on a gradual recovery path, and, despite some major concerns on the debt front, it is in better shape than at any point since the financial crisis began in 1996. After four years of negative growth following the financial crisis, real GDP rose by 1.1% in 2000/01 and again in 2001/02, in spite of the multiple shocks of 2001. The fiscal effort that began in 1998/99 has been sustained. Single-digit inflation, a key macroeconomic objective of the Government, was achieved for the sixth consecutive year (inflation was 7.6% at end-March 2002, a little higher than 6.4% in March 2001), largely through tight monetary policy. Significant improvements in private capital inflows and government borrowings from successful international bond issues in May and December 2001 led to a rebuilding of net international

[2] For more details regarding the macroeconomic situation, see (i) Jamaica: Staff Report of the Article IV Consultation and Review of the Staff Monitored Program, IMF Document No. EBS/01/83 dated June 14, 2001 (ii) Report No. P7493-JM, Jamaica: Emergency Economic Rehabilitation Loan, December 7, 2001, The World Bank; and (iii) Report No. 24689-JM, CAS Progress Report for Jamaica 2002-03 (which accompanies this loan).

reserves of over US$650 million during 2001/02, reaching US$1.9 billion by March 2002 (about 23 weeks of goods and services imports). A 15-year, US$300 million bond issue was successfully floated in June 2002. It was heavily oversubscribed at an interest rate of 10.75%. Also, S&P reaffirmed its B+ long-term foreign currency and its BB- long-term local currency sovereign ratings for Jamaica in March 2002, and projected a stable outlook based on the Government's maintenance of macroeconomic stability

6. In July 2002, a new SMP was agreed between the authorities and the IMF for 2002/03, signaling the Government's reaffirmation of fiscal discipline even during an election year.[3]

7. Real GDP growth was estimated at 3 percent from April to September 2001, primarily due to a recovery in agriculture from the previous year's drought, resumption of bauxite and alumina production after a disruption in a processing plant in the US, and growth in tourism. The economy was adversely affected by several major shocks in the second half of 2001 – an outbreak of violence in Kingston in July, the impact of the terrorist attacks on the US in September on tourism (aggravated by the slowdown in the US economy), floods in late November which damaged one-fifth of Jamaica's crop acreage, and an October-December 2001 strike in a major alumina producer that caused a 17 percent drop in mining output in that quarter. Finally, Jamaica again experienced heavy flooding in May 2002, which damaged agricultural crops and infrastructure. In spite of such multiple shocks, positive growth was experienced in 2000/01, and is estimated at 1.1 percent for 2001/02 and projected at 2.0 percent for 2002/03 (revised from earlier estimates of 2.5 percent).

8. These shocks have impacted most severely on tourism and its related sectors. Tourist arrivals for stopover visitors declined by 7.6 percent in 2001/02 compared to a growth of 6.3 percent in 2000/01 (cruise arrivals dropped by 5.1 percent in 2001/02 after a 14.4 percent growth in 2000/01). Net tourism receipts are estimated to have declined by almost 12 percent in 2001/02. A recovery in tourism is anticipated towards the second half of 2002/03, but remains vulnerable to economic conditions in the U.S.

9. The strong fiscal adjustment effort since 1998/99 weakened in 2001/02 due to the shocks, with the central government deficit at 5.7 percent of GDP, a substantial deviation from the May 2001 target of 2.8 percent. This was mainly due to lower revenues from taxes, but also to increased expenditure on security, tourism promotion and flood relief, wage settlements due earlier than anticipated, and interest payments related to the holding of FINSAC securities at National Commercial Bank (NCB). The central government primary surplus declined to 8.0 percent of GDP in 2001/02 from 11.8 percent in 2000/01, although still reflecting a significant fiscal adjustment effort.

10. Public sector debt declined from 131.9% at end-March 2001 to 130.6% of GDP at end-March 2002, less than the over 6 percentage points decline anticipated in the May 2001 SMP projection. On the external front, the debt service ratio rose from 14.6 percent of exports of goods and services in 2000/01 to 19.2 percent in 2001/02. The cost of servicing an expanding public debt poses significant fiscal challenges for the Government. There has been a downward

[3] IMF Country Report No. 02/197.

trend in interest rates, with the six-month Treasury Bill declining from 16.9 percent at end-March 2001 to 14.6 percent at end-March 2002 (it fell further to 13.8 percent at end-June 2002).

11. The real effective exchange rate has appreciated substantially relative to 1995 (44.8 percent between December 1994 and December 1998), although there has been a partial reversal of this after 1998 including in calendar year 2002 (7.7 percent depreciation between December 1998 and July 2002, including about 2 percent between April and July 2002). Much of this appreciation can be linked to the financial crisis and the resultant need to keep a tight monetary policy. The tight monetary policy, along with the trade liberalization, has successfully reduced inflation, but the resultant appreciation has also eroded competitiveness and growth prospects. Lower export earnings (due to lower prices on bauxite and aluminum), a decline in tourism receipts and increased investment income outflows have resulted in a widening of the current account deficit from 5.7 percent of GDP in 2000/01 to 8.0 percent of GDP in 2001/02 (5.3 percent projected in the July 2002 SMP). This occurred despite a 17 percent increase in remittances to US$986 million in 2001/02. Part of the current account deficit is "self-financing", since both FDI as well as remittances also lead to greater imports (also, remittances in kind are recorded both as merchandise imports and also as transfers). The rising trend in the current account deficit, accompanied by a long-term appreciation in the exchange rate is a cause for concern, and bears close attention.

12. However, in spite of difficult market conditions, spreads over US Treasury Bills on Jamaican bonds are relatively low, and net international reserves were above target at US$1.9 billion at end-March 2002 (about US$1.8 billion at the end of June), partly due to the US$250 million 20-year international bond issue in December 2001. In June 2002, Jamaica again successfully issued a 15-year US$300 million international bond, which was heavily oversubscribed, at a yield of 10.75 percent.

13. The Government program for the current fiscal year aims to accelerate growth through continued fiscal consolidation, macroeconomic stability and structural reforms. An increase in economic growth to 2.5 percent is forecasted for 2002/03. The primary sources of growth include recovery in agriculture, tourism and mining (however, the impact of the floods in May 2002 and a later-than-anticipated recovery in tourism may lower growth, thus the Bank's forecast for 2002/03 is a more conservative 2 percent) as well as continued modest growth in services, particularly in the telecommunications sub-sector. Under the new SMP, the Government has committed itself to further strong fiscal adjustment, including measures to improve tax compliance, increase user fees, and restrain expenditures on wages and salaries. Also, the central government deficit is projected to decline to 4.4 percent of GDP and the central government primary surplus to increase to 10.4 percent of GDP (public sector primary surplus to 11 percent of GDP)[4]. However, the overall public sector deficit is expected to remain high at 6.6 percent of GDP (6.8 percent in 2001/02), due to a projected increase in Bank of Jamaica's operating losses.

14. The high debt overhang and continued deficits, and the resulting debt service, mean that the Government's discretionary expenditure is seriously compromised. Sustained improvement in the adverse debt dynamics will need a reduction of the public sector borrowing requirement

[4] A review of these targets is expected before the end of 2002 to take account of the damage caused by floods in May 2002.

and a sustained reduction in domestic interest rates. It is estimated that the public sector debt will decline to 128.4 percent of GDP in 2002/03, after taking into account resolution of the FINSAC debt at the BOJ. This represents a 2.2 percentage-point decline over 2001/02, which is less than that projected in the May 2001 SMP.[5]

15. The Government's SMP foresees a tight monetary policy to target inflation of less than 7 percent for 2002/03. The primary objective of exchange rate policy is to maintain single digit inflation, while maintaining and strengthening the competitiveness of the economy. In the first quarter of 2002/03, the real effective exchange rate has depreciated marginally by 1.5 percent. The current account deficit is expected to increase to 8.2 percent due to higher oil prices and a slower than anticipated recovery in tourism. The target for net international reserves is US$1.6 billion at end-March 2003 (18.8 weeks of imports of goods and services).

II. THE JAMAICAN FINANCIAL SECTOR CRISIS

16. Jamaica faced a severe financial sector crisis in 1995-96. A detailed discussion of the causes and management of the crisis is available in Report No. P7397-JM: Report and Recommendation of the President for the first Bank Restructuring and Debt Management Program Adjustment Loan[6]. In brief, newly privatized banks and non-bank financial institutions operating under an inadequate regulatory and supervisory regime undertook risky lending and investment activities in an environment of a booming real estate market. When government macroeconomic policy caused high interest rates and the real-estate bubble burst, many of these institutions failed. The legal framework for intervening financial institutions was weak and gave inadequate powers of intervention, sanction, and enforcement to supervisors.

17. Insurance companies played a key role in triggering the crisis. They offered new insurance products in the early 1990s (popularly known as investment or lump-sum policies), which enabled them to take deposits disguised as insurance premiums. A small portion of the deposits went to insurance coverage, while the majority was used to invest in real estate, stocks, bonds, and securities. Once the liquidity problems emerged, insurance companies tapped mostly their related banks for funds, triggering the problems that surfaced in the banking sector.

18. The Government initially attempted to implement loss-sharing arrangements with depositors for the first few failed institutions. However, depositor confidence evaporated and runs began on the banking system. Depositors shifted their funds into stronger institutions – particularly foreign-owned – in an extensive flight to quality. The authorities then reassured the public by extending full coverage of all bank liabilities, revoking their original response to earlier bank failures. The implementation of this costly approach emerged from the Government's worries that large risk of ongoing bank runs would have become systemic increasing possibilities for capital flight, coupled with evidence of increasing social turmoil.[7] In

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[5] Based on a symmetric treatment of the resolution of BOJ losses, the decline was about 4.4 percentage points. Table 3 in the CAS PR notionally includes the resolution of BOJ losses in the debt stock before 2002/03 for purposes of symmetric comparison of the debt profile (see also footnote 4 in the CAS PR).

[6] The discussion in Report No. P7397-JM, although not repeated here, remains relevant to the proposed loan.

[7] Capital flight was lessened by significant flight to quality of deposits from troubled domestic banks largely to the Bank of Nova Scotia –an international bank with a large market presence, perceived as stronger by depositors.

the process, the Government effectively became the owner of, or a major investor in most of the domestically owned financial sector.

19. The Government initially established the Financial Institutions Services (FIS) to wind down the operations of the first two failed financial groups. In 1997, as the full extent of the crisis became clearer, the Government established another public sector entity, the Financial Sector Adjustment Company Limited (FINSAC), with a broader mandate to: (i) restore liquidity and solvency to distressed institutions; (ii) strengthen the financial management of institutions; (iii) improve the efficiency of the financial sector in mobilizing and allocating resources; and (iv) restructure existing financial institutions so that they could be attractive to private investors in the future. FINSAC assisted financial institutions and re-capitalized them by purchasing shares, making subordinated loans, and purchasing non-performing loans. FINSAC's activities in managing the crisis can be divided into two phases: the intervention phase and the rehabilitation phase.

A. The Intervention Phase of FINSAC's Operations

20. FINSAC implemented a series of interventions and acquired a large share of the ownership of the financial system. It provided assistance to five commercial banks, five life insurance companies, two building societies, and nine merchant banks. Initially, it provided some resources in cash, but when the size of the problem increased, it provided institutions with special, largely illiquid FINSAC notes that allowed capitalization of interest[8]. FINSAC notes carried mostly floating interest rates usually indexed to the 6-month Jamaican Treasury Bill rate[9]. The interest payment on almost all notes was capitalized in the form of fresh FINSAC notes. As of March 2001, FINSAC's gross support to the system amounted to about J$142.7 billion, 42.4 percent of GDP.

B. The Rehabilitation Phase of FINSAC's Operations

21. Subsequent to initial intervention, FINSAC attempted to rehabilitate intervened financial institutions through introduction of better management and cost-cutting measures, such as staff and branch rationalization in order to prepare them for sale.

Rehabilitation of banks

22. This involved mergers to consolidate the banking operations of all FINSAC controlled institutions into two banks –Union Bank (UB) and National Commercial Bank (NCB). FINSAC first merged (the good bank portion of) smaller intervened domestic banks into Citizens Bank, and changed its name to Union Bank in June 1999. It merged two smaller merchant and trust banks into NCB. As of March 2001 (before the sale of UB to the Royal Bank of Trinidad and Tobago, RBTT, became effective), institutions intervened by FINSAC –consolidated into NCB

[8] About 82 percent of the total amount of resources provided by FINSAC at the point of intervention was in the form of bonds.

[9] Only a few of the bonds carried fixed interest rates – mostly ranging from 9-10 percent for FINSAC notes denominated in Jamaican dollars and 7-9 percent for notes denominated in US dollars. FINSAC notes denominated in US dollars were a small fraction of overall FINSAC paper.

and Union Bank— held close to 45 percent of total commercial bank deposits of the Jamaican financial system.

Rehabilitation of life insurance companies

23. Concomitantly with the advances in the banking sector, the Government restructured the insurance sector. Importantly, in providing support to intervened insurance companies the Government cut off the financial ties that existed between these companies and related banks, thus improving the transparency and soundness of the system. This endeavor complements the concerted effort within the industry to return to the core business of insurance, while moving away from other financial activities in which they were heavily involved in the past. FINSAC undertook a major restructuring process and divestment strategy for the insurance sector. It sold the interest-sensitive deposit-like instruments of intervened insurance companies to Bank of Nova Scotia (BNS) and used Treasury bonds (LRS) and cash obtained from the MOF as assets to back up these liabilities. It sold the traditional life policies and pension funds of intervened insurance firms to non-intervened domestic insurance companies and new foreign entrants.

C. Impact of the Financial Sector Intervention on the Public Debt

24. The support programs aimed at averting the collapse of the financial system generated a large stock of debt as a result of the direct assistance given to banks and the purchase of non-performing loans by FINSAC, plus the accruals of interest being capitalized on the debt. The Government took over the majority of FINSAC's liabilities as of March 31, 2001 and it is servicing them in cash[10]. As of March 31, 2001 the total stock of FINSAC/FIS liabilities amounted to J$142.7 billion, equivalent to 42.4 percent of GDP, almost as large as Jamaica's external debt[11]. The main holders of this debt were the MOF, the BOJ, Union Bank, NCB, and others (mostly insurance companies).

III. THE GOVERNMENT'S BANK RESTRUCTURING & DEBT MANAGEMENT PROGRAM

25. FINSAC's intervention in the financial sector and regulatory reforms subsequent to the crisis have dramatically reduced the number of financial intermediaries in Jamaica and greatly simplified the ownership structure (In Report no. P7397-JM, see Annex III for details on the banking sector and Annex IV for details on the insurance sector). Total banking sector assets as of May 2002 were J$330 billion (US$6.8 billion) with commercial banks representing 76.6 percent of total, building societies 15.8 percent and near banks 7.6 percent. Currently there are 6 commercial banks, 11 merchant banks, and 4 building societies. As of May 2002, NCB and BNS together represent about 74 percent of total assets of commercial banks. The remaining 26 percent includes: Union Bank (RBTT Bank of Jamaica since November 2001), 14 percent; CIBC, 6.8 percent; Citibank, 4 percent; and TCB Group (domestic, now First Global), 1.7

[10] FINSAC bonds at the BOJ were converted into government bonds only in September 2002, and interest on them is being accrued, although at market interest rates. Details are discussed in Section III-D.

[11] The Government implemented a series of actions – supported by the Bank's first loan - aimed at restructuring this debt, which were effective April 1, 2001. The figures given in this section are prior to the restructuring.

percent. As of December 2001, life insurance companies had total assets of J$35 billion (US$720 million) and non-life insurance companies of J$17.6 billion (US$362 million). Of the large banks, BNS has the largest share in total commercial loan portfolio with 56 percent of the total (or 31 percent of its total assets, compared to 22 percent in investments), while 50 percent of the assets of NCB and about 65 percent (declining from 70 percent after redemptions by MOF) of the assets of Union Bank are primarily tied up in LRS that replaced FINSAC paper.

A. The Government's Financial Sector Restructuring Strategy

26. As discussed above, during the intervention and rehabilitation phases of the Government's support to the financial sector, FINSAC acquired significant control of the domestic financial system. In addition, since a large part of bank portfolios were concentrated in real estate –either as assets financed through loans or as collateral, FINSAC also became the owner of numerous real estate assets such as commercial and residential properties. The portfolio of problem loans bought in the restructuring process is also an important part of FINSAC assets. The Government adopted a phased strategy to dispose of the financial institutions and other assets in which it had acquired interests as a result of the crisis and the Bank's support to the Government has been in line with this phased approach. The divestment process is a crucial final component of the Government's financial restructuring strategy.

Divestment of Financial Institutions

27. The Bank's first loan supported FINSAC's sale of Union Bank to RBTT. At the time, FINSAC held majority equity stakes in two other major financial institutions – National Commercial Bank and Life of Jamaica. As part of the actions to be supported by the proposed second loan, these two financial institutions have been sold. FINSAC sold its entire majority shareholding in Life of Jamaica on November 15, 2001, to a subsidiary of Barbados Mutual Assurance Society for US$41 million. FINSAC sold its entire majority shareholding in NCB on January 11, 2002, receiving a down payment of about US$55 million, out of a total sale price of about US$125 million[12]. As a result, the Government has no majority equity stake in financial institution since January 2002 –although it is in the process of divesting equity holdings of about 26 percent in each of three institutions (Island life, Dyoll Insurance Co., and Victoria Mutual Building Society), as discussed below in paragraph 33.

Asset Disposal - Portfolio of non-performing loans

28. FINSAC acquired a non-performing loan portfolio of J$74 billion (face value of J$33 billion along with accrued interest) from intervened financial institutions. Disposal of these loans has been an important element of the resolution of the financial sector crisis. FINSAC established a workout unit to manage this portfolio and attempt recovery. By August 2001, this unit had recovered about J$5.7 billion. As part of the actions supported by the Bank's first loan, FINSAC hired an international consultant to assist in the process of disposal of the NPL portfolio and obtained a preliminary diagnosis of the status of the portfolio. As part of the actions to be supported by the second loan, the portfolio was sold to a subsidiary of Beal Bank of Texas on

[12] The sale price is based on the bank's net asset value as of September 2001.

January 30, 2002.[13] The Government received a down payment of US$23 million (about J$1.1 billion), and the sale is structured so that the government shares in the recoveries actually made by the purchaser according to the following schedule: 15 percent of the first US$50 million recovered, 25 percent of the second, 35 percent of the third, 45 percent of the fourth, and 50 percent of the remainder. The offer is based on cash flow projections for the next 3-4 years where the buyer expects to collect approximately US$215 million in gross proceeds, leading to total estimated income for the Government of about US$90 million in the next two years. This would result in a recovery rate of about 22 cents per dollar face value of NPLs. As of July 2002, FINSAC had already received about US$2 million in recoveries for a total of about US$25 million (J$1.2 billion) – including the US$23 million down payment.

Asset Disposal - Portfolio of other assets

29. FINSAC also acquired a large portfolio of other non-core assets during the intervention process (residential and commercial real estate, and other assets such as furniture & equipment, artwork, and motor vehicles). As part of the actions supported by the first loan, FINSAC had, by August 2000, sold J$11 billion of non-core assets. As part of the actions to be supported by the proposed second loan, FINSAC has made further progress in this area, with sales of J$15 billion. It has sold 98 percent of the portfolio of residential properties – realizing a total amount of J$0.5 billion. The disposal of commercial properties (including freehold land, industrial, & hotels) has been slower, with sales for J$10.6 billion accounting for about 75 percent of the total[14]. Out of six hotels it acquired, FINSAC has sold four and entered into a lease with an option to buy agreement for another hotel[15, 16]. FINSAC also sold J$3.9 billion in other assets.

30. To speed up the sale process of commercial real estate properties, FINSAC designed a new strategy in 2001 and packaged most remaining properties for sale in bulk [17], but delayed the bidding process until the first quarter of 2002 to avoid undermining the then ongoing sale of NPLs. The Government accepted bids from several interested parties until April 30, 2002. Although FINSAC found the offers received on bulk sales too low, it accepted individual offers on 9 of the 25 properties being sold, accounting for 40 percent of the total portfolio packaged for sale. FINSAC has provided the Bank with a list of sold and unsold properties as of July 2002, with several properties (specially those acquired in the process of selling LOJ in November 2001) under sale arrangements in process, expected to be finalized by the end of 2002.

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[13] Civil unrest in Jamaica in the summer of 2001 and the events of September 11, 2001 in the US adversely affected the interest of potential buyers in the first attempt to sell the NPL portfolio. However, soon thereafter, FINSAC aggressively marketed the portfolio and finalized the sale.

[14] These figures are based on the fire-sale value of the properties, as estimated by FINSAC.

[15] The Sandals Group has leased the property and has an option to buy it within three years.

[16] The last hotel pending disposal has a combined shareholding of Kassner Estate and FIS for a total of 78 percent. These two shareholders would like to dispose of their respective holdings together. The hotel is currently under a long-term management contract with Marriott, which makes interest from outside parties harder to materialize.

[17] This includes real estate properties that the Government retained after the sale of NCB and LOJ.

Winding Down of FINSAC

31. With the completion of FINSAC's responsibilities of intervening and rehabilitating crisis-hit institutions and subsequently, disposing of its majority equity stakes in intervened institutions, the Government closed FINSAC operations as of July 2002. The winding down of FINSAC, is expected to have a strong positive signaling effect of indicating the end of a crisis and the beginning of a new era with stronger financial institutions. However, FINSAC has had to deal with a number of issues as a consequence of the diverse nature of the subsidiaries of the financial institutions that it acquired. There were also legal proceedings associated with some of the interventions. The management of the Government's minority stakes in intervened institutions as well as the responsibility of completing the legal procedures required to formally close down institutions that have already ceased operations have been transferred to FIS (see Annex III).

32. The Government is proceeding with the divestment of FINSAC's minority equity stakes of 26 percent in Island Life, 26.5 percent in Dyoll Insurance Co., and US$8.25 million of preferred shares in Victoria Mutual Building Society (VMBS)[18]. In addition, out of the 172 companies –subsidiaries of the financial institutions that FINSAC had acquired— that FINSAC originally had to dispose/liquidate, it has dissolved 72; two are being stricken off awaiting notification from the Registrar of Companies; and 45 companies have had their documentation completed and reviewed and are pending the appointment of a liquidator (see Annex III). The remaining two categories include 29 companies for which FIS has assumed the operational responsibility to complete formalities, and 24 companies for which FINSAC is proceeding with the divestment of its shares. On the latter category, the resolution of some of the companies will be protracted, as there are major legal and other administrative issues surrounding them. The gross financial exposure of the Government on account of these remaining ownership stakes is small.

B. The Government's Strategy to Strengthen Regulation and Supervision of the Financial Sector

33. As FINSAC attempted to restore liquidity and re-capitalize weak institutions, the Government undertook the reform of the regulatory and supervisory framework. Significant progress has been made in several areas since the onset of the crisis. The supervisory power of the BOJ over commercial banks, merchant banks, and building societies has been strengthened. Jamaica has introduced a Deposit Insurance Act with limited protection to cover deposits up to J$300,000 (about US$6,600) of commercial banks, merchant banks, and building societies, funded by premiums paid by these institutions. Keeping in view that poor regulation and supervision of the insurance companies was a key problem in precipitating the crisis, a major overhaul of the regulation and supervision in the insurance sector was undertaken through technical assistance supported by the Inter-American Development Bank (IDB) and is being continued through technical assistance supported by the Caribbean Development Bank (CDB). A detailed discussion of the regulatory and supervisory framework for the banks and non-bank financial institutions in Jamaica as of September 30, 2000 is given in Report No. P7397 JM:

[18] The VMBS deal has been agreed upon in writing and finalization of legal documents is expected shortly (by end-September), while the other two transactions are at an advanced stage, expecting completion before the end of 2002.

Report and Recommendation of the President for the first Bank Restructuring and Debt Management Program Loan[19]. Annex IV of this document provides details on recent developments in the regulation and supervision of the banking sector since September 30, 2000. Annex V and VI of this document discuss details of the institutional structure of the insurance sector (the most significant of the non-bank financial institutions in Jamaica) and its regulation and supervision respectively.

Actions in the banking sector supported by the Bank's first loan

34. Following on several critical improvements of regulation for the banking system made since 1997, the Bank's first loan supported several actions of the Government in continuing to strengthen that regulatory and supervisory regime. Legislation empowering the BOJ to intervene in distressed financial institutions without the Finance Minister's approval was drafted. Cabinet approval was obtained to amend bank secrecy provisions to permit exchange of information between local financial regulatory agencies. The BOJ issued an updated "Ladder of Enforcement" to supervised entities, which incorporated the 1997 amendments into the previously circulated document that clarified steps in the intervention process. The BOJ, which had already undertaken a self-assessment of its compliance with the Basle Core Principles in 2000, agreed to undertake an independent assessment in 2001. The Government committed to make its best efforts in obtaining Parliamentary approval of legislative changes approved by the Cabinet in critical areas identified in the assessments.

Actions in the banking sector to be supported by the Bank's proposed second loan

35. Since the approval of the first loan, the BOJ has continued to strengthen its supervisory capabilities. It is widely acknowledged by supervised institutions that the scrutiny performed by the BOJ has dramatically improved since the crisis (see Annex IV for a summary).

36. In line with its commitments to the Bank, the BOJ undertook an independent assessment of its compliance with the BCP in 2001. The IMF led the assessment team with participation from staff of the Financial Services Authority of the UK and the Bank of Sweden. The assessment concluded that the BOJ is fully compliant with 11 principles, largely compliant with 8, materially noncompliant with 5, and noncompliant with 1. Thus, Jamaica shows a satisfactory level of compliance with the BCPs. Areas of weaknesses identified by the assessment relate to independence of bank supervisors, consolidated supervision, remedial measures (as impacted by BOJ's limited autonomy to take action), and market and country risks. In relation to market and country risk, the IMF-led team also acknowledged that work which had already proceeded apace under the BOJ's action plan arising from its earlier self-assessment would result in material upgrading in this area in the short term. Based on this assessment, the BOJ updated its earlier formulated action plan and implemented specific proposals to address areas of weakness. The main actions undertaken by the BOJ include the drafting of prudential regulations on country risk, market risk and consolidated supervision as well as IMF-sponsored technical assistance initiatives on market risk and consolidated supervision. The technical assistance received also included some training of supervisory staff in the areas of market risk and consolidated

[19] Although not repeated here, the discussion in Report No. P7397 remains relevant to the proposed loan.

supervision. The BOJ has also undertaken other training initiatives in the area of market risk, which have involved training of several senior examiners by the Federal Reserve Board, and specific assignments of such senior officers at Federal Reserve Banks on Market Risk examinations.

37. As part of the actions to be supported by the Bank's proposed second loan, the relevant legislation was amended to enable BOJ's compliance with two of the five BCPs (relating to consolidated supervision and remedial measures) in which Jamaica was found to be materially non-compliant.

- The BOJ was granted the necessary powers to carry out consolidated supervision, including extended jurisdiction over non-banking institutions integrated in banking groups. In addition, MOUs were signed among the two main financial supervisory agencies (BOJ and FSC), the Jamaica Deposit Insurance Corporation, and the Ministry of Finance, which gave legal underpinning to the formation of a coordinating body, the Financial Regulatory Council (FRC), chaired by the Governor of the BOJ. This Council commenced meetings in December 2000 and has issued reports to the Finance Minister;
- The BOJ was granted the power to require the restructuring of a group of companies to ensure that financial and non-financial activities are segregated in different sub-groups within an economic group so as to reduce the possibility of contagion;
- The BOJ was granted the power to require the segregation of non-banking activities in banks by the transfer of those operations to a separate corporate entity;
- The BOJ was given the power to impose penalties in cases of specified technical breaches of the banking statutes and the schedule of fines and penalties was upgraded;
- Powers of temporary management of deposit taking financial institutions were transferred from the Minister of Finance and Planning to the BOJ; and
- The categories of exemptions to bank secrecy laws were extended to permit disclosure of information where it is in the specific bank's interest that the information be disclosed (example for the purposes of the acquisition of the bank by outside parties).

38. To achieve compliance with the issue of independence of the supervisor, amendments to various statutes were introduced in March 2002 transferring from the Minister to the BOJ the power of temporary management; the Minister retains powers of approval and revocation of licenses, final determination on persons debarred from bank management, vesting the shares of an intervened institution and other regulation making powers. Similar to the reform of the process for determining fit and proper criteria pursuant to the granting of new licenses, the Minister is now also required to obtain the prior positive recommendation of the BOJ when authorizing the change of control of a deposit-taking institution or a banking group.

39. To achieve compliance with the two other core principles (relating to investment criteria and market risks) with which the BOJ is also materially non-compliant and, more generally, to strengthen the overall regulatory framework, the BOJ has proposed the introduction of further amendments to legislation including: (i) streamlining the provisions relating to the acquisition of interest in deposit-taking institutions and introducing new definitions of "control", "subsidiary", "parent company", and "capital base"; (ii) requiring institutions to notify the BOJ of any proposed acquisition of any other company and prior to undertaking of any new type of business, with the BOJ reserving the right to veto such acquisition or undertaking; (iii) requiring

shareholders of institutions to advise of any transaction which will increase a shareholder's holdings by incrementals of 5 percent or more, or will increase the shareholder's holdings to 20 percent, 50 percent or 75 percent or more of voting power or issued shares; requiring institutions to advise the BOJ of any investment or credit facility in excess of 5 percent of the capital base; and (iv) introducing a new definition of capital.

40. The BOJ has continued to update the ladder of enforcement (*"Guide to Intervention of Supervised Financial Institutions"*) that clearly spells out to the industry the supervisory approach of the BOJ, aimed at (i) recognizing areas of concern at an early stage, (ii) enabling prompt action to effectively contain the problems, and (iii) taking the appropriate steps to sort out the problems and minimize any systemic effects. This guide includes the sanctions that will be imposed by the BOJ or that the BOJ will refer to the relevant sanctioning body.

41. These amendments have corrected the shortcomings in the present legal framework that prevented Jamaica from fully complying with the BCPs. Hereafter, compliance with the principles would be accomplished through progressive implementation of the new laws, including new regulations and supervisory procedures, which the BOJ has started to implement. Although currently banks in Jamaica are not largely exposed to country and transfer risk (BCP 11), the BOJ has issued to the industry a guidance document on such risks that is now in force. The industry has effectively implemented this standard and this will make Jamaica compliant with this particular BCP.

42. As discussed above, a Financial Regulatory Council has been formed to improve the coordination among supervisors of different type financial institutions. Amendments to relevant laws to permit information exchange between supervisors have been approved by the Parliament. The FRC facilitates sharing of information and aids in the process of harmonization of important regulations (risk-based capital adequacy, reporting requirements, reserve requirements, crisis-intervention policies) to reduce the possibility of regulatory arbitrage.

43. With all the changes in banking laws and regulations introduced since the crisis, there is an acute need for consolidation and harmonization of the various pieces of legislations governing the deposit-taking system, amendments, and regulations so as to remove material inconsistencies, which now exist. Such consolidation would provide a clearer and cleaner framework for future operation of the banking sector. The Government has agreed that it will present an Omnibus banking statute to Parliament that will achieve this objective in 2003. The BOJ has already made proposals for the drafting of this law. This new Omnibus law will also upgrade BOJ's guidelines on minimum policies and procedures that it expects licensed institutions to comply with, and the "Standards of Best Practice", which have already been implemented, to the status of enforceable regulations.

44. The BOJ has also made proposals to the Government to address within the Omnibus law, other recommendations for legislative amendment included in the BCP to appropriately strengthen the regulatory framework, such as the introduction of specific regulation of leasing activities, the requirement that credit to related parties are extended on arms length basis, and the like.

Future reform agenda in the banking sector

45. Strengthening regulation and supervision in the banking sector is a continuous process and the BOJ is committed to ensuring that its institutional capacity stays in line with international best practice. At present, the BOJ is in the process of updating current policy and procedural manuals as well as designing and preparing inserts/manuals for the new areas under development (e.g. market risk, consolidated supervision), developing more robust and responsive information systems and systems of supervisory reporting, and continually upgrading its staff training program. It is also far advanced in its work on the development and implementation of a supervisory framework for credit unions and the development and implementation of a framework to evaluate market risk for financial institutions. BOJ staff has continued to take advantage of the US Federal Reserve Board's training programs for supervisors to upgrade their capacities and skills. The guidance document on consolidated supervision has been drafted, and is now being discussed with the industry.

Actions in the non-bank financial institution sector supported by the Bank's first loan

46. Recognizing that poorly regulated non-bank financial institutions – especially insurance companies – played a key role in precipitating the financial sector crisis, the Government took several steps to improve the regulation and supervision of non-bank financial institutions, which were supported by the Bank's first loan. Cabinet approvals for a new Insurance Act and amendments to several laws to permit exchange of information between regulators were obtained. The Jamaican Cabinet approved the formation of a new Financial Services Commission (FSC) with regulatory and supervisory responsibilities over all non-bank financial institutions –specifically insurance, securities, and pensions. A new Insurance law that addressed many of the weaknesses of the past and provided a sound basis for the future development of the industry was drafted and presented to Parliament. The Government prepared a "Green Paper" (and since drafted a "White Paper") on pension reforms and began the process of consultation with stakeholders on reforms to the pension system. The Government committed to make its best efforts to obtain Parliamentary approval of the above legislative measures. Since then, the Pension Act has been drafted to facilitate the supervision of pension administration by the FSC.

Actions in the non-bank financial institution sector to be supported by the Bank's proposed second loan

47. The proposed second loan supports several actions taken by the Government after the approval of the first loan to further strengthen the legal, regulatory, and supervisory framework for the non-bank financial institution sector.

- The new Insurance Act has been enacted.
- The Financial Services Commission has been established and is functioning. The old Securities Commission and Office of the Superintendent of Insurance have been closed and the FSC has taken over responsibility of regulating and supervising participants in the securities and insurance industry.

- The FSC has undertaken steps, in discussion with the Bank, to further strengthen its institutional capacity. It has put in place a framework for risk based supervision and its staff has been trained to conduct such supervision. A consultant hired by FSC is in the process of designing the appropriate framework for financial solvency analysis.

Future reform agenda in the non-bank financial institutions' sector

48. The Jamaican authorities have invested a lot of time, money and skills in updating the regulatory and supervisory framework for insurance since the financial crisis. The new insurance law and regulations are of high quality and they successfully address internationally accepted principles of insurance supervision. The law is highly detailed and sophisticated and will require substantial effort on the part of the new supervisory authority to implement it. As conceived, the FSC is likely to successfully and independently discharge its functions.

49. Over time, and after gaining substantial experience with the FSC and its operations, the Government will need to address certain areas to further strengthen insurance regulation and supervision and move it further towards international best practice (see Annex VI for details). As part of its ongoing program of strengthening regulation and supervision, the Government has agreed to take the following actions to further strengthen the insurance sector's regulatory framework:

- Although the FSC is structured to be largely independent, international best practice suggests that its independence from political intervention can be further improved through consultation with other boards or agencies and representatives of the insurance industry in the appointment of at least one member of the FSC's Board.
- Currently, the Insurance Act sets out the bases on which a license can be refused. Additional powers should be granted to the supervisory authority to enable it to refuse a license on the basis of an economic study, independent of the projected business plan, which addresses the question of financial viability of the new entrant.
- The rules regarding changes in control (acquisitions, transfer and amalgamation) of insurance providers need to be harmonized with the relevant licensing requirements.
- Regulations that better define standards (i.e., international ratings) for selection of foreign re-insurers, including the creation of a registry of admitted re-insurers that comply with such standards need to be revised.
- Regulations to monitor market conduct principles and to protect policyholders interests (fair treatment) need to be issued.

C. Establishment of Credit Bureaus

50. An important component of the infrastructure of a modern financial system is a centralized credit bureau through which relevant information of debtors would be available to financial institutions and other third parties, with adequate safeguards for protection of privacy. Such a bureau permits financial institutions to better manage credit risk exposures to borrowers as well as permitting the supervisor to better monitoring credit risk of supervised entities. A centralized credit bureau does not yet exist in Jamaica. The Government (as well as the banking sector participants) recognizes the importance of such an entity for the future growth and

development of the Jamaican financial market. As part of the actions to be supported by the proposed second loan, the Government has drafted a Credit Reporting Act for the creation of Credit Bureaus in Jamaica and submitted it for public consultation prior to its presentation to Parliament. This draft Credit Reporting Act provides for the licensing by the Minister of Finance of credit bureaus, with prior recommendation of the BOJ. It also spells out the conditions and limits for the disclosure of information, the form and content of consumer information, as well as the offenses and penalties for breaching of the law. Credit bureaus are to be considered as credit institutions, thus subject to the scrutiny of the BOJ, the FSC, and the MOF; managers and directors should comply with fit and proper provisions.

D. The Government's Strategy to Manage Public Debt Arising from the Financial Sector Crisis

51. The Government recognized the critical role of a sound public debt management strategy for the sustainability of the economy as a whole as well as for the sound functioning of the financial sector. The Government laid out its overall public debt management strategy in the April 2000 SMP. An integral part of this strategy is the approach to managing FINSAC debt arising out of the financial sector crisis.

Actions supported by the Bank's first loan

52. The cornerstone of the Government's strategy to manage the financial sector crisis related debt has been to explicitly recognize the financial cost of the crisis, managing FINSAC debt and improving the liquidity of the financial sector through replacing illiquid FINSAC notes with "performing" Treasury Bonds (Locally Registered Stock or LRS). As part of the Bank's first loan, the Government committed to convert all outstanding FINSAC debt to LRS and service this debt in cash effective April 1, 2001. The Government also obtained Cabinet approval for restructuring a portion of the FINSAC debt held by other public sector agencies. It wrote off about J$19.4 billion of debt held by the MOF. It also agreed on a restructuring plan for J$28.55 billion of FINSAC debt held by the BOJ (arising from the BOJ's provision of liquidity to banks in distress during the crisis) –inclusive of interest accrued until March 2001. The Government implemented all of its agreed upon actions by the agreed upon dates, except the one relating to FINSAC debt at the BOJ.

53. The principal reason for the delay in the resolution of the FINSAC debt at the BOJ related to the BOJ's position that the commitment made by the Government in the first loan, if not accompanied by other measures, would significantly impair the profitability of the BOJ in the medium term (See Annex VII, which includes the 2001 audited balance sheet of the BOJ). Concerns regarding profitability increased after the approval of the first loan due to the large open market operations of the BOJ to mop up liquidity as a result of rapidly accumulating external reserves. Therefore, despite the fact that the Government provided the Bank with a resolution of Cabinet and a letter from the BOJ and MOF outlining a mechanism to address the FINSAC bonds at the BOJ prior to the approval of the first loan, and although it authorized the BOJ to offset a portion of FINSAC bonds against its deposits at the BOJ, this was not implemented until recently. The Government, however, was keenly aware of the fact that the issue needed to be resolved prior to Board consideration of the proposed second loan.

54. In August 2002, the MOF and the BOJ reached agreement on a revised mechanism to address the FINSAC debt at the BOJ and a broader plan to restore BOJ finances, which includes the following actions:

- As per previous Cabinet approvals: (i) J$13 billion in FINSAC bonds has been offset against MOF deposits at the BOJ; (ii) the balance principal amount of J$15.5 billion in FINSAC bonds at the BOJ as of March 31 2001 along with J$3.2 billion of accrued interest up to March 31, 2002, were converted into Government securities paying market interest rates. This interest will be capitalized (fresh instruments at interest rates will be issued in lieu of cash interest payment) until 2007/08.
- The BOJ had receivables on its books from the Government amounting to J$8.3 billion, carrying below market rates of interest (see annex VII). This amount has been converted into Government securities earning market rates of interest. The interest on this instrument will also be capitalized until 2007/08.
- The BOJ has J$2.2 billion of zero-coupon LRS on its books. The Government has agreed to redeem these in cash prior to April 1, 2003.
- Any losses sustained by the BOJ in subsequent period will be settled, in accordance with the Bank of Jamaica Act, by the issuance of LRS. The effective date for the issuance will be April 1 of the year immediately following the calendar year in which the loss is sustained. Interest will be paid on a semi-annual basis at the prevailing 6-month Treasury Bill rate plus 1.50 percentage points, capitalized until 2007/08.

55. The above mechanism addresses the BOJ's concern regarding its profitability while increasing transparency through recognition of debt already in BOJ's books. Conversion of all low-yielding assets to securities paying market rates of interest would assist in bringing the BOJ back to profitability (on an accrual basis) in the medium term, under the monetary policy regime outlined in the SMP. Since after the restructuring all securities held by the BOJ consist of liquid securities yielding market rates of interest, its ability to conduct sound monetary policy will not be adversely affected. The proposed solution is a compromise reached between the MOF and the BOJ on the issue of resolution of FINSAC debt at the BOJ, within the commitments made by the Government to the Bank under the first loan. In essence, it converts quasi-fiscal losses to explicit government debt. The proposed solution does have some adverse implications as it contributes to further weakening the overall fiscal position, adds to the debt stock on an up-front as well as an ongoing basis, and delays the achievement of sustainability in public debt dynamics. The Bank, however, recognizes the constraints faced by the Government and appreciates that there were only a few degrees of freedom within which the Government can operate.

56. Any resolution of the FINSAC debt at the BOJ would have had implications on three major policy variables: (i) If the debt were to be retired or serviced in cash, in whole or in part, the Government would have had to find additional resources from within an already extremely tight fiscal program; (ii) If the debt were to be converted to securities paying market interest rates and the debt service is done through issuance of fresh market-rate yielding Government securities, the Government's stock of public debt – on a one-off and on an ongoing basis – would have increased. The level of public debt to GDP ratio would be higher and the trend of its decline would be less steep than earlier envisaged; and (iii) Relaxing monetary policy through

permitting larger, albeit moderate, depreciation (and potentially lower interest rates) would be another way to improve BOJ profitability, while enhancing competitiveness and growth potentials. However, this has adverse implications in terms of the Government's overall macroeconomic program under the SMP as well as having negative impacts on its servicing of foreign debt. Under the constraints, therefore, the Government has chosen a resolution mechanism that places emphasis on the first two items above – redemption of part of the debt in cash and accruing the balance at market rates but temporarily capitalizing interest.

Actions to be supported by the Bank's proposed second loan

57. Previously mentioned above, as a result of the actions supported under the first loan, with the replacement of the FINSAC paper at the BOJ with Government securities, there is no FINSAC debt outstanding in Jamaica –as reported in the Letter of Sector Development Policy (Annex II). The Government has explicitly recognized the cost of the crisis by taking all FINSAC debt on to its own books and is continuing to service all such debt held by the private financial institutions in cash.

58. The Government redeemed for cash J$7.6 billion in FINSAC/FIS bonds mostly held by third parties other than NCB, Union Bank, and LOJ. All remaining FINSAC/FIS bonds were replaced by LRS. The maturity structure of the debt was significantly lengthened in the replacement process. In the case of Union Bank, 83 percent of the FINSAC debt had maturity before 2006 as of March 31, 2001; however 100 percent of the bonds replaced by LRS have maturity between 2006-2016 and 70 percent of the replaced bonds mature after year 2011. The average interest rate on the earlier FINSAC bonds declined by one percentage point and it is now equal to the Treasury bill rate, with most US bonds remaining at their original fixed rates. The Government designed the swap of bonds at NCB (effective April 1, 2001) following a structure consistent with the Government's goal of improving its debt management. This had a sizeable impact due to the larger size of NCB, particularly since after replacement, 18 percent of bonds at NCB mature by 2005 and 24 percent by 2008, while the remainder matures between 2011-2012. The Bank's proposed second loan will support the continued servicing of this debt in cash.

59. In addition to the restructuring of FINSAC's debt held by the BOJ (supported by the first loan), the proposed second loan will support the following actions taken by the Government to improve BOJ's profitability: (i) replacement of J$ 8.3 billion in advances and other receivables from the Government (below market securities related to previous BOJ losses) with marketable securities, (ii) commitment to redeem in cash J$2.2 billion in non-interest earning securities during FY 2002/03, and (iii) commitment to settle any losses sustained by the BOJ in subsequent periods through the issuance of marketable Government securities. Interest accrued on the replacing securities will be capitalized with the issuance of Government securities until FY2007/08.

E. The Government's Strategy to Manage Overall Public Debt

60. As of March 31, 2002, the total non-financial public sector debt of the Government (excluding BOJ and net of non-financial public sector holdings of FINSAC paper, LRS, and other securities) amounted to J$485.5 billion (130.6 percent of GDP). Of this amount, domestic

debt (including FINSAC debt) amounted to J$290.8 billion or 78.2 percent of GDP. External debt accounted for J$194.7 billion or 52.4 percent of GDP[20]. As discussed in para. 10 and the CAS Progress Report (CAS PR) that accompanies this loan, this level of debt as a percentage of GDP remains very high, and has not declined as anticipated, even though it has stabilized over the last two years. However, this is after accounting for additions of 22 percentage points above that anticipated in the April 2000 SMP, reported in the May 2001 SMP (see paras. 64-66).

61. The broad objectives of the Government's debt management strategy over the medium term are to meet its annual borrowing requirements and reduce the debt service burden to sustainable levels. The Government strategy to achieve these goals is to maintain a prudent debt structure, further diversify the debt portfolio, increase reliance on market-determined instruments for domestic debt issuance, promote and build a liquid and efficient market for government securities, increase the transparency and predictability of primary market debt issuance, and continue to implement policies leading to lower interest rates and faster GDP growth.

62. The Government has been increasing the share of fixed rate debt in the domestic market, which was less than 15 percent in FY2000/01, increased to 44 percent in 2001/2002, and is expected to reach 60 percent in the medium term, more in line with international best practices. It also continued to reorganize the domestic debt stock towards longer-term instruments by replacing maturing Treasury Bills and other short-term debt securities with longer-term instruments. During FY2001/02, the stock of outstanding T-Bills declined 39 percent and the maturity profile of new LRS lengthened helped with the auction of the first 12-year LRS[21]. As a result, at end FY2001/02, 15.5 percent of the new debt issued had a maturity of 10 years and over compared with 14.3 percent at the end of FY2000/01. The Government's strategy to replace higher cost domestic debt with relatively lower cost foreign debt (under only modest depreciation of the Jamaican Dollar) is reflected in the increase in the share of external debt from 48.3 percent of GDP as of March 2001, to 52.4 percent of GDP at end-March 2002 (out of a total debt to GDP ratio of 130.6 percent). This reflects bond issues in the international capital markets as well as net inflows from IFIs, which are long-term funds at relatively lower rates. In response to the effects of the September 11, 2001 attacks, and the flood damage caused by Hurricane Michelle, the Bank provided US$75 million through the Emergency Economic Rehabilitation Loan, and the IADB provided US$40 million through a social sector loan during the year.

63. Management of this extremely high level of public debt will continue to remain a major challenge going forward. The data indicates that the Government has had limited success thus far in achieving planned reductions in public debt. The Government's debt to GDP ratio is higher than envisaged in the April 2000 SMP and the rate of decline projected at present is slower than that envisaged earlier. Unexpected external shocks, upward revisions in estimates of liabilities, as well as the resolution of BOJ's deteriorating finances (beyond FINSAC debt held at the BOJ) have all contributed to increases in public debt (see the CAS PR for details).

[20] Of the domestic debt, outstanding FINSAC/FIS securities –the remaining balance at the BOJ net of the offset of J$13 billion against Government liabilities at the BOJ— accounted for 4.2 percent of GDP.

[21] About 74 percent of new LRS issued in FY 00/01 had maturities of 5 years and over, compared with 43.6 percent of new issuance in the previous FY99/00.

64. Public sector debt stabilized at around 132 percent of GDP in 2000/01. As reported in the SMP completed in May 2001, the larger than projected level of debt was about 22 percentage points of GDP above the April 2000 SMP estimates. Around 1 percentage point of this difference was explained by lower growth and by the larger overall deficit of the non-financial public sector than earlier projected. The remaining difference reflected (i) the assumption of previously off-balance sheet items in the privatization process as debt and lower sale proceeds than anticipated; (ii) valuation effects resulting in part from the larger than expected depreciation of the Jamaican dollar; (iii) previously unforeseen debt that has been assumed and/or guaranteed by the Government; (iv) higher than expected capitalized interest on Financial Sector Adjustment Company (FINSAC) securities; and (v) the accounting treatment of FINSAC bonds held by the Bank of Jamaica (since resolved). Of the total debt outstanding as of end-March 2002, 52 percent was external. Of domestic debt, around three quarters was at floating interest rates and 10 percent U.S. dollar linked (including FINSAC securities in U.S. dollars).

65. The vulnerable fiscal situation in Jamaica is reflected by the high level of debt, weak growth, high real interest rates, severe compression of non-interest expenditures and little scope for raising already high taxes, large debt service obligations falling due over the next years, and a dependence on continued access to international capital markets. A stabilization and reduction of the debt to GDP ratio will require an ambitious and sustained adjustment effort, requiring continued very high levels of primary surplus. But the situation will continue to be precarious in the short-to-medium-term. As Annex C of the CAS PR shows, a fairly narrow range of parameter values can result in either a sustained decline in the debt to GDP ratio, or a continuous increase. Thus, if output were growing at 4 percent, real interest rates were 6 percent, and the primary balance were 10 percent of GDP, the debt burden would be more than halved over ten years, while a 2 percentage point deterioration in all these parameters would result in a failure to reduce the debt burden.

66. Inclusion of the effect of the BOJ resolution increases the accounting of the debt by 3 percentage points of GDP upfront (in 2002/03) and thereafter by about 1.5-2 percentage points of GDP per year for the medium term (See Table 3, CAS PR). The upfront increase arises from making explicit a quasi-fiscal loss of the BOJ prevailing for several years. The overall impact of the BOJ resolution is to make the declining path more gradual, with a reduction in the revised debt to GDP ratio from 130.6 percent in 2001/02 to 108.4 in 2005/06.[22]

67. The high level of public debt poses a significant risk to the stability of the banking sector. A large portion of commercial bank assets in Jamaica are Government bonds –obtained as a result of FINSAC interventions as well as through banks' own investment activities. As long as this debt is satisfactorily serviced, the banking sector is likely to remain sound. However, any difficulties in debt service are likely to be transmitted rapidly to the banking sector, impair their assets and hence place the capital adequacy and solvency of the sector at risk.[23] It is important to note that through strong efforts of the Government, the financial sector has been restored to

[22] However, based on a symmetric treatment of BOJ losses of previous years (as noted in footnote 5 above), the debt to GDP ratio declines from 135.2 percent in 2000/01 to 132 percent in 2001/02, and then is projected to decline to 108.4 percent in 2005/06 (Table 3 in CAS PR).

[23] The large share of Government bonds in total bank assets (with a risk-weight of zero) enables higher risk-adjusted capital ratios. However, in the event of deposit withdrawals, banks would have a limited capital cushion to withstand risks.

health and regulation has largely brought up to international standards. The key weakness of the banking sector, however, is its large exposure to Government debt. This exposure is likely to remain high for quite some time, until sustained economic growth permits banks to build up significant, good quality, loan assets. Hence, the Government's continued ability to service its large debt is key to the soundness of the banking sector.

68. Going forward, it is clear that high primary surpluses along with sound monetary and exchange rate policy that secure adequate external competitiveness to support growth while maintaining low inflation will need to continue to be maintained in addition to ensuring that no additional liabilities are taken on by the Government in order to put the public debt stock on a sustainable and declining path.

F. Regulations against Money Laundering

69. Since 1997, among several critical regulatory improvements in Jamaica, tighter procedures against money laundering have been introduced. Drug money laundering had been declared a criminal offense by virtue of the Money Laundering Act (MLA) passed in 1996. Supporting regulations were issued in 1997. Guidance Notes on Money Laundering, which are intended to bring to the attention of financial institutions the minimum standards required of an effective program to detect and deter money laundering, were also issued by the BOJ, in consultation with the industry, in July 2000. These Notes, which are being periodically updated, are comprehensive and set out policies and procedures as required under legislation and include procedures for voluntary reporting and provide examples of suspicious transactions.

70. Jamaica is a member of the Caribbean Financial Action Task Force (CFATF), a regional initiative to achieve the effective implementation of, and compliance with, the 40 Financial Action Task Force (FATF) Recommendations and the 19 CFATF Recommendations. Under the aegis of CFTAF, Jamaica undertook an evaluation of the implementation of the Kingston Declaration of 1999 that pointed out two shortcomings of the Money Laundering Act: the failure to criminalize non-drug money laundering and the omission to create an obligation on financial institutions to report suspicious transactions. Both these omissions have since been addressed through legislative amendments. Jamaica is not among the 19 non-cooperative countries or territories in the international fight against money laundering identified by the FATF.[24]

71. Jamaica is continuing its efforts to further improve financial sector transparency and has initiated the process of compliance with UN Security Council Resolutions 1373 and 1377, by initiating introduction of legislative amendments needed to address tax evasion and the financing of terrorist activities. An Executive Order has been issued to designate remittance companies as financial companies under the MLA. Also, under the MLA, financial institutions (including insurance companies) are required to report any suspicious transactions including those above a specific threshold. A Financial Crimes Unit (FCU) has been established, and now functions under the Ministry of Finance, while liaising with the Directorate of Public Prosecutions to investigate financial crimes. In addition, the BOJ and other financial sector regulators perform supervisory roles in their respective industries. The FCU is receiving training as part of the CDB

[24] Source: http://www1.oecd.org/fatf/NCCT_en.htm

technical assistance program. Also a specialized Commercial Court has been created, which is expected to expedite prosecution of civil cases against money launderers.

IV. EVALUATION OF THE FIRST BRDP ADJUSTMENT LOAN

72. Several evaluations of the first BRDP Adjustment Loan were carried out, including a review of the loan by the Quality Assurance Group (QAG), an Implementation Completion Report (ICR) for the loan circulated to the Board on December 21, 2001,[25] a review of the ICR by the Operations Evaluation Department (OED), as well as a review of the loan undertaken as part of the Bank's preparation and due diligence for the proposed second loan. The following is a brief evaluation of the first loan, based on these reviews.

73. A panel of QAG reviewers assessed the first phase of the BRDP in August 2001. Overall, the panel found the quality at entry of this operation, as well as the eight quality dimensions of the operation to be "Satisfactory" and the Bank Input and Processes to be "Highly Satisfactory." The panel's view was that the program is likely to meet its development objectives, despite considerable risks. However, it expressed some concern about the sustainability of the operation as the financing made available by the Bank was limited relative to the large need of funds by the country, which would constrain the country's ability to maneuver in the event of further domestic or external shocks. Still, the panel accepted the view that on balance, not providing any support would probably have been worse. The panel's report classified the operation as high-risk/high reward, commending several aspects of the loan including: (i) the large degree of collaboration with the IMF at the operational level in designing the macroeconomic elements of the program and with the IDB on sector aspects; (ii) adequate timing, by providing support after a gap of three years as well as after ensuring the Government's ownership of the program; and (iii) extensive assessment of underlying risks and consequently, adequate choice of lending mechanism through a programmatic approach, particularly given the Bank's disappointing past experience in the country.

74. A detailed assessment of the Bank's first loan prepared as part of the ICR found that, overall, the Bank's experience with the first loan was satisfactory. The loan supported actions that had already been completed by the Government prior to Board consideration as well as commitments of the Government to undertake several actions after Board approval. With the notable exceptions of its inability to meet baseline scenario targets in the SMP regarding overall public sector debt and the handling of FINSAC's debt at the BOJ, the Government had since implemented all of its commitments to the Bank.

75. The OED's evaluation of the ICR concluded that the Government had reached concrete goals in all the major areas specified in the loan with actions that would be hard to reverse. The OED rated the outcome of the project as "Satisfactory", with institutional development as "Substantial" and a sustainability rating of "Likely". The Bank's performance and the Borrower's performance were rated as "Highly Satisfactory" and "Satisfactory", respectively. The OED assessment lists several "lessons of broad applicability". First, a strong government commitment and ownership of the program--particularly in publicizing the strategy to internal and external constituencies--was critical to the success of its first phase. Second, the choice of

[25] Report No. 23336.

single tranche programmatic loans, building on the lessons of previous Bank experience with Jamaica, was key to restoring operational relations with the country by concentrating first on compliance with attainable short-term objectives and avoiding locking the client into an overly ambitious, politically sensitive, more rigid medium-term agenda. Third, close collaboration between the Bank and other IFIs allowed the Bank's more conservative views to be incorporated into the SMP and enabled the Bank to build on the work of the IDB.

76. Despite the overall satisfactory experience, however, three specific areas supported by the first loan faced unexpected difficulties, of which two – the sale of Union Bank and the issue of FINSAC debt at the BOJ – have since been resolved. The third – relating to evolution of the public debt – remains the major risk faced by the Government's BRDP and the Bank's loans in support of the program.

Sale of Union Bank

77. Prior to Board consideration of the first loan, the Government had provided the Bank with a signed sale contract in which RBTT Holdings had agreed to acquire Union Bank. Despite the fact that there were certain – mostly fairly standard – conditions precedent stipulated in the terms of the sale contract, the Bank considered the signed contract as adequate evidence of the sale of Union Bank. However, the final transfer of ownership of UB from FINSAC to RBTT was delayed until March 2001. This was mainly because the difference between prevailing market interest rates and those on LRS being offered to RBTT in exchange for FINSAC bonds lowered the valuation of the bank. Although the signed sale contract gave no room for negotiation on the interest rates on LRS, a final decision on the maturity structure of LRS had not yet been made, which enabled RBTT to reopen negotiations. The final resolution in March 2001 preserved the maturity structure originally proposed, which together with the lower interest rate on the replacing LRS enabled the Government to substantially improve its debt service profile. The Government, in turn, accepted a lower sale price for the bank and provided a letter indicating its willingness to cash LRS to meet UB liquidity needs upon receipt of a three months notice. Since March 2001, RBTT has been fully in charge of UB – although having been effectively involved in its management since December 2000. The bank is in the process of upgrading its information systems, staff capacity and skills, and has restarted fresh lending.

Restructuring of the FINSAC paper at the BOJ

78. As discussed above, the Bank's first loan supported the Government's actions aimed at restructuring FINSAC paper at the BOJ. The total amount of this paper as of March 31, 2001 was J$28.6 billion. The Government provided the Bank with an agreement signed by the MOF as well as the BOJ indicating that J$13 billion of the FINSAC paper would be offset against deposits of the Government held at the BOJ. In this regard, immediately thereafter, the Government authorized the BOJ to use the J$13 billion of Government deposits for the offset. For the balance of J$13.2 billion plus interest accrued until March 2001 (or J$15.6 billion), the Government would issue special LRS to the BOJ. The interest rate on these special LRS would be variable and computed in a manner to ensure that the BOJ did not incur cash losses. The implementation of this agreement was, however, delayed until August 2002, while broadened in scope. The principal reason for the delay in the resolution of the FINSAC debt at the BOJ

related to the BOJ's position that the commitment made by the Government in the first loan, if not accompanied by other measures, would have significantly impair the profitability of the BOJ in the medium term. The issue has since been resolved and a detailed discussion of the resolution mechanism is included in paras. 54-56.

Evolution of public debt

79. The Bank's first loan supported a commitment by the Government to ensure that its overall public sector debt in Jamaican dollar terms would be consistent with the base case scenario of the SMP. The objective of this commitment was to ensure that the growth in Jamaica's overall public sector debt was initially arrested and that subsequently, the public debt would be put on a declining and sustainable path. Despite an impressive policy effort, the Jamaican economy remains highly vulnerable with a large debt overhang (about 131 percent of GDP), which has reduced only fractionally since the formulation of the April 2000 SMP. Its evolution, the reasons thereof, and implications have been discussed above in paras. 64-66. Successful management of public debt is the most important challenge facing the Government.

V. BANK ASSISTANCE STRATEGY

A. Country Assistance Strategy (CAS)

80. The last CAS for Jamaica (Report no. 21187-JM) was discussed by the Board concurrently with the Bank's first BRDP loan on November 30, 2000. An update, which keeps the Bank's strategy largely unchanged for the next twelve months, is being presented to the Board concurrently with the proposed second loan. The CAS PR proposes that new Bank lending be limited to the two projects already identified in the last CAS – of which the proposed second BRDP loan is one –as well as one other project identified in the aftermath of September 11. The last CAS identified that the resolution of remaining financial sector problems is necessary for restoring growth and thereby employment opportunities. By allocating resources efficiently, well-functioning financial systems play a key role in the process of economic growth. The financial crisis has significantly impaired the Jamaican financial sector's ability to play that role. In Jamaica, moreover, the financial sector itself accounts for a significant fraction of GDP (15 percent in 2001), so a decline in value added originating in the financial sector has a major impact on overall growth. The vision of the Government's strategy to restructure the financial sector is that this will lead to greater competition, foster development of strong and well-capitalized financial institutions, and reduce the vulnerability of the system to future crises. This, in conjunction with a tightened fiscal stance and a resultant decline in interest rates, is expected to improve financial intermediation and enable the private sector to draw on a higher share of the considerable domestic savings to fuel higher growth.

B. Rationale for Continued Bank Adjustment Lending to the Financial Sector

81. The last CAS envisaged that a base-case assistance program for Jamaica would involve two adjustment loans to the financial sector of US$75 million each. The CAS PR provides an update on the implementation of the CAS discussed in November 2002 and proposes a continuation of the current strategy for an additional period of 12 months. The proposed lending

program of US$130 million includes the proposed second loan addressing the financial sector crisis in Jamaica, which was the second operation included in the last CAS. There is strong rationale for the proposed Bank assistance to the financial sector in Jamaica at this stage. First, resolution of the financial sector crisis is essential if the Jamaican economy is to achieve sustained economic growth in the future. Actions supported by the Bank's first loan went part of the way towards resolution of the crisis. The proposed loan would assist in taking the process near completion. Second, the Government has continued to strengthen its fiscal policy stance, despite adverse circumstances. IMF staff assessed the SMP to be broadly on track until September 2001, although public finances have significantly worsened since then, largely as a result of external shocks. The Government has responded by reaching agreement on a fresh one-year Staff Monitored Program with the IMF covering FY2002/03. Third, the Government has demonstrated its commitment to move the financial sector crisis resolution process to completion through its actions taken prior to and since the approval of the first loan. While the financial sector does face significant risks, a strong foundation has been laid for future development of the sector. Fourth, the Bank's experience in the first BRDP loan has been satisfactory. With the notable exceptions of the continued capitalization of interest on Government debt at the BOJ and less than anticipated reduction in the overall public sector debt, the Government has met all of its commitments under the first loan.

82. It is important to recognize that restoration of solvency and soundness to the banking system is a long-term goal that goes beyond a single operation. Past Bank experience in other countries (for example, in Mexico) has shown that it is more realistic to support a program of reforms with programmatic sector loans, involving a number of sequential operations that can be approved based on the success of the previous ones[26]. Therefore, the Bank's strategy in the financial sector in Jamaica has been to undertake a series of operations in a programmatic context, each focusing on distinct policy measures and actions that, taken as a whole, would contribute to the strengthening of the financial sector and supporting the Government's BRDP.

C. BRDP's Links to Poverty Reduction

83. The Government's BRDP should have a strong impact on poverty reduction. It is expected to create an environment for increasing long-term growth, reducing the probability of occurrence of future financial crises. Well-managed and well-capitalized banks operating under a sound regulatory and supervisory framework are likely to restart lending to the private sector, thereby improving access of the private sector to the financial system[27] [28]. As the actions being supported by the proposed loan are important steps in implementing the Government's BRDP, they would also contribute to poverty reduction.

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[26] Before the first loan, the Bank's most recent experience with a programmatic lending approach was with the Bank Restructuring Facility for Mexico (World Bank Report No. P7347 ME).

[27] From April 2000 to February 2001, average commercial bank lending rates fell by 2.5 percentage points, reflecting fiscal and monetary policy.

[28] Although there are issues relating to the consistency of the data on which BOJ estimates real credit growth (because of the purchase of NPLs by FINSAC, replaced with FINSAC bonds), the Bank's rough estimates, taking account of this, is that real credit to the private sector has been increasing since early 2002.

84. Improving the soundness of Jamaica's financial system will help sustain long-term growth and reduce poverty. There is strong evidence of a causal link between financial soundness and economic growth. Different measures of financial development, at a point in time, help predict subsequent economic growth, even after account is taken of other determinants of growth[29]. In turn, the international experience clearly shows a positive effect of growth on poverty reduction. A recent study (Dollar and Kraay, 2000) suggests that growth in per capita GDP would result in an almost one-for-one increase in the income of the poor[30].

85. The Government's BRDP involves completing the resolution of the intervened financial institutions affected by the financial crisis. A strong and solvent financial sector would have enhanced capacity to perform its functions of mobilizing savings and allocating capital to productive activities, at a time in which availability of financial services may become a major determinant of economic growth. Sustained economic growth, in turn, is key to consolidating recent gains in poverty reduction in Jamaica. As described above, the restructuring of intervened institutions by FINSAC involves providing them with performing notes (i.e. negotiable government securities that pay interest in cash). This would help reduce the liquidity constraints faced by these institutions, and help create conditions for the eventual resumption of prudent bank credit, which would help sustain growth.

86. Reducing the risk of another financial crisis in Jamaica will imply big gains in poverty reduction. The Government has significantly strengthened the legal, regulatory and supervisory framework for the financial sector and continues to do so on an ongoing basis. The objective of this effort is reducing the risk of a repeat of the financial sector crisis of the mid 1990s. Recent international experience shows that financial crises entail huge fiscal costs that crowd out social spending, with dramatic effects on poverty increases. Jamaica's public debt increased by 42.4 percent of GDP as a result of government interventions in the financial sector. Internationally, the 1999 banking crisis in Indonesia cost the country about 50 percent of GDP[31]; the Brazilian crisis of 1994 cost about 13 percent of GDP; and the Mexican banking crisis cost the country about 20 percent of GDP. To face these costs, governments must adjust other expenditures, generally social expenditures and other investments, which comprise a large share of the budget, with often devastating effects on the levels of poverty[32] and future rates of growth and competitiveness. Total debt service obligations in FY 2001/02 are estimated to account for 62 percent of total expenditures. The Government has committed to a macroeconomic program that calls for large and sustained primary surpluses in the medium term in order to enable the debt profile to be stable and declining. Such large surpluses and commitments to debt service reduce the possibility of using these funds for social programs and thereby make gains in poverty

[29] A review of evidence on the contribution of financial system development and growth is presented in Caprio and Honohan (2000).

[30] Dollar, David and Kraay Aart, "Growth is Good for the Poor", The World Bank, 2000. The positive impact of growth on poverty reduction is supported by extensive research, including Gallup, John Luke; Radelet, Steven; and Warner Andrew, "Economic Growth and the Income of the Poor", Harvard Institute for International Development, November 1998; Roemer, Michael and Gugerty, Mary Kay, "Does Economic Growth Reduce Poverty?", Harvard Institute for International Development, March 1997.

[31] See The World Bank, Finance for Growth, December 20, 2000.

[32] The 1982-82 Brazilian debt crisis caused incomes of the poor to decline by as much as 33 percent, well above the decline in average income. See De Ferranti, David and Perry, Guillermo, Securing our Future in a Global Economy, Chapter 5, p. 78.

reduction more difficult. A reduction in the risk of another banking crisis would, therefore, have a significant payoff in terms of both avoiding the increase in the ranks of the poor caused by the crisis and in liberating public funds for use in poverty reduction programs.

D. The Bank's Recent Emergency Assistance to Jamaica

87. In support of the Government's program, the Bank approved the Emergency Economic Rehabilitation Loan in the amount of US$75 million on December 20, 2001. The loan was intended to support the Government in its furtherance of sound macroeconomic policy, sustainable economic growth and poverty reduction in the aftermath of the economic shocks, which threatened to derail reform. The loan would enable the Government to rebuild damaged infrastructure, maintain spending in key social programs at a time of potential social unrest, invest in public sector reforms, and revive the tourism industry while still tackling the country's debt burden (see Report № P7493-JM).

E. Coordination with the IMF and the IDB

88. As in the first loan, the Bank has continued to work closely with the IMF and the IDB in order to ensure a coordinated approach to support the Government's efforts in restructuring the financial sector. The Bank participated in IMF Article IV and SMP assessment missions during 2001 and 2002. The Bank and the IDB have worked closely on all aspects of the proposed parallel financial sector operations of the two institutions. The IDB changed the original number of tranches of its operation approved in September 2000 from two to three. It disbursed a second tranche for US$40 million in March 2002 against compliance with roughly half the outstanding conditions, while the third tranche of US$35 million is pending the completion of the remaining actions originally supported by the loan. The CDB has approved a two-tranche loan for US$25 million in October 2000 and has similarly split its second tranche into two components, the first of which has been disbursed. The actions being supported by the IDB and CDB loans are consistent with and complementary to those being supported by the Bank.

VI. THE PROPOSED LOAN

A. Loan Objectives and Description

89. The Jamaican authorities have requested Bank support for the Government's Bank Restructuring and Debt Management Program (BRDP) described above. In November 2000, the Bank provided a loan of US$75 million as the first of two loans in support of this program. The proposed second loan was anticipated at the time of Board consideration of the first loan and will support further actions of the Government in moving the resolution of the financial sector crisis to completion. Disbursements under the proposed operation would help the Government in retiring a portion of the debt currently being held at formerly intervened financial institutions that have since been sold. The loan would thus assist in restructuring and improving the profile of the Government's debt. The Bank's proposed loan would result in restructuring about 5 percent of Government debt outstanding at formerly intervened financial institutions by replacing high-cost domestic debt with cheaper, longer-maturity international debt. Bank resources would be additional to the fiscal resources that the Government will have to mobilize to retire/service

FINSAC debt. The Borrower would be Jamaica with the Ministry of Finance and Planning being the Executing Agency. The implementation of the bank restructuring/resolution program has been carried out by FINSAC with the support of the MOF.

90. The proposed loan is expected to be disbursed in full in a single tranche upon effectiveness, expected before December 2002, in support of up-front reform measures that have already been taken by the Jamaican authorities (Annex 1). The loan closing date would be December 31, 2002.

B. Commitments under the Proposed Loan

91. **Letter of Sector Development Policy.** The authorities have submitted a Letter of Sector Development Policy (Annex II) describing the Government's strategy for restructuring the financial sector, strengthening supervision and regulation of the sector, and managing Jamaica's public debt, both in the short and the long term.

92. The proposed loan supports the following actions taken by the Government:

(i) **Life of Jamaica:** The Government has sold Life of Jamaica to a subsidiary of Barbados Mutual Life Assurance Society.

(ii) **National Commercial Bank:** The Government sold NCB to AIC Limited of Barbados (a subsidiary of AIC Limited of Canada).

(iii) **Bank of Jamaica's Profitability**: Beyond the actions supported by the Bank's first loan, the Government replaced J$8.3 billion in advances and other receivables from the Government (below market securities related to previous BOJ losses) with marketable securities. Interest accrued on the replacing securities will be capitalized with the issuance of Government securities until FY2007/08.

(iv) **Portfolio of Non-Performing Loans:** FINSAC has sold its portfolio of non-performing loans to a subsidiary of Beal Bank of Texas.

(v) **Portfolio of other assets including real estate:** FINSAC/FIS has divested about 98 percent of its total residential properties and 75 percent of total commercial properties as of the end-July 2002. It also sold other assets (including motor vehicles, artwork, furniture & equipment etc.) for J$3.9 billion.

(vi) **Supervision and regulation of the financial sector:** The BOJ was granted the necessary powers to carry out consolidated supervision with greater intervention powers, including extended jurisdiction over non-banking institutions integrated in banking groups. MOUs were signed among interested supervisory agencies and a coordinating body, the Financial Regulatory Council (FRC), chaired by the Governor of the BOJ was created. The BOJ has issued a revised "Ladder of Enforcement" to incorporate changes in 2001-2002. The legal amendments corrected the shortcomings in the legal framework that prevented Jamaica from fully complying with the BCPs. The BOJ is continuing the training program to enhance supervisors' skills in the weakest areas of bank supervision, including consolidated supervision and market risk. Regarding supervision of the non-banking sector, the new Insurance Act has been enacted and the Financial Services Commission has been established and is functioning. The FSC has undertaken steps to further strengthen its institutional capacity, including putting in place a framework for risk based supervision and training its staff to conduct such supervision.

(vii) Establishment of credit bureaus: The Government has drafted a Bill of law for the creation of credit bureaus in Jamaica, which was submitted for public consultation prior to its presentation to Parliament.

(viii) Winding down of FINSAC. FINSAC's operations have ceased as of July 2002. However, FINSAC remains as a legal entity to assist in the on-going liquidation processes.

(ix) Commitments regarding actions to be taken after Board consideration: The Government has committed in its Letter of Sector Development Policy to amortize the J$2.2 billion in zero coupon bonds held by the BOJ before the end of FY2002/03. Also, it committed to settle any losses sustained by the BOJ in subsequent periods through the issuance of marketable Government securities, on which interest accrued is to be capitalized with the issuance of Government securities until FY2007/08.

C. Disbursements, Records and Auditing

93. Loan disbursement would be made under simplified procedures for adjustment loans. The Borrower would be required to open and maintain a Deposit Account in US dollars in the BOJ. Upon effectiveness, the Borrower will submit a simplified withdrawal application against which the Bank will disburse the entire loan proceeds in one tranche into the Deposit Account for the Borrower's use. If after being deposited in the Deposit Account, the proceeds of the loan are used for ineligible purposes (i.e. to finance items other than redemption of government bonds that have replaced FINSAC bonds at formerly intervened financial institutions (para. 24), the Bank will require the Borrower to either: (a) deposit into the Deposit Account an amount equal to the amount of said payment, or (b) refund the amount directly to the Bank, in which case the Bank will cancel an equivalent amount of the loan.

94. The Deposit Account shall be audited by independent auditors acceptable to the Bank. The auditors shall submit a report not later than 3 months from the date of disbursement of the loan verifying that Bank funds have been used for the purpose specified above.

D. Impact, Benefits and Risks

95. **Social Impact.** The proposed loan would have little social impact in the short-run. In the medium and longer runs, however, the measures supported by this operation would have important social implications as they would assist in the creation of an environment conducive to the resumption of prudent lending to the private sector, with the associated benefits in terms of output growth and employment generation. The ultimate objective of the restructuring/resolution process supported by the proposed operation is a better functioning financial sector, able to withstand external shocks, allocate financial savings more efficiently, and better able to lend to the private sector. Given the low level of new real lending in Jamaica as a result of the financial crisis, it is hoped that new lending would spur economic growth and thereby create more job

opportunities, an important benefit in a country with a high level of unemployment. A banking system less vulnerable to crises will be better able to sustain growth and, therefore, deal with the poverty agenda described in the CAS.

96. **Environmental Impact**. The Bank Restructuring and Debt Management Program to be supported by the proposed loan is not expected to have any environmental impact. The loan is ranked U for environmental purposes.

97. **Benefits**. The proposed second loan would have several benefits. First, it would contribute to moving the resolution of the financial crisis toward completion by supporting the disposal of majority equity stakes in the last two remaining major financial institutions in Government hands to foreign investors. Through its support for the Government's debt management strategy, the loan would contribute to enabling the Government to continue its efforts at servicing the liabilities generated during the crisis in cash. This, in turn, would support the provision of greater liquidity to the banking system. Strong and well-capitalized financial institutions with adequate liquidity would be in better position to resume prudent lending to the private sector, with the attendant beneficial effects on growth, wider access, and employment. Second, the Bank's loan would have a strong positive signaling impact through closure of the crisis resolution agency upon the completion of its responsibilities. Third, the loan would support the continued strengthening of the regulatory and supervisory framework for the financial sector in Jamaica. This is expected to reduce the vulnerability of the financial system to future crises. It would also contribute to improving the environment for better lending practices through the creation of credit bureaus. Fourth, it would support the Government's program of debt management by contributing to the reduction of the stock of expensive domestic debt. This would modestly ease the Government's fiscal burden and reduce the pressure on domestic interest rates. Fifth, it is expected that the Bank's support together with that of the other IFIs will increase confidence of the domestic and foreign private sector regarding the Government's commitment to resolving the financial sector crisis and thereby contribute to greater economic activity. Finally, resolution of the financial sector crisis is key if Jamaica is to put its economy back on a sustained positive growth path. If the Government's program supported by the proposed operation is successful, a major benefit would be resumption of substantive economic growth and its consequent positive impacts in Jamaica.

98. **Risks**. Both the Government's program as well as the Bank's operations in support of the program face several significant risks. Recent exogenous shocks suffered by the economy have also highlighted the risks faced by the program. However, actions taken by the Government since the beginning of the crisis and subsequent to the approval of first Bank loan have simultaneously changed the nature of the risks and contributed to increased confidence that risks are manageable. As was the case with the first loan, the Bank recognizes these risks and that it is not realistically possible for the proposed operation to address all risks and mitigate them completely. Despite the risks, the Bank believes it is worth supporting the Government's program, in order to move the process of resolution of the financial sector crisis towards completion and attempt to restart growth in Jamaica.

99. **Macroeconomic risks**. Arguably the single biggest risk facing the program is that of potential macroeconomic instability. The Government has thus far been largely successful in stabilizing and lowering interest rates as well as generating primary surpluses broadly in line

with the targets set out in the SMP. These have enabled it to service its large stock of debt. However, going forward, there is a risk that servicing the public debt could become much more challenging. The events of September 11, 2001 in the US had major negative implications for the Jamaican economy resulting in large revenue shortfalls. The economy has low capacity to absorb more large exogenous shocks. The Government has already approached the IFIs for emergency assistance after the events of September 11, 2001. Additional resources may be harder to mobilize in the event of further difficulties. Government's tax collections are already quite efficient in Jamaica and spending is already on an extremely tight leash. There is little room for improvement in revenues or contraction in spending. If fresh exogenous events cause further fiscal pressures, which are addressed through additional borrowings, it is unlikely that the Government will be able to meet SMP targets in terms of putting its public debt on a sustainable path.

100. **Political risks.** Elections are due in Jamaica by March 2003. While the Government has thus far shown strong commitment to a credible macroeconomic program, it is not difficult to visualize a scenario where political compulsions cause higher than planned public expenditure in the short to medium term resulting in greater fiscal pressures. If financed through additional debt, political pressures could place Jamaica's macroeconomic program at risk.

101. **Social risks.** There is a risk that the extremely tight fiscal discipline required to make the proposed program successful may not be sustainable in the medium term. Although the tight discipline has not been the cause of the recent social tensions in Jamaica, such outcomes remain a risk if rapid economic growth does not resume.

102. **Financial sector risks.** The Government's financial sector restructuring program has been largely successful in placing the sector on a path to recovery. However, this has been achieved by placing a large amount of Government debt in the sector, which has resulted in high exposure of the sector to Government credit risk. Government bonds form the majority of bank asset portfolios, both because of replacement of FINSAC debt with government bonds as well as through their own investment operations. As long as the Government continues to service its obligations, the banking sector is likely to remain relatively sound. However, if the Government has difficulty servicing its debt, the quality of bank assets will almost certainly rapidly erode, with concomitant adverse impact on banking system soundness. In the short to medium term, the financial sector faces a significant risk of contagion from the Government's fiscal position.

103. **Regulatory risks.** Although banking sector and non-bank financial institutions regulation and supervision has been significantly strengthened, continuous vigilance will be necessary to ensure that there are no lapses in supervision, which could expose the financial system to additional risks. The FSC is a new entity and it must be provided with adequate support and autonomy to ensure that it successfully performs its functions. Jamaica now has a largely sound legal framework for the financial sector. It needs to ensure that implementation of the framework is sound.

VII. RECOMMENDATION

104. I am satisfied that the proposed loan complies with the Articles of Agreement of the Bank, and I recommend that the Executive Directors approve it.

James D. Wolfensohn
President

By Shengman Zhang

Washington, D.C.
September 17, 2002
Attachments

ANNEX I

JAMAICA: PROPOSED SECOND BANK RESTRUCTURING AND DEBT MANAGEMENT PROGRAM ADJUSTMENT LOAN MATRIX OF POLICY ACTIONS

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
Macro stability	Maintain sound economic policy framework	- Maintenance of sound macroeconomic framework consistent with policy objectives and programs in the SMP and Letter of Sector Policy.	- Continued maintenance of sound macroeconomic policy framework consistent with policy objectives and programs described in the SMP and commitments made in the Letter of Sector Policy.	- The Government has maintained sound macroeconomic framework consistent with policy objectives and programs outlined in the 2000 SMP and its revisions, 2000 CAS, and Letter of Sector Policy dated October 19th, 2000. The Government has been satisfactorily implementing its macroeconomic adjustment program as outlined in the SMP as applicable for each period.
	Reduction of public sector debt	- Government has committed to undertake periodic, scheduled reviews of performance as agreed under the SMP. - Satisfactory implementation of the Government's macroeconomic adjustment program as outlined in the SMP.	- Undertaking of periodic, scheduled reviews of performance as agreed under SMP. Satisfactory implementation of the Government's program under SMP. If macroeconomic performance is off-track, appropriate measures to be agreed with the IMF to put it back on track.	- The Government has been undertaking periodic scheduled reviews of performance as agreed under the 2000 SMP and its revisions. In August 2002, the Government entered into a new 2002/03 SMP with the IMF. This SMP incorporates appropriate measures to address the large macroeconomic shocks that took place since the first SMP.
		- Government has committed to ensure reduction of public sector debt in Jamaican dollar terms consistent with the	- Government's public debt reduction plan consistent with the base case scenario in the SMP to be on track.	- Largely due to external shocks and to the upward revision of the 2000/01 debt data, the reduction of public sector debt in Jamaican dollar terms has not been consistent with the base case scenario of

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
		base case scenario of the SMP.		the 2000 SMP. The Government has committed to a revised macroeconomic scenario reflected in the SMP approved in July 2002.
		Government has committed to explicitly assume all remaining FINSAC liabilities outstanding as of April 2001 as part of domestic public debt making full interest payments in cash.	Completion of assumption of FINSAC's liabilities as public debt and continued satisfactory servicing in cash of the same.	Government explicitly assumed, as part of its domestic debt, all FINSAC liabilities outstanding as of March 31, 2001. It has been making full interest payments in cash on all assumed liabilities to private financial institutions

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
FINSAC	Reduce debt and pay interest in cash on remaining stock of debt.	- Government stated that FINSAC will not incur additional liabilities over and beyond those stated in the Government's letter to the Bank dated August 31, 2000.	- FINSAC liabilities to be fixed at the level stated in the Government's letter to the Bank dated August 31, 2000.	- FINSAC did not incur additional liabilities over and beyond those identified in the 2000 SMP, as revised in December 2001.
		- Government has committed to use Bank funds to reduce the stock of FINSAC debt.		- Government used all funds from the first loan (Loan No. 7036-JM) to reduce Government debt held by private financial institutions. It has committed to use funds from the proposed second loan for the same purpose.
		- Cabinet approval has been obtained for the write-off of FINSAC debt owed to the Ministry of Finance amounting to J$19.4 billion.	- *Formalization of the write-offs/off-sets of FINSAC debt through necessary legislative actions (supplementary budgets).*	
		- Cabinet approval has been obtained for offsetting J$13 billion of FINSAC debt held by the BOJ against the sterilized deposits of the government at BOJ. - Cabinet approval has been obtained to restructure J$13.2 billion of FINSAC debt held by BOJ into cash		- In addition to the restructuring of FINSAC's debt held by the BOJ (supported by the first loan), the Government has taken a broader approach to improve BOJ's profitability, as reflected in the MOU between the MOF and the BOJ regarding the resolution of BOJ losses, signed on September 9, 2002. The MOU provides that the Government: (i) has replaced J$ 8.3 billion in advances and other

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
		interest paying Government bonds. Rate of interest to be set at a level to ensure that BOJ does not incur cash losses in any fiscal year. - Government has committed that FINSAC will use all proceeds from recoveries of NPLs and non-core assets, net of operating expenses, to reduce its outstanding liabilities.	- FINSAC to be applying all proceeds from recoveries of NPLs and non-core assets, net of operating expenses, to reduce its outstanding liabilities.	receivables from the Government (below market securities related to previous BOJ losses) with marketable securities, (ii) has committed to redeem J$2.2 billion in non-interest earning securities during FY 2002/03, and (iii) has committed to settle any losses sustained by the BOJ in subsequent periods through the issuance of Government securities. Interest accrued on the replacing securities will be capitalized with the issuance of Government securities until FY2007/08. - FINSAC has provided all proceeds from recoveries of NPLs and non-core assets, net of operating expenses, to the Government. The Government has used these funds to service its bonds replacing FINSAC liabilities.
Restructure banking sector	Restructure/ sell intervened banks.	- Union Bank (the second largest domestic bank) has been sold. - The following steps in the process of FINSAC	- FINSAC to have acquired more than 75 percent equity of NCB.	- Government has sold its entire equity in NCB to a private financial institution. This is the largest domestic bank with a

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
		acquiring an equity stake of more than 75% in NCB have been completed: (i) The Board of NCB approved the Schemes of Arrangements (the Schemes) to restructure NCB's equity; - (ii) Shareholders have been informed of the Schemes; (iii) The Jamaican Supreme Court issued an order directing NCB shareholders to meet on November 8, 2000 to consider, and vote on the Schemes. - Government has committed to complete the additional legal and corporate steps necessary to ensure that FINSAC has more than 75% equity of NCB. - New management has been appointed in NCB including (i) Managing Director (CEO), (ii) General Manager, Information Technology (CIO), and (iii) General Manager, Finance, Planning and Risk	- A rehabilitation and/or restructuring strategy for the bank to be developed by the new management team focusing on issues such as improving shareholder value, staff rationalization, cost reductions, systems upgrading and product improvement. - NCB to be brought to the point of sale through the restructuring process with the ultimate objective of resolving and selling NCB.	market share of 37 percent of total commercial bank assets.

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
		Management (CFO). - A plan, satisfactory to the Bank, to address NCB's potential liquidity needs prior to conversion of FINSAC paper into cash-yielding instruments and a strategy to manage liquidity subsequent to the conversion has been submitted. - A strategy, satisfactory to the Bank, to manage NCB during the time in which NCB is under FINSAC's or Government's control, has been submitted. - Government has committed to present a plan, satisfactory to the Bank, to restructure NCB by March 31, 2001.		
Sale of FINSAC non-core assets	Sale of non-core assets held by FINSAC.	- A plan acceptable to the Bank, for disposition/administration of FINSAC non-core assets has been submitted.	FINSAC will continue disposal of non-core assets with the objective of completing sale of entire portfolio.	- (i) Government has sold 75 percent of FIS's commercial real estate assets administered by FINSAC and 98 percent of FIS's residential real estate assets administered by FINSAC (acquired in the intervention process). (ii) Government has closed FINSAC operations as of June 30, 2002. It has transferred FINSAC's remaining asset administration and legal responsibilities to FIS and has provided the Bank with a satisfactory strategy for

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
				management, disposal, and winding down of these assets.
Divestment of FINSAC Non-performing loan portfolio	Divestment of NPLs by FINSAC.	- The diagnostic phase of NPL portfolio analysis has been completed. - Advisors have been hired to value and develop a strategy for sale of the NPL portfolio. - A plan acceptable to the Bank, for disposition/ administration of NPLs has been submitted.	- FINSAC will continue selling NPLs with the objective of disposing of the entire portfolio.	- Government has sold to a private financial institution FINSAC's entire NPL portfolio, which was acquired in the intervention process.
Insurance Companies – Life of Jamaica	Restructure/ sell intervened insurance companies.	- Legal opinion of independent counsel has been obtained to the effect that FINSAC currently has more than 75 percent of the voting rights of LOJ. - LOJ's Board of Directors has agreed that a shareholders' meeting will be convened wherein authorization will be given for FINSAC to obtain more than 75 percent of the equity of LOJ. - A plan, satisfactory to the Bank, to address LOJ's potential liquidity needs prior to conversion of FINSAC paper into cash-	Take necessary actions to resolve LOJ in order to sell the entity.	- Government has sold its entire equity in LOJ to a private financial institution. LOJ is the largest insurance company in the system with about 30 percent of total insurance assets.

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
		yielding instruments and strategy to manage liquidity subsequent to the conversion has been submitted. - A plan, satisfactory to the Bank with a strategy to manage LOJ during the time in which LOJ is under FINSAC's or Government's control has been submitted. - Government has committed to ensure that all necessary legal and corporate steps are taken so that FINSAC obtains over 75% of the shares of LOJ.		
Legal/ regulatory/ supervisory framework for the banking sector	Continue strengthening BOJ's supervisory and enforcement capabilities to ensure safe and sound banks in Jamaica. Ensure consolidated	- Cabinet approval has been obtained to enhance BOJ's intervention powers to deal early with financially distressed institutions.	- BOJ to have obtained greater intervention powers.	- Legislation has been passed by the Government's legislature providing BOJ greater independence and broader intervention powers by: • Granting BOJ the powers of temporary management of deposit taking financial institutions. • Granting the BOJ the legal and administrative powers to impose penalties in cases of certain technical breaches of statute by financial institutions.

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
	consolidated supervision and supervision of market risk			• Upgrading the schedule of fines and penalties for non-compliance by financial institutions. • Transferring all the supervisory powers of the Minister of Finance and Planning to the BOJ, except the powers to grant and revoke bank licenses and the power to vest shares of institutions.
		- Cabinet approval has been obtained to permit BOJ to share information on financial institutions with other regulatory/supervisory agencies.	- Amendment of BOJ Act to facilitate exchange of information among supervisory agencies.	• Granting BOJ (i) extended jurisdiction over non-banking financial institutions that are part of a banking group, and (ii) the power to require the restructuring of a financial group.
		- Cabinet approval has been obtained to establish a Financial Regulatory Council, to coordinate activities of bank and non-bank supervisors.	- Financial Regulatory Council established.	- The Financial Regulatory Council, consisting of representatives of the Bank of Jamaica, the FSC, the MOF and the Jamaica Deposit Insurance Corporation was formally established in and it is functioning satisfactorily, for purposes of coordinating the supervision of financial institutions. It has also provided reports to the Minister of Finance and Planning on technical guidance provided to the respective regulatory bodies.
		- BOJ has agreed to undertake independent assessment of Basle Core Principles (BCP) no later	- Continued strengthening of BOJ's supervisory capabilities. Independent assessment of BCPs to have been completed	- The BOJ completed an independent assessment of BCP in 2001 finding most of the 25 principles fully or largely

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
		than second quarter of 2001. This followed its self-assessment carried out in 2000.	no later than second quarter of 2001.	compliant. Subsequently, it has adopted a plan and begun undertaking specific training initiatives and capacity building measures thereunder in supervision and regulation of market risk exposure of supervised entities towards achieving full compliance with the BCP.
			- Revised capital adequacy norms to have been put in place by the BOJ and implemented by the banking industry.	- Legislation has been passed to include provisions dealing with consolidated supervision and market risk. Guidelines for risk management, inclusive of market risks, have been drafted by BOJ. Regulations to ensure capital adequacy (reflecting the amendments above) have been drafted, and they are being implemented by the market, and they will shortly be signed into law. Those Regulations will be subject to further amendment to take into consideration market risks not currently covered.
		- Cabinet approval has been obtained for development and implementation of crisis intervention policy. - Government has committed to make best efforts to obtain Parliamentary approval of above measures.	- Crisis intervention policy in place.	
		- BOJ has issued the "Supervisory Ladder of Enforcement" to take into		- BOJ, by amendments thereto in 2001 and 2002, has updated its Supervisory Ladder

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
		account 1997 amendments.		of Enforcement". - A Bill of law for the creation of credit bureaus has been drafted by the Government and submitted for public consultation prior to its presentation to Parliament.
Legal/ regulatory/ supervisory framework for the non-bank sector	Strengthen regulation and supervision of non-bank financial institutions.	Cabinet approval has been obtained for the establishment of the Financial Services Commission. Cabinet approval has been obtained for the new Insurance Act. Government has committed to make best efforts to obtain legislative approval of above measures.	- FSC established and functioning. - New Insurance Act enacted. - Continued strengthening of non-bank regulatory and supervisory capabilities.	- FSC has been established and it is functioning satisfactorily. - The new Insurance Act has been enacted and it is in line with international best practices, as determined by the Bank. - FSC has issued regulations governing FSC activities and has continued strengthening its supervisory capacity through training under a plan satisfactory to the Bank. - FSC has taken the following steps to strengthen supervision of non-bank financial institutions: • Hired consultants for the design of software for financial solvency analysis; • Designed two risk-based modules (one for general insurance

Issue	Objective	Actions of the Jamaican Government supported under the first loan	Actions originally proposed to be taken by the Government prior to the second loan	Actions of the Jamaican Government supported under the second loan
				supervision and the other for life insurance supervision) and began undertaking on-site supervision. - Government has committed to take the following actions to further strengthen the insurance sector's regulatory framework: • Issue regulations to harmonize the rules regarding changes in control (acquisitions, transfer, and amalgamation) of insurance providers with the licensing requirements therefor. • Issue regulations to monitor market conduct principles and protection of policyholders' interests (fair treatment). • Introduce non-binding consultation with other boards or agencies and industry in the appointment of at least one member of FSC's Board. • Revise regulations to better define standards (i.e., international ratings) for selection of foreign re-insurers, including the creation of a registry of admitted re-insurers that comply with said standards. - -FSC has provided the Bank with a satisfactory time-bound plan to complete training of its supervisory staff.

ANNEX II

LETTER OF SECTOR DEVELOPMENT POLICY

Kingston, September 10, 2002

Mr. James D. Wolfensohn
President
The World Bank

Dear Mr. Wolfensohn:

1. The Government of Jamaica has undertaken a series of actions to resolve the financial sector crisis that occurred in the mid-1990s as well as to contain and reverse the adverse debt dynamics that arose as a result of Government intervention in the financial sector. The Government has successfully restructured all the financial institutions in which it had intervened and the majority of shares held by the Financial Sector Adjustment Company Limited (FINSAC) in these institutions have been divested. In addition, the bulk of other assets acquired in the process have been sold. FINSAC debt held by these institutions and BOJ has been restructured and assumed by the Central Government. The agencies with responsibility for supervising financial intermediaries in Jamaica have been strengthened. Debt management is being done in the context of a major fiscal effort—aimed at generating a primary surplus as high as 10.5 percent of GDP and an overall deficit of no more than 4.4 percent of GDP in 2002/03.
2. This Letter of Development Policy describes Jamaica's current economic conditions and provides details of the financial sector reforms undertaken. In support of these initiatives, the Government requests a second loan from the World Bank for the amount of US$ 75 million. This request is in line with the Bank's expressed intention to provide up to US$150 million in programmatic support, of which a loan of US$75 million was provided in November 2000.
3. This support is intended for the final resolution of the banking crisis and the improvement of financial intermediation in Jamaica. Resumption of growth of real bank credit to the private sector will assist in the recovery of output growth and employment.
4. The Government is confident that the broad set of macro-economic and financial sector reforms that have been implemented have restored the financial sector to health and reduced its vulnerability to future shocks, while containing the overall financial cost of the crisis. At the sector level, the Government's bank restructuring strategy is intended to

achieve four objectives: first, the completion of the restructuring and sale of the remaining FINSAC shares in the intervened financial institutions as well as disposal of other assets acquired by FINSAC as a result of the intervention; second, closure of FINSAC upon the satisfactory completion of its responsibilities signalling the end of the financial sector crisis resolution; third, restructuring and management of the public debt arising from the intervention; and, fourth, continued strengthening and consolidating of the legal, regulatory, supervisory, and enforcement framework for the safe and sound operation of the financial sector. The Government has achieved the first objective through the sale, merger, or closure of all intervened banks and non-bank financial institutions, depending on their viability. The Government does not have a majority stake in any financial institution in Jamaica and the few remaining minority stakes are small and in the process of disposal. Foreign investors have invested heavily in Jamaica's financial institutions. All non-performing loans (NPLs) acquired during the intervention have been sold as well as the majority of the non-core assets. Responsibility for managing and disposing of the remaining assets has passed from FINSAC to FIS. In order to achieve the second objective, FINSAC ceased operations in July 2002, although it will continue as a legal entity to enable it to complete certain legal formalities. In line with the third objective, there are no FINSAC bonds outstanding in Jamaica as of the date of this letter. All FINSAC bonds have been converted to Government obligations, are tradeable, carry market rates of interest, and with the exception of bonds at the BOJ, are being serviced in cash. The fourth objective has been achieved through continuation of efforts at formulation and approval of necessary legislation and regulations to move Jamaica's financial sector regulation closer to international best practices. This will be a continuing effort.

1. **Macroeconomic Framework**

5. The Government's macroeconomic programme has evolved since the approval of the first loan by the World Bank, largely in reaction to unexpected shocks such as the impact of the terrorist strikes in the US on September 11th, 2001 on the Jamaican economy, violence in Kingston in July 2001, and floods in the country in 2001 and 2002. These shocks have had significant adverse implications for the Government's fiscal position. The Government acknowledges the support of the Bank in assisting Jamaica to cope with these shocks through its Emergency Rehabilitation Loan approved last year. Despite these shocks, however, the Government has maintained a sound macroeconomic framework consistent with policy objectives and programmes outlined in the original SMP and its revisions and the Bank's CAS. The Government has been satisfactorily implementing its macroeconomic adjustment programme as outlined in the revised SMP. The Government has been undertaking periodic scheduled reviews of performance as agreed with the Bank under the first loan. In August 2002, the Government entered into a new SMP with the IMF. This revised SMP incorporates appropriate measures to address the macroeconomic shocks described earlier.

6. During the first half of fiscal year 2001/02, the Jamaican economy was growing at an annualised rate of 3 percent, reversing a trend of flat or no GDP growth over the previous four fiscal years. IMF staff had assessed the SMP to be broadly on track until September 2001, with all quantitative targets for the end of September 2001 met. This was due mainly to the strong recovery of agriculture from the previous year's drought; a

resumption of bauxite and alumina production after disruption in a processing plant in the U.S. and positive, albeit lower, growth in tourism. Inflation was higher than envisaged, at 7½ percent, largely due to administrative increases in transportation prices in June.[1] This, however, represents the sixth consecutive year of single digit inflation. Net international reserves at the end of March 2002 were US$1.9 billion, significantly higher than the SMP target, largely reflecting successful international bond issues in May and December 2001, and buoyant private capital inflows.

7. However the economy suffered four major shocks in 2001/02: (i) an outbreak of violence in a section of Kingston in July; (ii) a significant reduction in visitor arrivals caused by the September 11, 2001 events in the US and the slowdown of the world economy; (iii) major infrastructure damage and population dislocation as a result of wide scale flooding in the eastern parishes of the island associated with Hurricane Michelle that have reduced real GDP growth for the fiscal year as a whole to around 1 percent; and (iv) the closure of a bauxite refinery due to labour problems impacted GDP growth and revenue flows to the Central Government. Lower revenues, higher expenditures on security, tourism promotion, and flood relief and rehabilitation resulted in an increase in the fiscal deficit, despite significant cutbacks in other expenditures.[2] The Central Government's deficit rose to 5.7 percent of GDP corresponding to a primary surplus of around 8 percent of GDP. Interest rates continued their downward trend, except for a brief interruption in October when they were increased temporarily to facilitate orderly adjustments in the exchange rate.

8. The main challenges facing the Jamaican economy continue to be high public sector debt and low economic growth, which has been further exacerbated by recent flooding in May 2002. The challenges will be addressed by continuing fiscal consolidation, maintaining macroeconomic stability and through further structural reforms. Within this context, the Government plans to reduce the Central Government's fiscal deficit by 1.3 percentage points of GDP in fiscal year 2002/03 to 4.4 percent of GDP, with a primary surplus of around 10.5 percent of GDP, to be achieved through continued restraint in expenditures and further strengthening of tax administration to improve revenue collection. These targets will be reviewed shortly in light of estimates of the additional spending required for reconstruction as a result of the May floods as well as the success of our efforts to obtain international assistance in this respect. Exchange rate and monetary policies are intended to promote growth through maintaining and, if possible, enhancing competitiveness while preserving single digit inflation. The target for Net International Reserves is US$1.6 billion at the end of March 2003. Improvements in public sector management will continue with the restructuring of the remaining (generally smaller) public enterprises through reorganizations, mergers, transfers and privatisation.

9. The aim of the fiscal measures in the 2002/03 programme is to reduce the Central Government's deficit by 1.3 percentage points of GDP over the 2001/02 outturn, to

[1] At end March 2002, the 12-month inflation was 7½ percent. However, excluding the transportation price increase in June, the rate would have been around 6 percent.

[2] Higher expenditures also include larger wage expenditures due to earlier than anticipated wage settlements and higher interest payments related to the National Commercial Bank's (NCB) holding of Financial Sector Adjustment Company (FINSAC) securities.

4.4 percent of GDP, consistent with a primary surplus of about 10.5 percent of GDP. To achieve this, the Government intends to implement a series of measures to increase revenue collection. These include strengthening of the compliance machinery, reduction in preferential exemptions, and continuing expenditure restraint. However, the Government is committed to at least maintain the real level of spending on social safety nets in 2002/03. The deficit of the rest of the public sector, of just over 1 per cent of GDP in 2001/02, will increase by 1 percentage point of GDP to 2 percent in 2002/03. This results from the quasi-fiscal operations of the Bank of Jamaica (BOJ), which is projected to make a loss of 3 percent of GDP, up 1 percentage point on FY 2001/02. These losses arise largely from the sterilization of the impact of past accumulation of foreign reserves on the money supply and a 16 percentage points reduction in the cash reserve. Continued emphasis will be placed on improving the performance of public enterprises where a surplus of 0.6 percent of GDP is projected in 2002/03 (unchanged from last year). The overall public sector deficit will decline by about ½ percentage point to around 6½ percent of GDP, with a primary surplus of about 10.5 per cent of GDP. These fiscal targets will be reviewed in light of additional reconstruction spending resulting from the floods and the results of the Government's efforts to generate international support for this spending.

10. Total public sector debt is projected to decline from 129 percent of GDP at the end of 2001/02 to 124 percent by the end of 2002/03[3]. The Government will limit the approval of projects under the deferred financing scheme to an amount consistent with an increase in public sector debt of J$2 billion (0.5 percent of GDP) annually, and minimize the issuance of Central Government guarantees for borrowing by the public or private sector.

11. The Government believes that the above measures are consistent with generating the indicative primary surplus and the overall deficit but there are downside risks. First, domestic interest rates may not decline as rapidly as assumed and, second, the real GDP growth projections may not be realized. In either of these events, the Government is committed to taking measures to contain deviations from targets, through further cuts in expenditures. Any additional outlays or shortfalls in revenues will also be offset by expenditure cuts elsewhere.

12. The main objective of exchange rate policy is the maintenance of a credible and stable market consistent with an internationally competitive economy. In keeping with these objectives, the BOJ will allow the exchange rate to reflect underlying market forces and will continue to permit limited flexibility in the rate provided that exchange rate movements do not appear destabilizing. In the context of further fiscal consolidation, a moderate lowering of interest rates should be possible without triggering an increase in inflation. Accordingly, the BOJ has designed a monetary programme for 2002/03, which entails some increase in net claims on the public sector by the banking system, and continued lowering of interest rates to encourage faster growth. Lower interest rates would result in an 8 percent real expansion of credit to the private sector, which is important to maintain the momentum of economic growth. Although the cash reserve and

[3] This, however, does not take into account the additional debt arising as a result of the replacement of FINSAC debt at BOJ with Government bonds. This is expected to add about 4 percent of GDP to the debt stock.

liquid asset requirements have been reduced significantly in the recent past, the liquid asset requirement remains relatively high at 27 percent. The BOJ proposes a further 7 percentage points reduction in the liquid assets ratio to 20 percent in 2002/03 and the cessation of remuneration of prudential reserves on foreign currency deposits.

13. Significant progress has been made towards strengthening the supervisory framework for banks and non-bank financial institutions with amendments to the BOJ legislation to supervise financial groups, and the establishment of the Financial Services Commission (FSC), the entity in charge of supervising non-bank financial institutions. FINSAC has successfully discharged its mandate to restore the liquidity and solvency of the financial system, and that institution's operations were wound up in July 2002. Residual responsibilities were handed over to the Financial Institutions Services Limited (FIS). The Government has initiated the introduction and enforcement of legislative amendments to address tax evasion and any financing of terrorism activities and established a Financial Crimes Unit to investigate and prosecute money-laundering offences. Simplification of the tax system will be examined.

14. Progress has been made in improving public sector management with the assistance of the Bank and other international partners in recent years.[4] The Government plans to restructure the remaining (generally smaller) public entities through reorganization, mergers and transfers, privatisation, and closure. New legislation has been passed in Parliament (the Public Bodies Management and Accountability Act) to improve transparency and accountability of public entities.

15. In the current stable inflation environment, competitiveness will be enhanced by wage moderation and increased productivity. The recently established productivity centre should play a useful role in assessing productivity developments.

16. The policies outlined in the SMP are expected to help lay the foundations for the medium-term achievement of higher growth, more employment, and moderate inflation. Growth is expected to accelerate to 3-4 per cent a year on average by 2005, as a result of growth in tourism, as well as in mining, agriculture, and financial and other services. Inflation can be contained at around 5 percent per year in the medium term while strengthening competitiveness. The six-month Treasury Bill rate is projected to decline significantly from the current level (13.8 percent), while public sector primary surpluses will be kept over 10 percent of GDP. Continued fiscal consolidation helped by faster growth and lower nominal interest rates could shift the public sector overall balance to a surplus by 2005/06. Such an improvement in the overall balance could lower the public sector debt from around 129 percent of GDP at the end of 2001/02 to below 100 percent of GDP by 2006/07, which in turn would support further declines in real interest rates.

17. The Government acknowledges that it has been unable to meet its commitment made to the Bank under the first loan of ensuring reduction of public sector debt in Jamaica dollar terms consistent with the base case scenario of the original SMP. This has largely occurred due to the impact of the unanticipated external shocks as well as additional liabilities that had to be taken on by the Government including measures to address the profitability of the BOJ. The Government is fully aware that the extremely large public

[4] The Bank provided assistance through the Public Sector Modernization Project.

sector debt poses the greatest challenge to macroeconomic management in Jamaica. Continued satisfactory servicing of the debt is also critical to the soundness of the financial sector. Focusing on the objective of reducing the debt over GDP ratio and improving the term structure of Jamaica's public sector debt, will require a very disciplined approach to containing public sector expenditures and improving tax collections in order to achieve the fiscal targets set in the SMP. As part of this effort, the Government intends to apply the resources obtained from the Bank loan to foster a more rapid decline in the public sector domestic debt. A clear aim of Government policy is a sustained reduction in the public debt to GDP ratio.

2. Status of the Financial Sector and Resolution of the Crisis

18. The liberalization of the financial system that occurred in the decade from the mid-1980s to the mid 1990s, was not accompanied by a sufficiently robust prudential and supervisory infrastructure, and 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 BOJ. The Government addressed the financial sector problems through the creation of FINSAC, charging it with the responsibilities of intervention, rehabilitation, and divestment. The intervention, rehabilitation, and divestment phases of FINSAC's operations have been completed and FINSAC's operations have ceased. The resolution of the crisis has come at a very high fiscal cost. The total cost of the restructuring was estimated at 37 percent of GDP as of March 2000.

19. The Government recognizes the need for a long-term, comprehensive solution to address the increasing debt burden associated with the FINSAC liabilities and the lack of liquidity faced by financial intermediaries. The Government has undertaken the following strategy to reduce FINSAC's debt:

(i) FINSAC's debt to the Central Government (the Ministry of Finance and Planning) has been written off.

(ii) FINSAC's debt at the BOJ has been restructured. J$13 billion of FINSAC debt at the BOJ has been amortized by the Central Government. The outstanding balance of J$15.55 billion along with accrued interest up to December 2001 has been converted to a 25-year Government bond paying market rates of interest. Given the Government's fiscal constraints, however, the interest on this debt to the BOJ will be accrued and capitalized. In this manner, the financial soundness of the BOJ will not be compromised.

(iii) Union Bank of Jamaica Limited (UBJ) has been sold to RBTT Holdings Ltd. Proceeds from the sale have been used to reduce the stock of FINSAC debt held by UBJ by an equivalent amount. Part of the proceeds from the Bank's first loan was also used to redeem FINSAC bonds at UBJ. The balance of the FINSAC paper at UBJ has been replaced with Government securities paying interest in cash.

(iv) National Commercial Bank Jamaica Limited (NCB) has been sold to AIC (Barbados) Limited, a subsidiary of AIC Limited of Canada. Proceeds from the sale have been used to reduce the stock of Government debt held by NCB. Part of the proceeds from the Bank's first loan was also used to redeem Government bonds at NCB. The balance of the FINSAC paper at NCB has been replaced with Government securities paying interest in cash.

(v) Life of Jamaica Limited (LOJ) has been sold to Barbados Mutual Life Assurance Society. Proceeds from the sale have been used to reduce the stock of Government debt held by LOJ. The balance of the FINSAC paper at LOJ has been replaced with Government securities paying interest in cash.

(vi) The entire portfolio of NPLs acquired by FINSAC as a result of the intervention has been sold and the proceeds used to reduce Government debt outstanding. A portion of the NPLs were recovered directly by FINSAC while the majority has been sold to Beal Bank of Texas under an arrangement in which the Government received an upfront payment and a share in recoveries made by the buyer. It is expected that the NPLs will yield approximately 22 cents per dollar of principal. The proceeds received thus far from the sale have been used towards reducing Government debt held by the financial institutions and future receipts will be used in a similar manner.

(vii) FINSAC assumed responsibility for many non-core assets such as commercial and residential property, artwork, automobiles etc. during the intervention process. With the exception of commercial real estate assets, almost the entire portfolio of other assets has been sold. 75% of the commercial real estate assets have been sold and the management of the remaining assets has been transferred to FIS. The proceeds received thus far from the sale have been used towards reducing Government debt held by the financial institutions and future receipts will be used likewise.

(viii) The Government has used all proceeds from World Bank, IDB, and CDB loans supporting its financial sector resolution strategy to reduce the stock of FINSAC debt. Proceeds from the second loan being requested from the World Bank will be used to retire Government debt held by the private financial institutions.

20. Through the steps outlined above, the Government has explicitly assumed all FINSAC liabilities outstanding as of March 31, 2001 as part of domestic public debt. It has been making full interest payments in cash on all assumed liabilities to private financial institutions. As committed to the Bank under the first loan, FINSAC did not incur additional liabilities over and beyond those identified in the Government's letter to the Bank in August 2000 and the revised SMP. The Government has used Bank funds from the first loan and will use funds from the proposed second loan for reduction in stock of Government debt held by financial institutions.

21. As discussed above, the Government has proposed a mechanism to deal with the losses of the BOJ. The proposal is in line with the commitments made to the Bank by the Government in the first loan. The main implications of this proposal are a one time increase in the debt stock over and beyond that programmed thus far, ongoing additions to the debt stock to the extent of capitalized interest payments made to the BOJ which could potentially slow down the rate of decrease in the debt/GDP ratio, and slow achievement of cash profitability by the BOJ. However, the Government believes that

this proposal clearly demonstrates its commitment to comprehensively deal with the FINSAC debt as well as its willingness to explicitly recognize the financial cost of the crisis and address the assets of the BOJ. There is no FINSAC debt outstanding in Jamaica as of the date of this letter. The Government's fiscal constraints dictate that, for the medium term, servicing of this component of the debt at the BOJ will have to be capitalized. Finally, the Government has attempted to ensure that the financial soundness of the BOJ and its ability to implement sound monetary policy will not be compromised by the proposed resolution mechanism.

3. Strengthening of Legal, Regulatory, and Supervisory Framework

A. Bank Supervision

22. 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 within the BOJ. Specific actions include: (i) implementation of the amendments to the legislation enacted in 1997 in order to enhance the supervisor's powers to take certain prompt corrective measures, including the power to require "Board Undertakings", issue "Directions" and "Cease and Desist Orders" which previously could only be done by the Minister of Finance; (ii) tightened prudential limits on connected lending; (iii) introduction of Basle capital requirements to be set at 10% of risk-based assets (more conservative than the standard 8%); (iv) a broader, more exacting definition of what constitutes "fit and proper" in respect to managers, directors and major shareholders of banks; and (v) tightened investment limits and greater powers to allow for the examination of accounts of holding companies.

23. In March 2002, Parliament approved, and the Governor General assented to, several amendments to the Banking Act, the Building Societies Act, the Financial Institutions Act, and the Bank of Jamaica Act to further enhance the legal supervisory framework. Thus, (i) the power to assume temporary management was transferred from the Minister to the BOJ, (ii) the BOJ was empowered to impose fines against supervised institutions for the breach of statutes, (iii) the BOJ was granted extended jurisdiction over non-banking institutions that are part of a banking group, as well as the power to require the restructuring of a financial group. The Minister of Finance has only retained the powers to grant and revoke bank licenses and to vest shares of institutions determined to be non-viable by the BOJ.

24. The BOJ has undertaken a self-assessment of Jamaica's compliance with the Basle "Core Principles" and followed it up with an independent review of such principles during 2001. The independent assessment concluded that Jamaica was largely compliant with 19 of the 25 Core Principles and compliance with another was achieved shortly after the assessment. Principles where compliance is lacking include areas such as evaluation of market risk, consolidated supervision of financial conglomerates, and enhanced ability to supervise related party transactions. The BOJ has taken a series of steps aimed at strengthening its capabilities in these areas and moving it closer to compliance with the Core Principles. These efforts will continue until Jamaica achieves compliance with all the principles. The BOJ has issued "Money Laundering Guidelines" to be followed by commercial banks, merchant banks, building societies, cambios and bureau of exchanges (inclusive of credit unions operating such facilities) and compliance with them by the industry is being monitored by BOJ. In addition, the Bank of Jamaica Act will be

amended to introduce remittance companies among the institutions to comply with Anti-Money Laundering (AML) requirements. A task force was set up to analyse the legal framework for AML and to propose amendments to include Terrorist Finance as a criminal offence.

25. In order to improve the supervisors' ability to detect weaknesses early 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 analyse the systemic risks in the system. The ongoing process for improving supervisory practices includes the recently updated "Guide to Intervention of Supervised Financial Institutions" (a ladder of enforcement that includes the amendments up to March 2002). The Guide will be continuously updated to reflect changes in legislation.

26. An inter-agency crisis intervention policy, which addresses the above issues and the individual and collective roles of each of the regulators of the financial system, was completed in August 2000 and Cabinet approval has been obtained. In keeping with its mandate to supervise all deposit taking institutions, the BOJ has also recently been given responsibility to oversee the operations of credit unions in Jamaica. The BOJ will strengthen its capability to handle this new responsibility.

27. 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 regard the BOJ, JDIC (Jamaica Deposit Insurance Corporation), the FSC (a new non-bank supervisory entity-Financial Services Commission) and the Ministry of Finance and Planning have strengthened formal inter-institutional mechanisms, including the signature of Memorandum of Understandings (MOUs) among them, through the establishment of a Financial Regulatory Council for consultation and the systematic sharing of relevant information, which help to ensure the consistency of prudential norms, facilitate consolidated supervision, minimize the risks of contagion, prevent regulatory arbitrage, and facilitate timely discussion on policy for the financial sector. The Financial Regulatory Council meets on a monthly basis and issues a semi-annual report to the Minister of Finance on technical guidance provided to the respective regulatory bodies.

28. The Financial Regulatory Council considers 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; iii) the adequacy of reporting requirements in respect of 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 and iv) the determination of the lead regulator and the coordination of examinations for dually licensed entities.

29. 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 enacted legislation to deal with this potential problem such as tightening of investment limits and restrictions on connected lending. Additional enhancements to limit the risk of contagion

from non-banking businesses to the banks include i) the legally binding BOJ Guidance Note on "Separation of Deposit Taking Activity from Managed Fund Activity," which is now being implemented by the industry; ii) empowering the BOJ to examine and inspect the books of not only holding companies and subsidiaries of a deposit-taking licensee but also other members of the group; iii) empowering the BOJ to require the restructuring of a financial group; and iv) assess that shareholders, directors, and managers of holding companies meet the fit and proper criteria. To further strengthen financial groups, regulations will be issued under the BOJ Act to address consolidation and consolidated supervision, including capital adequacy and credit limits on a consolidated basis.

B. Non-Bank Supervision

30. In the context of strengthening financial sector reform, the Government has created a new non-bank supervisory authority, the FSC. A new Insurance Act has been enacted by Parliament. The FSC will implement the new Insurance Act and will be responsible for the licensing, regulation and supervision of entities dealing in securities, collective investment funds (e.g. unit trusts and mutual funds); investment advisors, the insurance industry (companies, brokers, agents and sales persons) and private pension funds. The Government understands the importance of having an autonomous supervisory entity. Therefore, the law ensures that the entity has adequate enforcement powers, including the power to levy fines, and intervention authority. 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.

31. The FSC is functioning satisfactorily and all senior level appointments of the FSC, including the CEO, have been made. The FSC has developed its organizational chart, and plan of its future operational strategy, which it is in the process of implementing. The FSC has begun issuing necessary regulations for the industry and continues to strengthen its supervisory capacity through training programs. Specifically, the FSC has taken the following steps to strengthen supervision; (i) it has hired consultants for the design of filing software for financial solvency analysis; and (ii) it has designed two risk-based modules for both general and life insurance supervision and began on-site supervision following training reports.

32. While the Government is confident that the new Insurance Act is in line with much of international best practice, it recognizes that there are areas where further improvement can be made. The priority of the Government thus far has been to put in place a sound basic framework for regulation and supervision of the financial sector. As the sector stabilizes and begins to grow, the Government will implement further improvements in the regulatory framework. Future strengthening will include: (i) issuing regulations to harmonize the rules regarding changes in control (acquisitions, transfer, and amalgamation) requirements; (ii) issuing regulations to monitor market conduct principles and protection of policyholders' interests (fair treatment); (iii) introducing non-binding consultation with other boards or agencies and industry; (iv) consulting with other supervisory boards or relevant government agencies and industry associations in the appointment of one member to the FSC Board to promote transparency beyond the publication of commissioners' names in the *Gazette*; and (v) revising regulations to better

define standards for selection of foreign insurers including the creation of a registry of admitted reinsurers that comply with said standards.

C. Creation of Credit Bureaus

33. The Government recognizes that an important component of the infrastructure of a modern financial system is a centralized credit registry through which relevant information of debtors would be available to financial institutions and other third parties, with adequate safeguards for protection of privacy. Such a registry would permit financial institutions to better manage credit risk exposures to borrowers as well as permit the supervisor to better monitor credit risk of supervised entities. Since a centralized credit registry does not yet exist in Jamaica, the Government has decided to undertake the necessary legislative actions to create the legal and regulatory environment for the private sector to be able to establish a credit registry in Jamaica. A Bill of law for the creation of Credit Bureaus has been drafted and has been submitted for public consultation prior to submission to the legislature. The Government will use its best efforts to obtain legislative approval of the law.

D. Conclusion

34. Jamaica has made significant progress in addressing the issues resulting from the financial sector crisis of the mid 1990s and in initiating structural reforms of the sector. As described in this letter, the Government has brought the resolution of the crisis to near completion. Only minor, and largely administrative, actions remain. The Government is committed to ensuring further sound development of the financial sector and believes that the policies to be implemented during the next two years should assist in this process. The World Bank's assistance will be beneficial to the success of the Government's program.

Sincerely yours,

Omar Davies
Minister of Finance and Planning

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ANNEX III

STATUS REPORT ON THE LIQUIDATION OF FINSAC

As at August 9, 2002

FINSAC's exit strategy[1]

The Financial Sector Adjustment Company (FINSAC), which was incorporated on January 29, 1997, has successfully worked towards achieving its mandate of resolving the problems of solvency and liquidity which occurred within the financial sector during the crisis of the 1990s and has provided for a comprehensive and sustainable rehabilitation of the sector.

The agency employed a three-phased strategic plan, which included:

1. Intervention phase;
2. Rehabilitation phase;
3. Divestment phase;

It has completed the intervention and rehabilitation phases and is now in the final segment of the divestment phase. All major shareholding in financial institutions such as NCB and LOJ have been divested, and arrangements have been made to divest the minority shares in Dyoll and Island Life before the end of this calendar year. As a result, the primary focus is now on the winding down activities (see below) and the divestment of the remaining real estate portfolio.

It should be noted however that FINSAC has been forced to deal with a number of issues – "matters arising" –as a consequence of the diverse nature of the subsidiaries of the financial institutions that FINSAC acquired. There were also legal proceedings associated with some of the interventions in some instances. These and other issues must be addressed despite the pending closure of FINSAC.

To facilitate FINSAC's winding down, all its residual activities will be handled through Financial Institutions Services (FIS).

These activities will mainly consist of:

- Processing and finalizing claims arising under the representations and warranties of the various Share Sale Agreements FINSAC entered into;
- Monitoring the performance of covenants made under some of the Sale Agreements (for financial institutions), specifically those pertaining to the payment of the purchase price of entities, FINSAC sold;
- Resolving residual issues relating to insurance, asset disposal –the real estate portfolio and the recently sold NPL portfolio;

[1] This section replicates a letter provided by the Government on July 26, 2002 describing FINSAC's exit strategy.

- Providing full property management services for all properties in the FINSAC portfolio (remaining 50 percent of the commercial properties need to be sold);
- Managing and maintaining accounting processes for transactions relating to all operating entities (in which FINSAC has interest) especially those properties managed by Jamaica Mutual Properties Limited & LOJ Property Management Limited;
- Handling & monitoring complex liquidation issues for Mutual Life Group, Crown Eagle Group, NCB Group, & Corporate Group;
- Liaising with brokers and the continuation of remaining sale activities; and
- Monitoring debt collection and reconciliation.

To facilitate the above, the following initiatives have been undertaken:

1. FINSAC is no longer an operating entity and a small staff complement has been retained on contract with FIS to deal with FINSAC-related matters.
2. All properties and subsidiary company acquisitions from NCB pursuant to the scheme of arrangements and LOJ pursuant to the sale to the Barbados Mutual Consortium have been done through FIS. These properties and companies are owned by FIS.
3. FIS has established a focused liquidation team to work assiduously on the winding up of the numerous subsidiaries and affiliated companies acquired by FINSAC.

Table 1 Classification of Companies as at August 9, 2002

AREAS OF ACTIVITY: LIQUIDATION	STATUS	DISPOSAL/MANAGEMENT STRATEGY	TIMEFRAME	COMMENTS
Strategies for winding down have been determined based on the level of complexity and nature of the issues outstanding. While the exercise for some of the pending companies should not exceed 3 months, the majority of cases are not expected to be completed in less than 12 months.	FINSAC had external assistance through an international consulting company to undertake the project of winding down/liquidate 172 companies. Now FINSAC is proceeding as follows:			
	Category 1: Completed There are 72 companies in this category, these have either now been dissolved or the responsibility for their dissolution lies with the intervened entity.	○ With the sale of NCB & LOJ, Finsac's interest in the relevant companies "fell away".		
	Category 2: Strike off initiated/ pending-2 companies	○ These companies have no assets or liabilities; strike off has been initiated.	September 2002	Awaiting confirmation from the Registrar of Companies
	Category 3: Liquidation recommended-45 companies	○ Have no substantive issues; planned to be liquidated by an in-house Liquidator.	Ongoing	All documentations have been completed and reviewed. FINSAC's board approved the appointment of Claudette Booth as liquidator for these companies. The appointment of the liquidator is now

AREAS OF ACTIVITY: LIQUIDATION	STATUS	DISPOSAL/MANAGEMENT STRATEGY	TIMEFRAME	COMMENTS
				pending. In order to expedite the liquidation process FINSAC is considering a proposal presented for the transfer of the assets/liabilities from smaller companies into a holding/parent company, strike those companies off and liquidate the holding company. This will mean there will be fewer companies to take through the longer liquidation process.
	Category 4: Assignment/ Transfer of Interest to FIS-29 companies	• These are companies with lawsuits and unresolved administrative issues; as well as those having properties in the process of sale; but the sales are expected to be protracted.	Ongoing	Given the relationship with FINSAC and FIS, it has been decided that the actual legal transfer is not necessary, but FIS will continue to treat with these operationally.
	Category 5: Divestment of Shares/ Interest in progress-24 companies	• Companies in which FINSAC has shares or interest. Effort is being made to sell these.	Ongoing	These companies are currently in Receivership. Winding-up of 8 of these companies that are in the Corporate Group is dependent on resolution of a major lawsuit.

CLASSIFICATION OF COMPANIES AS AT AUGUST 2002

CATEGORY 1 *Completed*	*CATEGORY 2* *Strike Off Initiated/ Pending*	*CATEGORY 3* *Liquidation Recommended*	*CATEGORY 4* *Assignment/Transfer of Interest to FIS Recommended*	*CATEGORY 5* *Divestment of Shares/Interest In Progress/Pending*
UNION BANK GROUP (5) Citizens Assets Mngmnt Ltd. IFCOL Leasing Jamaica Citizens Inves. Ltd Odessa Services Ltd World Trade Services Corp **DYOLL GROUP (9)** Cayman Financial Services Limited Cayman Insurance Centre Caribbean National Group Limited Dyoll/Wataru Coffee Company Limited Dyoll Life Insurance Company Limited Dyoll Caribbean Financial Services Limited National Building Society of Cayman Ltd. New Seville Development Limited Dyoll Insurance Co. Ltd. **LOJ GROUP (15)** Atlantic Southern Insurance Aviation Service Global Bahamas Holdings Global Life Assurance Co Global Life Assurance Bahamas Health Corporation Jamaica Hitek Software Engineering Inter-American Marketing Corporation International Investments Ltd International Systems and Service Corp. Lested Development Limited LOJ Pooled Investment Funds Ltd. LOJ Property Management Limited St. Andrew Developers Ltd. Life of Jamaica Limited	**MUTUAL LIFE GROUP (1)** Jamaica Housing Dev* **UNION BANK GROUP (1)** Union Bank Holdings Ltd	**CORPORATE GROUP (1)** Capital Assurance Bldg. Society **CROWNE EAGLE GROUP (7)** Coolit Limited Crown Eagle Life Insurance Eagle Foundation for Enterprise Eagle Nominees Limited Fairfield Developments Forte Belle Management Trumpton Limited **EAGLE MERCHANT BANK GROUP (5)** Crown Eagle Hotels Limited Eagle Commercial Bank Eagle Permanent Building Society Eagle Trust Co. Ltd. West Coast Holdings Ltd **HORIZON GROUP (2)** Horizon Building Society Horizon Life Limited **ISLAND LIFE GROUP (1)** Island Victoria Bank Limited **MUTUAL LIFE GROUP (6)** Commercial & Residential Development Ltd. Dural Development Halsbury Ltd Consort Manufacturing Mutual Services (C'bean) 866 Realty Inc. **NCB GROUP (13)** Carp Corporation Limited Cherry Brook Limited Club Jamaica Beach Resort Computer Services & Prog. Egnaro Limited Epsom Holding Limited Glen Abbey Limited Mutual Securities Limited Mutual Security Trust & Merchant Bank NCB Group Limited NCB Trust & Merchant Bank Noxid Limited (formerly Kayrich) Pembroke Hotel Enterprises Ltd **UNION BANK GROUP (4)** Citizens Building Society Citizens Merchant Bank Ltd. Citizens Finance & In. Agency Doncaster Holdings Ltd. **VMBS GROUP (3)** Renovation Limited Tisane Limited Summerhill Development Limited *COMPANIES ALREADY IN LIQUIDATION* **NCB GROUP (2)** National Mutual Investment Ltd. Zentor Limited **CROWN EAGLE GRP. (1)** Woodpecker Limited	**CALDON GROUP (1)** Caldon Finance Merchant Bank Ltd. **CORPORATE GROUP (5)** Corporate Group Limited Corporate Life Insurance Corporate Merchant Bank Friends Group Limited WSLB **CROWNE EAGLE GROUP (8)** Ciboney Group Limited Ciboney Hotel Developers Ciboney Hotels Limited Ciboney Proprietors Limited Exeter Holdings Limited Leisure Operators Limited Luxury Resorts Enterprises Number Sixty Limited **DYOLL GROUP (2)** Buck Security Merchant Bank Limited (In L'dation) Caribbean Trust and Merchant Bank Ltd (in L'dation) **EAGLE HOLDINGS GROUP (4)** Cinchona Heights Limited Eagle Holdings & Investment Ltd. Hillhaven Limited Old England Coffee Dev. **EAGLE MERCHANT BANK GROUP (1)** Eagle Merchant Bank Ltd. **FIDELITY (1)** Fidelity Finance Merchant Bank Ltd (In Liquidation) **HORIZON GROUP (1)** Horizon Merchant Bank (In Liquidation) **INDEPENDENT MERCHANT BANKS (2)** Intercontinental Merchant Bank Limited (In L'dation) Partner Merchant Bank Limited (In Liquidation) **MUTUAL LIFE (4)** Jamaica Mutual Holdings Jamaica Mutual Life Assur. Jamaica Mutual Pension Fund Jamaica Mutual Properties	**CORPORATE GROUP (10)** Jamaica Observer Limited Levart Limited Continental Import/Export Corporate Money Market Formidable Limited CMB Investments Limited WB Finance & Inv. Kelner Limited Klienworth Limited Tamron Limited **CROWNE EAGLE GROUP (2)** Ebony View Limited Luxury Resorts International **DYOLL GROUP (1)** Dyoll Group Limited **EAGLE HOLDINGS GROUP (1)** Jamaica Fruit & Shipping Company Limited **ISLAND LIFE GROUP (1)** Island Life Insurance Company Limited **EAGLE MERCHANT BANK GROUP (2)** Eagle Investments & Securities EBH Investment Corporation (USA) **MUTUAL LIFE GROUP (7)** Int'l Hotel (O'seas) Ltd. Int'l Hotel (St. Lucia) Ltd Ja. Hotel Properties Assoc Ja. Hotel Properties Inc. Jamaica Hotel Ltd. Jamaica Mutual Inc. Mutual Turks & Caicos
72	**2**	**45**	**29**	**24**

ANNEX IV

SUPERVISORY AND REGULATORY REFORMS IN THE JAMAICAN BANKING SECTOR

KEY REGULATORY & SUPERVISORY ISSUES	INTERNATIONAL BEST PRACTICE	PRE-CRISIS SITUATION IN JAMAICA	CURRENT STATUS IN JAMAICA
Preconditions for effective banking supervision:			
Market discipline	Adequate flow of information to market participants; appropriate incentives.	Less than optimal information to the market when supervisor not provided with accurate data by licensees; likelihood of rumors	Major improvement in level and detail of information flow to market (financial indicator trends in addition to pre-existing data on individual financial entities)
Safety net	Appropriate level of systemic protection—confidence. Limited guarantee	Full guarantee	Limited guarantee through establishment of a deposit insurance corporation in 1998. Current coverage per depositor per institution now J$300, 000.
Supervisory powers	Operational independence and resources; Sufficient enforcement powers;	Not legally independent; no minimum period of appointment All enforcement/intervention powers held by the Minister.	Not legally independent; no minimum period of appointment Enforcement/intervention powers of supervisors have continued to be enhanced.
	Powers for effective resolution of problems in banks, including exit;	Actions to be taken by the Minister	Supervisor may assume temporary management of a weak institution. The Minister retains the powers of licensing and de-licensing institutions, vesting of shares of failed institutions, final sign off on fit and proper requirements as well as to issue Regulations.

KEY REGULATORY & SUPERVISORY ISSUES	INTERNATIONAL BEST PRACTICE	PRE-CRISIS SITUATION IN JAMAICA	CURRENT STATUS IN JAMAICA
	Interagency cooperation and sharing of relevant information.	No information sharing	MOU signed among financial supervisory agencies underpinned the formation of the Financial Regulatory Council (FRC), which is chaired by the Governor of the BOJ. It commenced meetings on December 2000.
	Clear criteria for lead regulator.	No lead regulator	MOU governing FRC activities broadly defines the role of the lead regulator under the Crisis Intervention Matrix.
Licensing and structure:			
Permissible activities	Clear definition of the scope of permitted activities, at a minimum deposit taking activities reserved to banks	Deposit taking activities de facto permitted to insurance companies	Deposit taking activities still not exclusively reserved to licensed banks, as insurance companies continue de facto to issue products with miniscule 'insurance wrapper' with the bulk of premium payments going to a "deposit fund" or 'deposit like' instrument.
Ownership structure	Financial strength of major shareholders; effective supervision not hampered by group structures; transparency	Opaque groups.	BOJ may request changes to the ownership structure of financial groups where determined that transparency and effective supervision is hindered or viability of licensee is threatened.
Fit and proper criteria	Stringent criteria applicable to owners, directors and senior management. Accountability and responsibility of managers and	Certain requirements for owners and managers.	Requirements enhanced, and now extended to non-banking companies within conglomerates that include a deposit-taking

Key Regulatory & Supervisory Issues	International Best Practice	Pre-Crisis Situation in Jamaica	Current Status in Jamaica
	directors		licensee. There is also automatic statute barring of owners, directors and senior managers of failed financial entities.
Transfer of shares	Controlling interests approved by supervisors	Minister's approval	Minister's approval, fit and proper requirements enhanced.
Major investments.	Approved by supervisors (to avoid undue risks and supervision hindrance)	Limits on fixed assets and investments in enterprises established in law	Limits on fixed assets and more stringent limits on investment in enterprises established in banking law.
Prudential regulations and requirements			
Risk-based capital adequacy:	Risk-based capital requirement Main risks (credit, country, market, interest rate, liquidity) taken into account Requirement on solo and consolidated basis	Deposit-based capital requirements Deposit-based, not risk-based capital requirements Only on solo basis	Risk-based and deposit-based capital requirements Credit and market risk incorporated in capital requirements. The law enables the Minister to issue capital requirements on both solo and consolidated basis. Regulations to be signed into law in the near future.
Credit risk management (CRM): (i) Credit-granting standards and credit monitoring process.	Supervisors evaluate policies, practices, and procedures for granting and monitoring of current portfolio Credit bureau. Access to other intermediaries positions	Supervisor evaluates policies, practices and procedures for granting and monitoring of credit portfolio No credit bureau; banks do not know other banks' exposures	Supervisor evaluates policies, practices and procedures for granting and monitoring of credit portfolio No credit bureau; banks do not know other banks' exposures. Law proposal tabled by the government on Feb. 2002
CRM: (ii) Asset valuation	Asses quality; adequacy of loan-loss reserves	Not sufficiently prudent provision requirements.	Prudent provision requirement

Key Regulatory & Supervisory Issues	International Best Practice	Pre-Crisis Situation in Jamaica	Current Status in Jamaica
CRM: (iii) Concentration and large exposures	Identify and set limits (consolidated basis).	Prudent limits in place but solo basis	Prudent limits in place on solo and consolidated basis as now provided for in law.
CRM: (iv) Connected lending	Arm's length basis, effective monitored and limited (consolidated basis)	Same limits as for unconnected parties	Much more stringent limits than for unconnected parties now in place on solo and consolidated basis. Amendment to law needed (to explicitly require arms length basis for related party credit)
CRM: (v) Country and transfer risk	Identify and monitor country risk and transfer risk. Reserves	No requirements	Guidance document in force
Market risk management	Banks supervisors must determine that banks measure and control market risks; where appropriate, set a capital cushion	No provisions for market risk	Guidance document on market risk drafted, now being discussed with the industry. Training of supervisors on market risk in progress.
Internal controls:	Overall prudent management in accordance with policies and strategies established by board; know-your-customer (laundering)	Standards of best practice were being formulated for application by industry. Money laundering Guidelines in place.	Enforceable "Standards of Best Practice" including additional standards issued. More formal Money Laundering Guidance Notes issued.
Methods of ongoing supervision			
Bank management contact	Regular contact with bank management and thorough understanding of banks' operations (on- and off-site).	Initial strengthening and reorganization of staff	Strengthening and re-organization of staff and methodology enhancement continue. Information flows improved.
Off-site surveillance	Prudential reports both solo and consolidated and from non-financial companies of the group	Structured prudential reporting regime in place, less-than-optimal information available.	Monitoring capabilities enhanced: Quarterly Performance Targets Regime, Financial

KEY REGULATORY & SUPERVISORY ISSUES	INTERNATIONAL BEST PRACTICE	PRE-CRISIS SITUATION IN JAMAICA	CURRENT STATUS IN JAMAICA
			Stability Monitoring Committee.
On-site examinations; external auditors	Means of validating information. Clear guidelines related to frequency and scope of examinations. Policies and procedures in place. Roles of auditors and supervisors clearly differentiated	Clear guidelines re frequency and scope of examinations Less-than-optimal external audit reports.	On- and off-site examinations enhanced. Training on consolidated supervision and market risk for supervisors in progress. Requirements for auditors and audit reports have significantly improved. Supervisor may now require change/expansion in scope of audit. The Minister will shortly be issuing Regulations on the qualification of auditors.
Consolidated supervision	Ability to review both banking and non-banking activities, both domestic and foreign. Both (solo and consolidated) prudential requirements	Review only banking activity Solo prudential requirements	Legal ability to review all group companies' activities. Solo and consolidated legal and prudential requirements. Training in progress on consolidated supervision
	Information sharing among different supervisors	Insufficient	MOUs signed among financial supervisory agencies. Financial Regulatory Council (FRC), chaired by the Governor of the BOJ commenced meetings on December 2000.
Information requirements			
Accounting standards	Comparable information; based on internationally accepted accounting principles and rules	Profits were easily inflated by uncollected income	Accounting standards improved, more in line with international standards and principles
Scope and frequency of	Determined by supervisor; some	Scope and frequency stated in law	Determined by law and

KEY REGULATORY & SUPERVISORY ISSUES	INTERNATIONAL BEST PRACTICE	PRE-CRISIS SITUATION IN JAMAICA	CURRENT STATUS IN JAMAICA
reporting	reports may be "event generate"	and determinable by supervisor, however questionable timeliness and reliability	supervisor. Better quality reports
Confirmation of the accuracy of the information submitted	Responsibility of banks' management; assessed by external auditors. Special reports could be decided by supervisors	Managers were not perceived as taking sufficient responsibility for the information.	Managers sign the official statements. Audit reports improved. BOJ can ask auditors for further work. Regulation drafted that would give the power to supervisors to revoke the appointment of auditors and prevent appointment of non-qualifying auditor
Disclosure	Comprehensive and not misleading information regarding activities and financial position of banks.	Disclosed information was frequently inaccurate and misleading	Improved disclosure standards. BOJ can legally require further disclosure
Formal powers of supervisors			
Corrective measures	Appropriate intervention to protect depositors, creditors, and prevent widespread contagion.	Minister can assume temporary management, suspend or revoke a license	Minister may suspend or revoke a license or vest shares of licensee in himself to facilitate sale or restructuring and present to the Court a petition for the winding up or initiate reconstruction

KEY REGULATORY & SUPERVISORY ISSUES	INTERNATIONAL BEST PRACTICE	PRE-CRISIS SITUATION IN JAMAICA	CURRENT STATUS IN JAMAICA
	Graduated, and timely, supervisory response (restrict activities, restrict paybacks to shareholders, replace management, conservatorship) and vigilance	Minister can require undertakings, give directions, issue cease and desist orders and take temporary management. Minister presents to the Court a petition for the winding up or initiates reconstruction Initial Supervisory Ladder of Enforcement	BOJ can require undertakings, give directions, issue cease and desist orders, and assume temporary management. Supervisory response/ intervention steps enunciated to industry in updated Ladder of Enforcement document.
Liquidation procedures	Ability to close or assist in the closure of financial institutions.	BOJ assists in closure of financial institutions.	BOJ assists in closure of financial institutions.

ANNEX V
JAMAICA – OVERVIEW OF THE INSTITUTIONAL FRAMEWORK OF NON-BANK FINANCIAL INSTITUTIONS

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This annex was prepared on the basis of information obtained during a Bank mission in August 2001. The main text of this report contains details on more recent actions taken by the Government.

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1. Insurance is not, in general, well developed in low-income countries. Demand from households is weak because poor people have few possessions and cannot afford the insurance premiums. Similarly poor people have little demand for life insurance as they find it already difficult to set aside funds for short-term precautionary purposes and are therefore unable to provide for their long-term financial needs. Insurance is also underdeveloped in low-income countries because of the absence of the necessary infrastructure. Insurance relies on the law of large numbers and the compilation of data about the occurrence of accidents and the resulting financial losses. Data on loss experience are essential for setting premium tariffs but the collection of such data requires extensive cooperation among insurance companies and an advanced organizational network.

2. Insurance business in developing countries often suffers from widespread mistrust between insurance companies and their customers. To protect against fictitious claims and insurance fraud, insurance companies include clauses that limit their liability in cases where material information is not provided at the time an insurance policy is bought. Policies have also exclusion clauses stipulating that insurance cover is not provided under certain specified circumstances. Such exclusion clauses make insurance contracts difficult to understand and give rise to disputes. In some countries, these disputes cause prolonged delays in settling claims, which accentuate the mistrust of insurance companies.

3. The insurance market in Jamaica is relatively developed but suffered greatly because of the recent financial crisis. Already in October 1996, a joint IMF, WB and IDB mission carried out a comprehensive assessment of the Jamaican Financial sector. It was found that the two largest life offices (Mutual Life and Life of Jamaica) were insolvent and had substantial cross lending and ownership links with the banking sector. This was itself also severely distressed. The links between the banking and insurance sectors have been severed and a thorough revision of the insurance regulation and supervision is taking place[2]. The Financial Sector Commission (FSC) is going to replace the Office of the Superintendent for Insurance (OSI) as the new regulator and supervisor for insurance, adding pensions and securities to its responsibilities.

4. Today FINSAC has recapitalized Island Life and Life of Jamaica and divested the insurance portfolios of Crown Eagle Life, Dyoll Life and Mutual Life. First Life and Guardian Life of Trinidad acquired their portfolios, with the latter acquiring the bulk of the portfolios. Barbados Mutual Life acquired a controlling interest in Island Life and is in the process of buying Life of Jamaica. It is expected that the process of consolidation will continue with the

[2] See section on insurance regulation and supervision.

merge of Island Life and Life of Jamaica. Barbados Mutual is expected to introduce a more conservative style of management and more products in the market fostering innovation.

5. By all means the Jamaican insurance industry, and especially the life-insurance industry, is re-starting its activity in a totally new supervisory and regulatory environment, just established and soon to be enacted. Everything is in a status of flux and market participants have the feeling of re-starting with a clean slate. The prospect for growth will rely on the development of an appropriate supervisory process and correct implementation of a newly designed regulatory framework that on paper appears to meet most of the internationally accepted standards. Of course, the highly expected economic recovery will allow companies to "go back on their feet".

Size and structure of the Jamaican market

6. Data on the Jamaican insurance market is relatively hard to collect. The Office of the Superintendent of Insurance (OSI) is currently being phased out and soon-to-be replaced by the already established Financial Sector Commission (FSC). Most of the information reported here relies on factual evidence collected during a 5-day mission in Kingston during August 2001. The data reported here have been provided by the Jamaican Association of General Insurance Companies (JAGIC) and by the Life Insurance Companies Association of Jamaica (LICA)[3].

7. Written premiums for Jamaican life and non-life insurance companies totaled JMD 12.04 billion in 1998 and JMD 12.80 billion in 1999. In 1999, life[4] and non-life represented 43 and 57 percent of the market, respectively. Jamaica, compared to countries with similar per-capita GDP has a fairly developed insurance market. Insurance penetration amounted to 4.8% of GDP in 1998 and 4.6% of GDP in 1999. Per capita premium was US$ 127 in 1998 whilst US$ 117 in 1999, the difference mainly accounted for a depreciation of the exchange rate.

Table 1: International Comparison of Insurance Industry, 1999

Country	Real per-capita GDP (US$) /1	Premium over GDP (%) /1	Premium per-capita (US$)	Life and Health (%)	Non-life (%)
Morocco	3,421	2.58	32.54	37.65	62.35
Egypt, Arab Rep.	3,423	0.69	9.11	28.79	71.21
Ukraine	3,460	0.92	5.64	9.72	90.28
Jamaica /2	3,565	4.56	117.30	43.42	56.58
China	3,620	0.15	1.14	57.79	42.21
Philippines	3,803	1.40	12.38	53.75	46.25
Jordan	3,958	1.76	29.60	29.08	70.92

Notes: 1 1999 Egypt and Jamaica, 1998 all other countries; 2 Life and Health includes pension funds assets.
Sources: AXCO, LICA, JAGIC, and WB calculations.

8. At the end of 1999 there were 8 life and 17 non-life insurance companies. During 2000 and 2001 life insurance companies were absorbed by Guardian life. The life insurance market is highly concentrated. The largest company, Life of Jamaica, had in 2000 40% share of the ordinary life market, 54% of the group health market, 36% of the group life market, and 70% of

[3] Background material provided by AXCO and from previous WB, IMF, and IDB missions has also been used.
[4] And health.

the pension asset management. The non-life market comprises of some 14 companies and it is less concentrated than the life market: the largest 5 companies control over 60% of the market. The process of consolidation in the life market has been desirable, as the market, especially during the last recession, could not ensure the financial viability of too large a number of companies. It is not clear whether consolidation is also needed in the non-life market. Although margins have been eroded considerably during the last years, the economy is slowly rebounding. Despite the fact that companies work with considerably low loss ratios, and that minimum capital standards have been recently increased, industry participants feel that the non-life insurance market is still small to support a large number of profitable companies.

9. Table 2 reports data on the growth of the life insurance industry between 1990 and 1999. Whilst the class of group life and health has expanded during the last decade and through the financial crisis, individual life has been contracting since 1993. The reasons for the unfavorable development of individual life can be traced in the recent financial crisis and deteriorating economic condition. With increased unemployment, lapses have increased and policyholders have simply stopped insuring. Another reason for the decline in premiums is related to the shift from long-term protection to short term investment (quasi deposit) products. In any case, after a period of stagnation, the economy is expected to rebound and already in 1999 gross premium income for this market increased by 26% in nominal terms. In 1999, the individual life market produced premiums of JMD 4,751 million (USD 100 million) in 1999, or 73% of total life.

Table 2: Written Premium of Life Insurance Industry (JMD million)

Year	Individual	Group	Health	Total
1990	557.7	49.2	102.4	709.3
1991	996.0	41.8	131.4	1169.2
1992	5,011.1	64.5	236.7	5,312.3
1993	6,426.8	101.4	364.7	6,892.9
1994	5,300.3	170.7	556.2	6,027.2
1995	5,512.5	211.4	767.4	6,491.3
1996	4,366.7	312.7	912.5	5,591.9
1997	4,117.3	336.3	1,123.6	5,577.2
1998	3,778.5	444.5	1,345.6	5,568.6
1999	4,752.1	472.1	1,312.7	6,536.9

Sources: AXCO, LICA.

10. Table 3 reports data on the growth of the non-life insurance industry between 1990 and 1999. Motor insurance represents 64% of total market. Its share has been increasing from 48% in 1990 at the expenses of property insurance. In general the non-life industry has been stagnant for the whole second half of the nineties mirroring the poor performance of the whole economy during the same period.

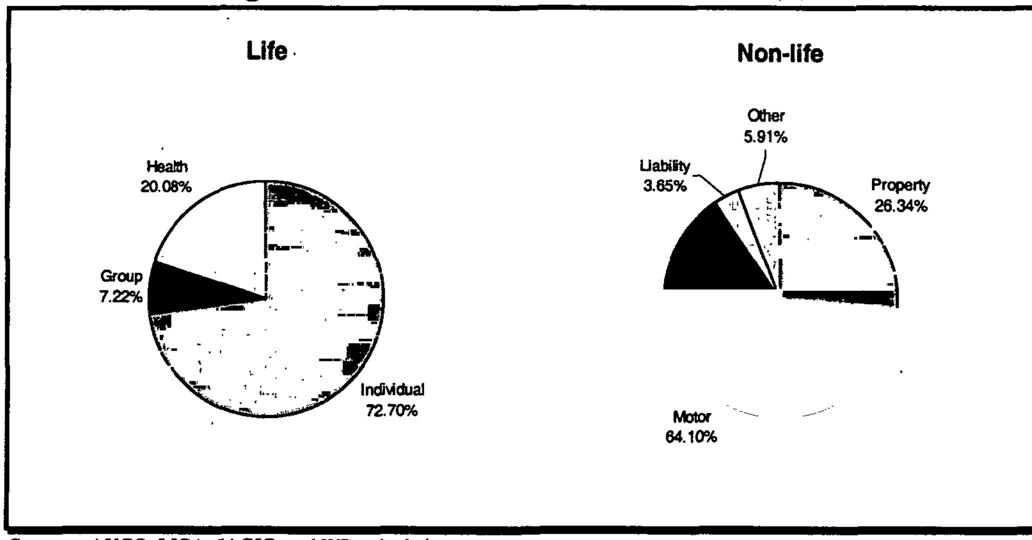
Table 3: Written Premium of Non-life Insurance Industry (JMD million)

Year	Property	Motor	Liability	Other	Total
1990	405.4	509.6	44.5	86.7	1,046.2
1991	522.8	712.4	41.5	133.8	1,410.5
1992	1,040.4	1,216.2	72.5	247.5	2,576.6
1993	2,447.6	1,865.4	120.6	375.8	4,809.4
1994	3,315.5	2,618.0	157.9	521.9	6,613.3
1995	3,093.9	3,130.6	179.0	565.0	6,968.5
1996	2,854.8	3,568.3	195.0	546.3	7,164.4
1997	2,197.3	3,634.0	202.2	582.1	6,615.6
1998	1,732.0	4,020.0	208.9	513.4	6,474.3
1999	1,862.1	4,532.2	258.1	417.6	7,070.0

Source: AXCO

11. Figure 1 summarizes the structure of the life and non-life markets in Jamaica. Within non-life, motor insurance accounted for 64% percent of gross premium income whilst within life, individual life accounted for 73%.

Figure 1: Life and Non-life Market Shares, (1999)



Sources: AXCO, LICA, JAGIC, and WB calculations.

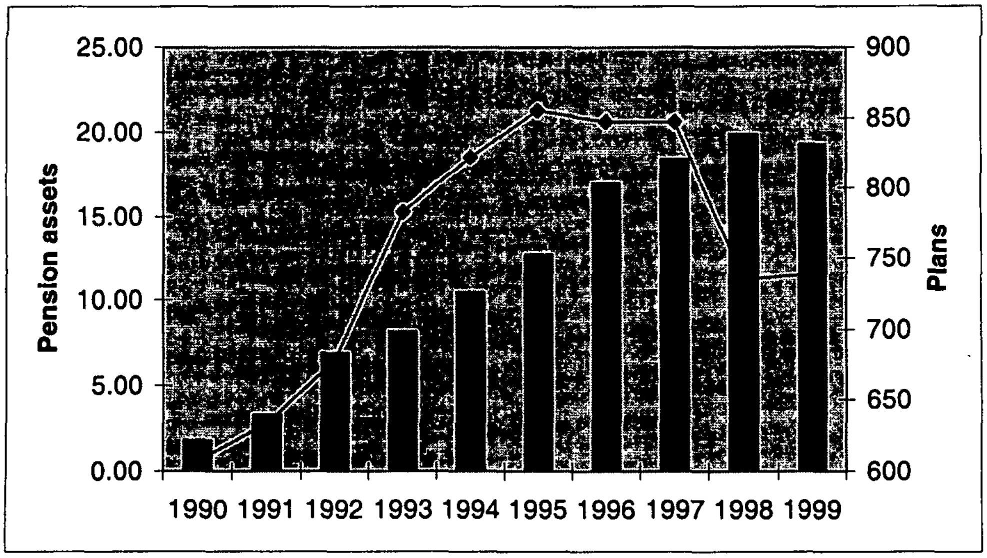
Products

12. Life insurance companies sell individual and group life, healthcare and personal accident[5], and manage voluntary occupational pension plan assets. Jamaican life insurers write most of personal accident and healthcare business. Some non-life insurers write a certain volume of stand-alone personal accident business. Most of the business is group healthcare coverage, and Life of Jamaica is estimated to be the only life company to write personal accident insurance.

[5] The normal scope of cover for personal accident is either death only or death and loss of limbs and/or permanent/total temporary/partial temporary disablement.

13. **Voluntary occupational pension schemes** existed prior to the establishment of the National Insurance Scheme (NIS) in April 1966. Presently there are some 1,500 registered schemes, which are either self-administered or pooled with pension administrators. A considerable amount of assets has been accumulated in these funds. Between 1990 and 1999 the pension assets managed by insurance companies increased by more than 1,000% as shown in Figure 2. In 1990, life insurance companies managed around JMD 2 million from some 600 plans whilst in 1999 they managed around JMD 19 billion from some 740 plans. It is estimated that these represent a 50 to 70% share of total occupational pension assets.

Figure 2: Pension Assets and Number of Funds, (JMD million)



Sources: LICA.

14. The insurance market leader in pension funds is Life of Jamaica (LOJ). During the recent financial crisis LOJ lost more than JMD 2 billion of pension plan assets due to over-investment in illiquid real estate. Due to the recent financial volatility, companies are moving away from guaranteed management to segregated pooled funds. Although guaranteed products are becoming less popular, it is clear that the new supervisory authority will need to exercise close supervision on the way companies price guarantees.

15. **Group life** assurance mainly consists of life policies on a term basis, as endowment-type contracts have lost popularity during the years of high inflation. As of 1999, 19838 group life contracts were in force insuring slightly more than 200,000 individuals. This is estimated to be 18% of labor force. LOJ is again the market leader for this product.

16. **Individual life** is by far the dominant class producing some 70% of total life premium income (including health). This class of business has contracted by more than 40% since 1993 reflecting the economic stagnation after the financial crisis. The two main products sold within this class are term insurance for protection and investment-linked life policies for investment.

17. **Property** insurance represented some 26% of total non-life premium income in 1999. Homeowners' business is written as a separate class, whilst small commercial risks are written in

the property account. Homeowners have largely stopped insuring after the large Hurricane seasons of the late 80s when premium rates increased considerably. Demand from households is still weak after the subsequent decline in rates because poor people have few possessions and cannot afford the insurance premiums.

18. There has been little activity in the **construction** sector, due to the depressed state of the economy and absence of new major investments. Major contracts are often insured overseas.

19. **Motor** insurance is the largest class within non-life. Third party motor insurance is obligatory for both bodily injuries and property damage. Limits have recently been increased. There is no risk pool or alternative provisions for accidents involving uninsured drivers. Although detailed statistics were not made available, it is estimated that some 50% of drivers have comprehensive cover. The motor class is intensively competitive. Companies retain some 90-95% of premiums using excess of loss and proportional reinsurance for the rest. Since there are no tariffs, some insurers are said to continuously undercut the market and this form of price war has led to steep reductions in margins.

20. The third largest class of non-life insurance is **liability** (product, third party, and professional indemnity). The class of third party liability has grown in recent years but not dramatically. As with other large risks, large industrial and commercial risks are frequently placed overseas under master policies. What is insured in the local market is often, but not always, heavily reinsured abroad. Product liability is very small and generally written as an extension of third party liability. Finally, professional indemnity is also very small. Market participants have witnessed an increased interest in this product. Ideally, due to the increasing focus in the new legislation on corporate governance and responsibilities of directors, it would be advisable that directors and senior insurance management be required to take professional indemnity insurance.

Efficiency

21. Efficiency in the insurance industry is difficult to measure because, like all other types of financial services, there is no easy definition of the output of the sector. Various measures are used for comparative purposes but these are subject to considerable subjectivity that substantially reduces their usefulness. For life insurance business, underwriting performance is even more difficult to measure because of the longer-term liabilities. In this section we focus on underwriting performance on non-life insurers.

22. For the non-life business, underwriting performance can be measured by the loss ratio. The loss ratio usually measures net accrued claims as a proportion of net earned premiums, i.e., gross claims paid less claim provisions at the beginning of the year plus claim provisions at the end of the year less the receipt from reinsurers over gross premiums received less premiums ceded (net or retained premiums) less premium provisions at the end of the year plus premium provisions at the beginning of the year. It shows the percentage of premiums that are paid back to the insured and a high ratio normally indicates an efficient and competitive industry while a low ratio would indicate relative inefficiency. Notice that because payments for losses may be spread over a number of years, especially for so-called long tail business, such as automobile insurance where claims may take several years to settle, insurance companies make transfers to loss reserves to cover future payments. Differences in reserving policies and manipulation of

reserves for tax and other purposes usually reduce the usefulness of the loss ratio as an index of efficiency and an index average over two or more years should be taken.

23. Unfortunately, due to lack of data the loss ratio reported in Table 4 are calculated as gross claims over gross premium income. Despite this shortcoming, the data clearly shows that the non-life market is non-competitive and probably inefficient.

Table 4: Non-life insurance, loss ratios (%).

Year	Property	Motor	Liability
1990	9.5	56.9	44.6
1991	31.3	68.2	57.8
1992	17.8	59.2	56.3
1993	12.8	54.3	56.0
1994	5.2	54.3	51.0
1995	10.2	59.2	33.9
1996	11.2	68.3	59.1
1997	31.5	80.2	45.7
1998	26.8	76.8	64.0
1999	33.2	69.1	47.6

Sources: AXCO

24. As expected, the loss ratio for the motor insurance class is higher than for the property and liability classes. However, it appears that in average all companies work with low loss ratios[6]. In developed economies this would be around 80-90 percent. The low loss ratio seems to suggest that tariffs are set too high with respect to the risk taken and that companies are rather inefficient.

Distribution

25. For non-life insurance all channels are used with the exception of bank assurance. Direct selling appears to be the more common. Most motor insurance is sold via agents, and brokers would be involved only with major private or commercial fleets. The agency system is widely used, with some agents working directly with companies, whilst others work on a sub-agency basis through general agents. Many of the agents are based elsewhere than Kingston and as a consequence, companies do not have offices outside major urban areas. Finally, brokers handle some 60-70% of total non-life premiums.

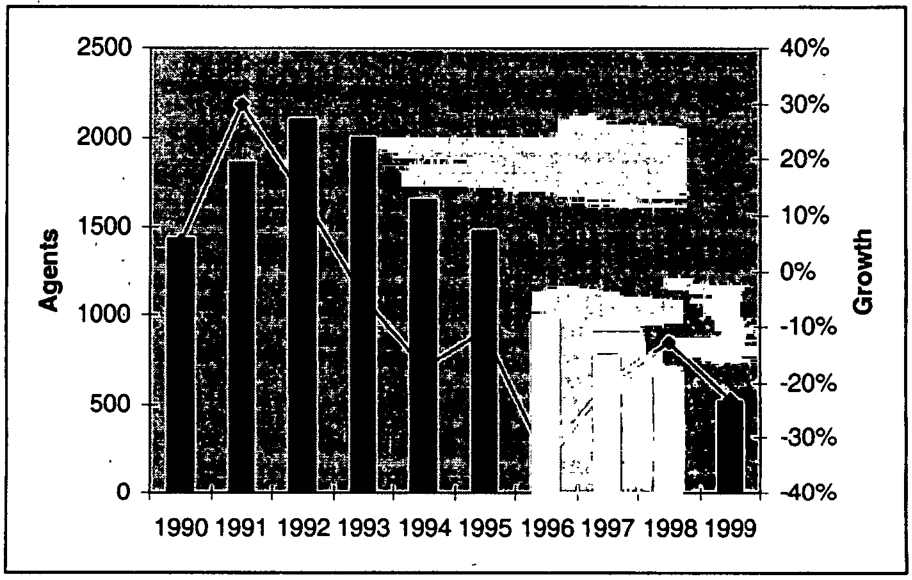
26. Life insurance business is distributed through own sales forces, independent agents and insurance brokers. Most individual life business is sold through company sales representatives or independent agents. Group life insurance and pensions business is sold through brokers. It is estimated that 50% of group healthcare business is sold via brokers, with the reminder being sold via company agency sales forces or independent agents.

27. Most insurers have their own marketing and sales departments with staff mainly paid on a commission basis. The excessive size of the sales force has been an important element in the

[6] Unfortunately it was not possible to collect data on expense ratios. For very inefficient companies, the loss ratio can be very high and "consume" a large share of gross premium income.

financial insolvency of many of life insurance companies during the recent financial crisis. As a result of the re-capitalization and re-structuring of the companies that went insolvent, the number of life sales representatives has decreased dramatically as shown in Figure 3.

Figure 3: Life Sales Force, year-end size and growth (1990 - 1999)



Source: LICA

28. The insurance supervisory authority licenses agents. A fit-and-proper test is carried out at the time of licensing to determine the qualification and moral standard of applicants. Training and professional examinations are undertaken through LICA. Agents need to take professional indemnity insurance. Despite the legal requirements, it is estimated that many agents are not registered and are allowed to operate. The lack of supervision and poor implementation of regulation in this area raises concerns regarding the extent with which consumer protection is ensured.

29. Brokers handle mainly group life and pensions business. Similar licensing requirements for agents are applied to brokers. Most of brokers have only indirect links with reputable overseas brokers. Only Fraser Fontaine and Kong are local correspondent offices of Marsh Inc, whilst International Insurance Brokers has links with AON. Due to poor data collection, it is not known how many of the 30 registered brokers have survived the recent financial crisis.

Asset allocation

30. Insurance companies build up substantial technical reserves, which are available for investment in long-term and marketable financial instruments. Life insurance companies have long-term liabilities and their development constitutes an increase supply of long term funds in the economy. Also non-life companies, that cover relatively short-term risks, accumulate substantial reserves, which represent long-term resources for companies that experience a reasonably steady growth in their business. In fact, because the loss claims facing non-life insurance companies suffer from various processing delays until they are settled and are thus exposed to the vagaries of inflation, non-life insurance companies in OECD countries tend to

place a high proportion of their technical reserves in long term maturity assets like stock and bonds that generally provide a better hedge against inflation.

31. Under Schedule 34 of the 1971 Insurance Act there is a statutory requirement that reserves be established for unearned premiums, unexpired risk, outstanding claims. Premium reserves are accumulated using the 1/24 rule, which is reflected in proportional treaties as a 40% reserve. This is usually a good rule of thumb for accumulating reserves. In addition, a claims equalization reserve has to be calculated at 5% of gross premium income. Reserves must be maintained in liquid assets.

32. Pension funds are usually held in a deposit administration account or a pooled investment fund. Under the former, funds are invested in the life company's general fund, whereby the capital is guaranteed and a minimum return on investment is also guaranteed. Under the pooled investment fund, the funds of various pension plans are pooled and invested by the life company separately from its general funds. No guarantee applies to segregated pooled funds.

33. All investments must be in approved securities, listed in the 1971 Act. The essentially include real estate, Government securities, Jamaican approved shares, or other assets authorized by OSI. The new Insurance Act, to be passed before the end of 2001, lists very detailed diversification and matching requirements for the allocation of reserves. It also allows increased shares of foreign investment reflecting the concerns regarding the lack of sound and liquid assets in the country. In particular, insurance companies will be required by law to establish an investment committee and implement an investment policy. The investment policy establishes the limits by type of asset or by sector for the allocation of reserves. It establishes strict internal control mechanisms to ensure that investments are properly authorized. It finally establishes standards to be followed for so that reserves are invested only in sound and liquid assets, purchased at fair market value.

34. Great emphasis is made on increasing the quality of governance and internal controls in the new legislation. This involve, among other, requiring companies to appoint external actuaries, establish an investment committee as a subcommittee of the Board of Directors, and establishment an ongoing internal audit function. The focus on appropriate diversification of asset risk is an attempt to avoid the problems of the recent past. Table 5 shows the asset allocation of life insurance companies during the period 1992 – 1999. Over investment in real estate (that in 1997 reached 42% of total assets) has been one of the major determinants of companies' insolvencies. The rapid shift into Government securities, the share of which trebled between 1997 and 1999, is a logic reaction to the recent events.

Table 5: Life Insurance Asset Allocation (JMD million)

Category	1992	1993	1994	1995	1996	1997	1998	1999
Real Estate	4,011.4	5,388.4	8,006.2	9,218.0	9,497.5	8,756.1	NA	3,101.3
Mortgage Loans	442.7	676.3	533.9	599.3	455.0	458.3	NA	181.8
Gov. Securities	453.3	551.1	710.1	842.4	1,437.7	3,914.1	NA	12,395.4
Policy Loans	265.5	307.9	344.5	380.6	463.6	483.3	NA	611.7
Unit Trust	791.8	396.5	542.5	444.4	7,008.3	661.2	NA	200.6
Common Stock	6,082.2	1,969.5	2,216.9	2,200.7	1,997.5	1,135.2	NA	633.2
Corp. Bonds	189.6	273.7	57.2	403.6	532.7	349.7	NA	181.0
Deposits	1,222.2	1,088.9	1,666.9	2,344.9	2,285.8	2,274.5	NA	2,212.0
Other	3,759.2	8,304.8	8,606.9	10,321.2	5,139.3	2,728.8	NA	1,971.3
Total	17,217.9	18,957.1	22,685.1	26,755.1	28,817.4	20,761.2	NA	21,488.3

Notes: Pension funds assets are excluded. Assets are on a non-consolidated basis. The category "Other" includes investments in affiliated companies.
Source: LICA

ANNEX VI

OVERVIEW OF THE REGULATORY AND SUPERVISORY FRAMEWORK FOR NON-BANK FINANCIAL INSTITUTIONS IN JAMAICA

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This annex was prepared on the basis of information obtained during a Bank mission in August 2001. The main text of this report contains details on more recent actions taken by the Government, including the enactment of the new Insurance Act.

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I. INSURANCE SECTOR

Introduction

1. The Jamaican legislative and supervision frameworks for insurance are currently being updated. This is an evaluation of the Jamaican draft insurance law and regulation, and of the progress made in the establishment of a new supervisory authority for insurance[7]. Since the recent financial crisis the Jamaican authorities have spent considerable effort in updating the financial sector regulation and revamping supervision. This was also supported by technical assistance provided by international donors. Rather than an overall description of the new draft insurance law and supervision arrangements, this report aims at addressing specific issues identified during an identification mission that took place at the end of August 2001.

2. As a general comment, the new insurance draft law and regulations are of high quality and they successfully address internationally accepted principles of insurance supervision. The legislation is highly detailed and sophisticated and a major concern relates to the ability of the newly established Financial Sector Commission (FSC) to successfully implement it. The current draft law and regulation contains important elements of risk based supervision and it puts a lot of weight on the role of on-going audit functions and external actuaries of the companies. Nevertheless, the style of supervision likely to be developed in the short run will undoubtedly be a traditional tight "a priori" control on all operations and activities of the insurers. The lesson learned during the recent financial crisis implies that proper determination of solvency position of companies or validation of figures and information will be of major concern to the supervisory authority. At the same time companies and new staff in the FSC will need time to adapt to a new way of supervising and regulating the market. In particular, it is believed that some time will be needed by the market and by the supervisor to develop and apply strong standards of corporate governance and market conduct. However, the current draft legislation is designed to promote these principles (the recommendations made here tend to reinforce them) and in the medium term the FSC is likely to evolve its style of supervision into a style of partnership/consulting. In this second style of supervision the FSC should be able to rely to some extent on the internal controls and self-governance rules of the insurers and to focus mainly on guaranteeing fairness of the services offered in the market and adequate solvency levels of the players. In order to

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[7] The new Jamaican regulatory framework relating to insurance comprises the Financial Sector Commission Act establishing a new regulatory and supervisory authority for insurance, pensions and securities, the soon-to-be enacted draft Insurance Act and some 157 pieces of implementing regulation. The draft law and regulations are subject to constant modification before being submitted to parliament. The draft law reviewed here is dated beginning of August 2001.

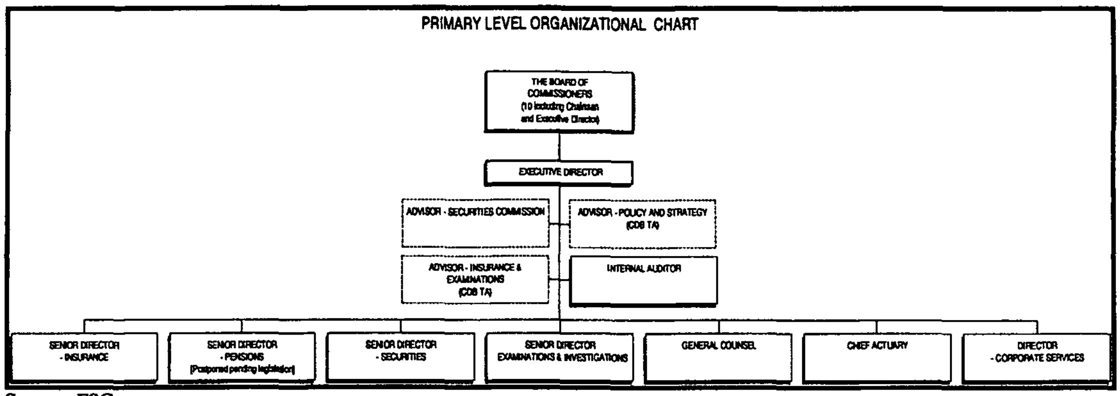
succeed in this evolution, it will be absolutely necessary to promote strong controls and self-governance rules in the insurers internal organizations.

Organization of the Supervisory Authority

3. The FSC Act of 2001 has established a new financial sector supervisory authority responsible for supervision and regulation in the securities, insurance, and private pensions areas. The FSC Act describes the powers and responsibilities of the FSC. In the area of insurance, the new institution will replace the Office of the Superintendent for insurance (OSI) once the draft Insurance Act is passed. This is likely to happen by the end of October 2001.

4. At the time of writing (beginning of September, 2001) the FSC was in the process of being staffed and organized. As detailed in the next figure, a Board of Commissioners deferring the daily operations to an executive director will govern the FSC. Insurance supervision and regulation will be the object of activity of the sector-specific Department of insurance, and the three departments (Examinations, Legal, and Actuarial/Research) offering cross-functional services to all sector departments. The Corporate Services Departments will be handling administrative issues related to licensing.

Figure 1: FSC's Organizational Structure



Source: FSC.

5. After the Insurance Act is passed, the market will finance the FSC through fees and a share of gross premium income premiums (likely to be around 0.75%) for which no transition phase has been designed. Although the industry will certainly recognize the usefulness of the services provided by the new supervisory authority, pressure for a transition phase to comply with the new regulation will certainly emerge.

6. The budget at disposition of the FSC will allow for the retention of qualified personnel. The Minister of Finance has approved a competitive salary range and has the authority to approve, on an ad hoc basis, salaries in excess of such range. This has been the case for the Executive Director and likely to be the case for the not yet identified Chief Actuary.

7. All senior staff, with the exception of the Chief Actuary, the General Counsel, and the Director for Pensions have been hired. The Board of Commissioners has been appointed and the Executive Director nominated. The Minister of Finance appoints all 9 commissioners in the

Board. These, in turn, select the executive director. The FSC is likely to have 77 staff. As far as insurance is concerned, personnel are likely to be transferred from the still active OSI and missing staff will be hired from the market.

8. On paper the FSC enjoys full autonomy to independently discharge its functions. Indeed the Minister of Finance has powers that are mostly limited to administrative issues and general financial policy. However, the governance structure with all Commissioners being appointed by the Minister of Finance might indirectly expose the FSC to excessive political interference in prudential matters. Other jurisdictions have often adopted some form of consultative process between the political power and the industry. In Mexico, for instance, the head of the insurance supervisory authority reports to a Board of Governors (Junta de Gobierno) where the Ministry of Finance (SHCP), Bank of Mexico, Bank and Securities National Commission, the insurance Supervisor (CNSF), the National Commission for Retirement Savings (CONSAR), and independent experts are represented. This is a non-appointed collective body established by law with independent experts appointed through a consultative process with the industries supervised. The collective body ensures balance between political interference and industry interests. At the same time, the fact that the industry does not directly appoint members of the Board of Governors avoids problem of partisanship within the financial industry. In Canada, emphasis is made on "newcomers", like community or teacher representatives with no vested interests in insurance and who are expected to, and often do, provide balance and common sense to every day operations. It is understood that a similar approach has been chosen in Jamaica but where the composition of the Board is at the discretion of the Minister of Finance. It is believed that the current situation can be improved by requiring the Minister to consult other boards and agencies in the appointment of the FSC Board. Whilst the appointed Commissioners will always meet the standards currently set in the FSC Act, consultation should take place with the Bank of Jamaica, the Actuarial Society, the Jamaica Institute of Chartered Accountants, Consumers protection organization, and industry. It would not be advisable to have the industry directly appoint few or any commissioner without appropriate checking and balances. The same bodies, or agencies external to the MOF should be able to initiate the removal process of any commissioners not meeting the standards of morality and good conduct foreseen in the law. Responsibility for appointment and removal would still lie within MOF.

Licensing

9. The legal provisions on licensing (registration) are in place through the insurance supervision law. These can be found in the Part II of the draft law and Part IV of the draft regulation. The classes of insurance business foreseen are divided into "general insurance" (non-life) and "long-term insurance" (basically, life and health insurance). The permitted types of legal form under which companies can operate on the market are indirectly defined as "body corporate" in Section 6 of the draft law with reference to the Company Act. In further reading the draft law it can be inferred that these are joint stock companies and mutual companies.

10. Composite companies cannot exist and only separate juridical persons can conduct life and non-life business. Furthermore, Section 26 of the draft law requires that companies with more than one license keep asset in separate funds, one for each license.

11. Regulation 137 prescribes that all placement of insurance business can only be done by insurance companies registered in Jamaica. However, there is a detailed treatment of non-

registered activity. This aims at regulating and supervising cross border operations. In particular it aims at ensuring consumer protection for operations with "brief case agents" selling policies in Jamaica under no supervision. It is not clear how this activity can be regulated or supervised. Ideally, a clear regulatory framework on cross border operations would encourage foreign companies to contact the supervisory authority when wishing to sell products in Jamaica without actually registering a company. However, it is doubtful that without strong collaboration with supervisory authorities in potentially many home countries, consumer protection can be pursued.

12. The draft law clearly details the licensing requirements for local and foreign insurers. These are very detailed and meet international standards. In particular, this include fit and proper test for directors and senior management. These persons must possess the necessary knowledge, skills and integrity for their positions. The same rules apply to shareholders with more than 10% of company's total shares carrying voting rights. Of all these persons, the supervisory authority obtains, among others, full names, address, nationality, details on occupation during the previous 10 years, particulars about any conviction or offence committed in connection with financial services (participation in unsound transactions; bankruptcies caused by dishonesty; tax evasion), frauds and dishonesty.

13. The insurance supervisor has the authority to refuse to issue the license to operate if facts exist from which it can be deduced that the holders of a qualifying participation are in an economic situation which may be hazardous to the soundness of the applicant; do not have sufficient resources to keep the company solvent on an on-going basis; or are or have been directly or indirectly involved in illegal transactions affecting their suitability. The supervisory authority can also refuse the license if directors or senior managers do not possess the necessary qualifications to conduct insurance business in an efficient manner. However, there is no provision in the draft law that enables the supervisory authority to refuse the license on the basis of an economic study of market conditions. Jamaica is a small market and although the recent financial crisis has forced consolidation, it clearly cannot absorb too large a number of insurance companies. The FSC should have the authority to judge on the optimality of allocation of applicant's capital. In the CIMA region a feasibility economic study has been used with some degree of success to offset the negative impact on entry of very low minimum capital requirements. However, even now that requirements have been increase, such study is thought to be of considerable value in the analysis of applicants' business plans. It appears that Section 11 of the draft Insurance Act could be amended to increase FSC powers in this direction.

14. Information on the products offered by the insurer (general policy conditions, technical basis for the calculation of premium rates and provisions) need also to be submitted to the supervisory authority. The draft regulation allows for the adoption of a file and use approach but it also leaves the door open for product control. The new supervisory authority would like to have sufficient degrees of freedom to modify the extent of product supervision according to the financial strength of a company. The extent of regulatory intervention would depend on the development of a regulatory ladder. However, all this needs testing once the new supervisory authority will be fully operative.

15. The license applicant must submit a business plan outlining the proposed business of the company for at least three years ahead. The business plan provides information on the types of obligation the company proposes to incur; the types of risk it proposes to cover; details on the

company's insurance and reinsurance program; and the estimated sums to be spent as setting-up costs and to promote the business. However, the business plan as detailed in Schedule 3 seems not to require the applicant to submit the projected development of business and capital or solvency margins so that controls can be made ex post on the soundness of the business plan. The FSC Executive Director ensured that the projected solvency margins will be required as integral part of the business plan.

16. The draft law seems also not to require the licensing authority to control the source of funds (in relation to regulation on money laundering, for instance), and any outsourcing contract. Although the draft law clearly states that license can be refused if it appears that the company is formed to conduct criminal activity like money laundering, consideration should be given to the need for having an explicit requirement to control the legality of the source of funds.

17. The draft law requires the applicant to appoint an actuary and an auditor. A fit and proper test for company's actuary is required, similar to the one carried out for owners, directors and senior management. Standards for the selection of auditors are also defined in Part VII of the draft regulation dealing with corporate governance issues. In particular, Regulation 73 requires that appointed auditors must belong to the Jamaica Institute of Chartered Accountants.

Changes in control

18. Section 13 requires that any change in particulars specified in the application after registration need notifying to the supervisory authority. Section 32 requires the approval of the supervisory authority for transfers or acquisition of any part of the business subject to the jurisdiction of the court in Jamaica or if benefits accruing are from policies issued and payable in Jamaica. Sections 32 and 33 detail the requirements for allowing acquisition, transfers, and amalgamations. The requirements for acquisition, transfer or amalgamation are different from the licensing requirements relative to owners and it is not clear how effective this part of the draft law can be to allow for proper screening of changes in control. Ideally changes in control should be defined in terms of shares and/or voting rights and the same licensing standards should be applied when screening new owners. The new supervisory authority has to be satisfied that the regulation, as now drafted, achieves this objective. Alternatively, it is recommended that it be amended accordingly.

Corporate Governance and Market Conduct

19. Issues relating to corporate governance are covered in Part II (Sections 36 to 47) of the draft law and Part VIII of the draft regulation. Insurers are required to appoint an external actuary establish a conduct review committee, and audit committee, and an investment committee. There are detailed rules on the authority and responsibilities of these committees. There are also detailed rules on restrictions on related party transactions and self-dealing as fiduciary aimed at identifying potential suspicious transactions. The audit committee would perform an on-going audit function with reporting duties to the Board of Directors and supervisory authority. These committees would represent independent functions to monitor risk management functions, investment, and underwriting risk.

20. The insurance draft law does not define the role and responsibilities of the board of directors. Board of directors should be required to accept and commit to internationally accepted

principles of corporate governance. They should also be made accountable to these principles. The Company Act defines the role and responsibilities of Board of Directors. However, in such Act there is a strong bias towards shareholders. In an insurance company is the responsibility of directors to manage the company in accordance to their responsibilities with respect to shareholders and policyholders, and subject to internationally accepted standards of corporate governance. Accountability should be achieved within these boundaries. Directors who expressed written dissent to specific actions or policies that later happen to fall outside the boundaries before mentioned should not be made accountable for eventual consequences.

21. Section 155 of the draft insurance law states that "In determining what are the best interests of the company, a director, or senior officer shall take into account the interests of its shareholders and policy holders and those persons to whom the director or senior officer owes a fiduciary duty". The FSC Executive Director ensured that this is already an important step in recognizing policyholders' interests without contradicting the spirit of the Company Act. However, it is not clear whether the reference to policyholders' interest is sufficient in protecting consumers' rights. Rules referring to consumer protection are scattered in the draft law but it was not possible to find an explicit statement referring to the duty of insurance entities to have policies in place on how to treat customers fairly, or even to have a compliant officer to deal with consumers' complaints. The sprit of the draft law appears to be weak on aspect such the responsibilities of board of directors market conduct. For instance, it is not clear why the establishment of complaints procedures and proper communication to customers are not among the responsibilities of the conduct review committee.

22. On the one hand it is necessary to increase responsibility of Directors in the area of corporate governance and market conduct. On the other hand this should not represent an excessive constraint in meeting responsibilities towards shareholders. The balance between these objectives can only be achieved by the people directly involved in drafting the new Insurance Act. However the following basic issues should be formally addressed in the draft law and not left to interpretation. It is recommended that the conduct review committee, or equivalent body directly reporting to directors, be required to ensure the fair treatment of consumers; that marketing of product be conducted in a clear, truthful, and non misleading manner; that plain language be used in all contract and policy illustrations; that full disclosure of risks and benefits of product be made to consumers; that agents be fully qualified in selling products; that no discrimination be made; and that agreed claims be paid promptly.

Investment Regulation

23. Sections 23 and 24 of the draft insurance law and part VII of the draft regulation contain regulation relating to investment of technical provisions covering liabilities. The regulation foresees the constitution of an investment committee, preparation of investment policies, nomination of custodians, separation of assets by type of license. The draft regulation is extremely detailed and sets investment limits by type of assets, issuers, sectors, and nationality. It is thought to be adequate to achieve appropriate diversification and maybe liquidity. However, no reference was found to maturity and currency asset-liability matching. The problems in the life insurance industry during the last crisis were in part due to inappropriate matching of asset liabilities. Insurance companies invested most of their reserves in illiquid assets (real estate) whilst asset holders exercised their claims on assets. In some jurisdictions with small capital

markets a liquidity requirement is introduced in the investment regulation so that companies cannot invest in shares that are not liquid as defined by the stock exchange or the Securities Commission. Liquidity is usually defined in terms of number of trades of a specific stock over a given time period. Equivalent liquidity indicators can be devised for all traded assets. It is recommended that liquidity, as well as maturity and foreign exchange matching, requirements be introduced in the legislation.

24. Finally it is not clear whether the same investment rules apply to asset managed by life insurance companies for private pension schemes. The case of Life of Jamaica (LOJ) is very important here. The company provides different products among which is a real estate fund. However, since pension funds a highly liquid assets in the hands of contributors LOJ needed to borrow at unfavorable interest rate during the economic crises to restitute contributions[8]. It appears that a liquidity requirement of 25% of total assets be required for this fund in the future.

Reinsurance

25. The draft insurance act does not cover the supervision of reinsurers. However, it gives the FSC powers to monitor and control reinsurance arrangements. For instance, at the time of licensing, companies must provide evidence of satisfactory reinsurance arrangements. The lack of satisfactory reinsurance arrangements is also ground for cancellation of license (Section 15(a)(iv)). Hence, the control of reinsurance treaties is object of on-site supervision.

26. Section 8.4.8 of the Actuarial Regulations for General insurance Companies states that the Actuary's Report to the FSC should: a) indicate the amounts assumed recoverable from the reinsurers; and b) specify any unusual problems or delays expected to be encountered in the collection of the relevant amounts from the reinsurers. The FSC reports that the actuary is required to describe the reinsurance arrangements and any changes that have taken place in the period. In addition, specific details that the actuary should highlight in the report are given, including: a) a reinsurance contract or cover note is not signed; b) a dispute has arisen with a reinsurer; c) the reinsurer has a history of not settling accounts promptly; d) the reinsurer's experience under the treaty is so minimal or other circumstances exist that cause there to be a high probability that the reinsurer will deny liability; e) the reinsurer has significant financial exposure to Jamaica and/or the Caribbean in the event of a catastrophe; f) the reinsurer is known to have been the subject of regulatory restrictions in its home jurisdiction. Obviously, it is not expected that the actuary assess the financial condition of each reinsurer. However, the actuary would have discussions with management, the auditors and the reinsurers if possible in order to determine any credit risks.

27. The regulation leaves to the company and company's actuary to exercise prudential control on reinsurers. This is correct as ultimately the quality of reinsurance affects the company's profitability. However, other jurisdictions have complemented this with a more pro-active approach to reinsurance supervision on the part of the supervisory authority. In Mexico, for instance, the local supervisor has established a register of "admissible" reinsurers based on

[8] For arguments supporting the need for immediate vesting and illiquid pension funds see the following two papers and quoted reference. Impavido, G., and A. R. Musalem (2001) Contractual Savings, Stock and Asset Markets, World Bank Policy Research Paper: 2490. Catalan, M., Impavido G., and A. R. Musalem (2000) Contractual Savings or Stock Market Development: Which Leads? World Bank Policy Research Paper: 2421.

ratings of rating agencies. This is complemented by constant collaboration with foreign supervisors to cross check actuary's reports and opinion expressed by management. Changes in ratings are also object of discussion among local and foreign supervisors. The FSC is satisfied that the institution of a registry of "admissible" reinsurers would be beneficial. Companies with non-admitted reinsurers would be identified as exposed to undue credit risk and this would be reflected in their minimum solvency margin. In any case, due to the highly specialized nature of reinsurance activity, it is recommended that the FSC organizational structure be changed to include a Reinsurance Division within the insurance department. This should be staffed with reinsurance specialists who, among others, would update the before mentioned registry.

Financial Reporting

28. Financial reporting forms have been designed and the FSC is currently in the process of selecting consultants to design an integrated piece of software for financial information filing and solvency monitoring. It is expected to select the consultant for this task by December 2001.

29. At present, financial reporting is required on quarterly basis with information covering the previous quarter. Once a fully automated filing information system is in place the marginal cost for companies to move from quarterly to monthly reporting should be very low. In many jurisdictions monthly reporting covers information for the previous 3 months. This "moving window" gives the opportunity to both the supervisor and the company to update information and discover mistakes (if any) or more serious problems.

On-site Inspections

30. Personnel have been trained in the use of a new inspection manual. On-site inspections have been already carried out using the new manual. The manual is very detailed and it is too early to say whether this will facilitate the use of an audit approach to on-site inspections.

Conclusions and Recommendations (for the insurance sector)

31. The Jamaican authorities have invested a lot of time, money and skills in updating the regulatory and supervisory framework for insurance since the last financial crisis. This process is being completed in these months. Hence, this report merely witnesses the important changes that have already taken place and provides marginal recommendations.

32. The new insurance draft law and regulations are of high quality and they successfully address internationally accepted principles of insurance supervision. The draft text is highly detailed and sophisticated and will require substantial effort on the part of the new supervisory authority to implement it. The FSC is well designed and the process of hiring key personnel is at an advanced stage. As conceived, the FSC is highly likely to successfully and independently discharge all its functions.

33. Despite this, recommendations are here listed for consideration of the Jamaican authorities.

34. Although not currently an issue, independence of FSC from political intervention can be improved by requiring the Minister to consult other boards and agencies in the appointment of the FSC Board. Whilst the appointed Commissioners will always meet the standards currently

set in the FSC Act, consultation should take place with the Bank of Jamaica, the Actuarial Society, the Jamaica Institute of Chartered Accountants, Consumers protection organization, industry, academia, et cetera. Responsibility for appointment and removal would still lie within MOF. This mechanism of nomination/appointment has the advantage of ensuring continuity of service in the board of directors beyond what ensured by the rules of removal with cause in the FSC act. It has also the advantage of ensuring that technically competent people are nominated on the Board. This would complement the rules, assessed to be rather generic, on fit and proper test as they appear in the FSC act. It finally has the advantage of promoting collaboration between the market and its supervisor.

35. In reviewing the licensing rules it was noted that there is no provision in the draft law that enables the supervisory authority to refuse the license on the basis of an economic study of market conditions. Jamaica is a small market and although the recent financial crisis has forced consolidation, it clearly cannot absorb too large a number of insurance companies. Section 11 of the draft law should be amended accordingly.

36. Also, no explicit requirements for controlling the source of funds (in relation to regulation on money laundering, for instance), and any outsourcing contract were found. Although the draft law clearly states that license can be refused if it appears that the company is formed to conduct criminal activity like money laundering, consideration should be given to the need for having an explicit requirement to control the legality of the source of funds.

37. Requirements relating to changes in control are differently stated from the requirements imposed on owners on licensing. The requirements for acquisition, transfer or amalgamation are different from the licensing requirements relative to owners and it is not clear how effective this part of the draft law can be to allow for proper screening of changes in control. Ideally changes in control should be defined in terms of shares and/or voting rights and the same licensing standards should be applied when screening new owners. The new supervisory authority has to be satisfied that the regulation, as now drafted, achieves this objective. Alternatively, it is recommended that it be amended accordingly.

38. The draft law is thought to be still weak in areas such as market conduct and corporate governance. It is recommended that directors be made responsible for the fair treatment of consumers: this could take place at the level of the conduct review committee, or equivalent body directly reporting to directors. Directors' responsibility in this area would include: 1) ensuring that marketing of product be conducted in a clear, truthful, and non misleading manner; that plain language be used in all contract and policy illustrations; that full disclosure of risks and benefits of product be made to consumers; that agents be fully qualified in selling products; that no discrimination be made; and that agreed claims be paid promptly.

39. The investment rules of reserves/technical provisions seem not to include liquidity, or maturity or foreign exchange matching requirements. These should be an integrant part of the very sophisticated rules already in place.

40. The new insurance legislation does not adequately cover the supervision and regulation of reinsurers. Reinsurance activity is an object of supervision by the FSC as in Part II of the 2001 Insurance Act it is stated that license can be revoked if "unsatisfactory" reinsurance

arrangements are made. The FSC believes that the institution of a registry of "admissible" reinsurers and the definition of adequate standards for admission (on the basis of international ratings, for instance) would be beneficial. Companies with reinsurers that are not admitted would be identified as exposed to undue credit risk and this would be reflected in their minimum solvency margin. In any case, the reinsurance activity is a highly specialized activity and it is recommended that the FSC organizational structure be changed to include a Reinsurance Division within the insurance department. This should be staffed with reinsurance specialists who would update the before mentioned registry.

II. Regulation of other Non-Bank Financial Institutions

A. *Securities Sector*

41. The FSC Act also provides for the vesting of all assets, rights and liabilities of the former Securities Commission with the new Commission and all rights, powers, privileges, immunities or duties previously enjoyed or performed by the Securities Commission are henceforth to be enjoyed and performed by the Commission. In addition, the Commission is given increased powers to give directions to licensees (securities dealers and investment advisors) in relation to unsound business practices or other breaches under the securities act. Licensees under the Securities Act will now be obliged to inform clients if clients funds are placed in offshore investments and to keep records of such investments. The insider trading provisions have also been extended to prohibit a person who contemplates making a takeover offer from dealing with securities of the target company if the fact that the offer will be made is "unpublished price sensitive information". The Act also prohibits that person from communicating such information to anyone else and prohibits anyone receiving such information from passing it on or acting upon it. There has also been a substantial increase in the penalties for contravention of the provisions of the Securities Act.

B. *Unit Trusts*

42. The Unit Trusts Act has been amended to transfer responsibility for the supervision of unit trusts to the new Commission. The amendment also increases the penalties under the Unit Trusts Act and requires managers of unit trusts to keep proper accounts and records to be audited annually and to provide accounts to the Commission.

C. *Pensions*

43. A further crucial element of the Government's efforts to strengthen the financial sector and to improve its institutional structures and regulatory framework concerns the proposed reform of the pensions system. These efforts are in response to the fall out in the financial sector that seriously jeopardize the viability of numerous pension funds which were imprudently invested and had to be assisted by FINSAC. Presently, there are approximately 1500 registered pension schemes, which are either self- administered or managed/invested by pension fund administrators. However, no legislation exists to provide effectively for their regulation. The minimal provisions in the Income Tax Act are primarily concerned with the tax-exempt status of pension schemes and impose few requirements on the operations of these schemes.

44. The need for a serious reform of the pension system was recognized in 1994 with the establishment of a Pensions Reform Committee (PRC). The PRC was constituted with representation from a broad cross section of persons involved in and concerned with pensions

operations and administration in Jamaica. The recommendations of the PRC formed the basis of the reforms proposed in a Green Paper, which was tabled in Parliament in January 1999. The proposals in this paper stimulated much discussion. In May 2001, a White Paper on the Reform of the Pension System in Jamaica was presented in Parliament. The White Paper proposed that the newly established Commission assume responsibility for the efficient regulation and supervision of entities involved with pension funds. The enactment of a new National Pensions Act was foreseen as a crucial part of this process. The new National Pensions Act is intended to incorporate provisions dealing with the following key aspects:

- Licensing and registration requirements for pension/superannuation fund and managers/administrators of pension funds;
- Full disclosure of information to the members of the pension/superannuation fund and the Commission;
- Accountability of the trustees and managers/administrators of such funds for their operation;
- Investment limits;
- Enabling self-employed persons and persons in non pensionable employment to provide for retirement income at levels commensurate with the provisions of occupational pension schemes;
- Funding for parental provisions by children;
- Voluntary indexation of pensions; and
- Mandatory preservation and portability of pension rights.

45. The White Paper lists detailed licensing and registration requirements. All approved pension funds established in Jamaica will be required to register with the Commission. All managers and administrators of pension funds must be licensed and comply with appropriate fit and proper person requirements. The Commission must similarly register trustees of pension funds and licenses and registration can be cancelled, revoked or refused. The new Act will also contain detailed conditions for the registration of pension schemes, requirements for full disclosure and accountability both to the Commission and to the respective members of the schemes. In the event that a member of a pension plan considers that their best interests are not being served or are being jeopardized in any way, they shall have recourse to the Commission. Strict investment criteria will be spelt out in the Act and provision will also be made for penalties for non compliance, portability of pension rights, limited indexation of pensions and various incentives to improve the attractiveness of approved retirement schemes.

46. An initial draft of the National Pensions Act is expected to be tabled in Parliament shortly. Submissions will be invited and a second reading of the Bill is expected to occur early in 2002. The pension reform proposals have been widely discussed and a high level of consensus has been achieved. The introduction of the National Pensions Act based on the proposals contained in the White Paper will represent a significant advance for Jamaica and a further strong element in the reform of the non banking financial sector.

D. Regulatory Arbitrage

47. The crisis of the 1990's witnessed an unsatisfactorily high level of regulatory arbitrage. To improve coordination in the activities of the various regulators and reduce the scope for regulatory arbitrage, the authorities have:

- Signed a Memorandum of Understanding signed between the Supervisor of Banking Institutions, the Executive Director of the Commission, the Executive Director of the Jamaica Deposit Insurance Corporation and the Financial Secretary;
- Established a Regulatory Policy Council (Council); and
- Begun the process of harmonizing prudential norms across the entire financial services industry.

48. The MOU mandates the Council to develop policies and strategies to facilitate greater coordination and information sharing between the various supervisory agencies operating in the Jamaican financial sector. The MOU allows for consolidated supervision and the conduct of coordinated examinations for duly licensed entities. The MOU also makes provision for the establishment of the Bank of Jamaica as the lead supervisor for the parent company of a bank-controlled financial group (i.e. financial holding company) and the Commission to be the lead regulator for a non-bank financial group controlled by an insurance company (or other non-bank financial institution). It also seeks to minimize the risks of contagion and facilitate timely discussions on policy for the financial sector. Legislative amendments to facilitate this process and formally establish the Council are being drafted. The Council meets monthly under the Chairmanship of the Supervisor of Banks and, to date, appears to be working satisfactorily with good exchanges of information and a spirit of cooperation. The possibilities for regulatory arbitrage have been greatly reduced.

E. Summary (Other non-bank financial institutions)

49. In summary, the regulatory framework that is being put in place in respect of the non-banking financial sector appears sound and well thought out. The experience of other jurisdictions, particularly that of South Africa, has been studied and the lessons from this and other parts of the world have been taken into account. There is strong industry support for the new Commission and widespread enthusiasm for the executive appointments that have so far been made. Clearly, it is early days but the preliminary indications would suggest that the new Commission would prove to be an effective response to the regulatory weaknesses of the non-bank financial sector identified as a result of the recent banking crisis.

ANNEX VII
BANK OF JAMAICA FINANCES

1. The BOJ's mid-term projections reported large yearly operational losses expected from 2002-2006, as a continuation of the losses that emerged in 2001. An examination of BOJ's cash operations indicates a more precarious situation with losses since 2000, primarily because interest due on all FINSAC instruments has been accrued and capitalized since 1999.

2. The first Bank loan supported the resolution of FINSAC debt held at the BOJ based on the approach reflected in the Government's BRDP. However, the implementation of crucial elements of the proposal was delayed by the BOJ in the context of the need to improve its financial position. The BOJ explored alternatives to address its deteriorating profitability in a comprehensive manner, dealing with the resolution of FINSAC debt together with other under performing assets. The Bank also provided technical assistance in this process. In August 2002, the Government presented to the Bank a modified approach to resolve BOJ finances that recognizes old quasi-fiscal losses and improves the income generating capacity of the BOJ. The following sections discuss factors affecting BOJ losses; the original proposal to address FINSAC losses; and medium term implications of the revised approach to handle FINSAC bonds at the BOJ and BOJ finances.[9]

A. Identification of the factors affecting the losses

3. Two major factors have influenced the worsening of BOJ's financial position: Large costs of open market operations (OMOs)[10] and impaired income generating capacity due to the composition of the BOJ's balance sheet.

i. The following aspects led to increased OMOs, at large costs.
   - A significant growth in net international reserves in a context of increased overseas borrowings by the Government (see Table 1);
   - The provision of support to institutions that experienced severe liquidity problems during the financial sector crisis of the mid 1990's and;
   - The reduction in the cash reserve ratios applicable to financial institutions since 1999.

In order to counter any inflationary impulse, the BOJ sterilized the Jamaica Dollar liquidity impact of the reserves build-up and neutralized the liquidity impact of the resources provided to the financial sector and the cash reserves release into the system. Sterilization was achieved through an expansion in the BOJ's liabilities, at market rates.

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[9] Sections A-C are largely based on a report received from the BOJ: *Reducing losses and returning to profitability*. This report presented an alternative proposal to address BOJ finances. The Bank also commissioned a report by Carlos Budnevich (consultant, previously at the Central Bank of Chile) to explore ways to address this issue. The MOF's modified proposal, reported in section E, took these efforts into account.

[10] Open market operations (OMO) were introduced in the mid-1980s as an indirect instrument of monetary policy. In the early years, the growth in the stock of OMO instruments was driven by an exponential growth in BOJ losses in the absence of earning assets and in a context of high interest rates. In later years the growth was propelled by an increase in (a) liquidity support for troubled financial institutions (b) accumulation of NIR and (c) reduction in cash reserves ratio from 25% to 9%.

Table 1. Bank of Jamaica: Audited Balance Sheet, December 2001

	2001	2000
	J$'000	J$'000
ASSETS		
*Foreign assets**	89,932,881	47,872,693
Local assets		
Notes and coins	39,196	25,496
Securities- marketable	29,243,864	27,930,619
- non-marketable (FINSAC & Non-interest bearing LRS)**	29,206,156	29,164,474
Advances to banks and other financial institutions		2,921,425
Due from Government and Government Agencies***	9,026,607	8,556,035
Fixed assets	1,152,334	1,150,083
Other	7,829,610	4,549,879
	76,497,767	74,298,011
	166,430,648	**122,170,704**
LIABILITIES CAPITAL AND RESERVES		
Notes and coins in circulation	22,367,790	20,572,228
Deposits and other demand liabilities	95,778,359	53,803,473
Securities sold under repurchase agreements	38,446,253	42,156,477
Foreign liabilities	291,721	378,697
Other	8,326,681	4,293,292
	165,210,804	121,204,167
Capital & Reserves	1,219,844	966,537
	166,430,648	**122,170,704**

*Items reclassified to conform to 2001 presentation.
**Includes the entire balance of FINSAC bonds and accrued interest capitalized, and J$2.2 billion in Non-interest bearing LRS (maturing in 2035-2036).
*** Includes previous losses at the BOJ. As of December 2001, the balance of advances and other receivables from the Government (excluding Government agencies) was 8.3 billion, which were replaced in 2002 with marketable securities as part of the modified approach to deal with BOJ finances (see below).

Source: Bank of Jamaica

ii. The BOJ's income generating capacity was impaired by the existence of the following under performing and non-performing assets, which accounted for the bulk of its total assets (Table 1). These assets represent quasi-fiscal losses emerging from the financial support of the BOJ to financial institutions during the financial crisis of mid 1990s for FINSAC bonds, and from losses accumulated during the macroeconomic difficulties of 1989-1994, for other under-performing assets:

- About 80 percent of total FINSAC bonds that earn below market interest rates (at about 10 percent). These instruments were issued consequent to the provision of the liquidity support to troubled financial institutions during the financial crisis.
- Non-interest bearing LRS
- Advances to and Receivables from the Government & Government Agencies that earn below market remuneration (largely derived from unsettled BOJ losses).[11]

[11] The Government is required, by the Bank of Jamaica Act to pay to the BOJ, out of a Consolidated Fund created for this purpose, the losses incurred by the BOJ. Section 9 (3) provides that if, in the opinion of the MOF, a

4. Concurrently, over the past two years, the BOJ's earnings from its holdings of LRS have declined due to the combined effect of declining stocks and falling interest rates. In addition, while earnings from gross foreign reserves are significant and have been growing, the interest rate paid on these investments is between 9-10% below that earned on domestic securities.

B. Original proposal

5. The proposal for the resolution of FINSAC debt with the BOJ, as reflected in the first loan, was to become effective at 31 March 2001. It required:

- The redemption of $13 billion of FINSAC debt held by the BOJ utilizing $13 billion of deposit liabilities to the central government at the BOJ;
- The conversion of the remaining $15.5 billion of FINSAC debt, inclusive of interest accrued to 31 March 2001 to a Government debt instrument;
- The instrument issued above to earn interest at a rate of approximately 13.5 percent, as this would have provided the BOJ with enough income to break even on its operations.

6. The Government, given cash flow challenges, informed the BOJ that it would be unable to pay that rate of interest and had only allocated $700 million from the 2001/02 fiscal budget and subsequent budgets to service the debt. In essence, this implied payment at an interest rate of 4.73 percent per year.

7. The implementation of this proposal would have worsened the bottom line position of the BOJ and did not address the critical issue of the profitability of the institution. The combination of the redemption of $13 billion of FINSAC bonds and remuneration of 4.73 percent interest on the converted instruments would have seriously impaired the earnings of the institution over the near and medium terms.

8. Since 31 March 2001, certain additional factors have led to further worsening of the financial position: the build-up in foreign assets due to the Government's foreign borrowing for 2001/02, and the additional cash reserves releases that occurred during the period as part of the gradual decline of reserve requirements. The corresponding growth in open market liabilities associated with these two occurrences and the concomitant interest costs have resulted in losses in 2001 and would have led to further losses in the medium term. The following table summarizes the BOJ's projected financial position for the next five years if the proposal was implemented.

Table 2. Effect of Original Proposal on BOJ Finances

In J$ million	2002	2003	2004	2005	2006
Cash Losses	11,551	11,333	9,394	7,214	5,383
Accrued Losses (P&L)	8,417	7,817	6,716	5,720	5,096

Source: Bank of Jamaica

payment to the BOJ to clear the losses cannot be made from this Consolidated Fund, then such losses may be cleared by the issue to the BOJ of securities charged to the Consolidated Fund.

9. Although, following Cabinet approval, the Government authorized the BOJ to offset the J$13 billion of FINSAC debt against its deposits, the BOJ did not implement it, because it assessed that the proposal was going to have large detrimental effects on its finances. Thus, the issue of the FINSAC debt to BOJ remained unresolved at the end of the BOJ's financial year, 31 December 2001. For the year 2001 the BOJ sustained accrued losses of $1.3 billion and cash losses of $2.5 billion despite the fact that since March 2001 the BOJ's financial statements have been prepared on the basis that the proposal is not implemented, that is, the total of FINSAC bonds obtaining at 31 March remains unchanged and Government deposits are inclusive of the $13 billion earmarked by the MOF to write down the debt.

C. Revised proposal: towards profitability in the medium term

10. Improving the income earning capacity of the BOJ is integral to restoring it to profitability. Based on the composition of the balance sheet of the BOJ with a large proportion of below market assets, the rate of earnings on its assets is significantly lower than the cost rate on its liabilities, which for the most part reflect market rates. As noted above, among domestic assets, about 80 percent of FINSAC bonds earned below market interest rates of 10 percent, which together with Non-interest Bearing Liabilities and Receivables from the Government and Government Agencies that also earn below market interest rates, accounted for about 23 percent of total assets as of December 2001. In addition, the BOJ has accumulated reserves at a fast pace, with foreign assets accounting for more than half of BOJ's total assets. The BOJ's strong efforts to sterilize these reserves to avoid inflationary pressures and devaluation have come at a high cost, further worsening its financial position.

11. Against the background, an alternative method of reducing the accrued (and cash, albeit more gradually) losses was agreed to between the MOF and the BOJ in August 2002, reflected in an MOU signed on September 9th between the MOF and the BOJ. This approach addresses under-performing assets beyond FINSAC bonds, recognizing that other under-performing assets were also adversely affecting the BOJ's balance sheet and profitability.

12. The features of the set of actions implemented for the resolution of BOJ losses are:

- As per Cabinet approvals: (i) an amount of J$13 billion in FINSAC bonds has been offset against an equivalent amount of MOF deposits at the BOJ; (ii) the balance principal amount of J$15.5 billion in FINSAC bonds at the BOJ as of March 31 2001 along with J$3.2 billion accrued interest up to March 31, 2002, were converted into Government securities paying market interest rates. This interest will be capitalized (fresh instruments at market rates of interest will be issued in lieu of cash interest payment) until 2007/08.
- Receivables from the Government amounting to J$8.3 billion carrying below market interest rates have been converted into Government securities earning market rates of interest. The interest on this instrument will also be capitalized until 2007/08.
- The Government is committed to redeem the J$2.2 billion in zero-coupon LRS (included in Table 1 as part of non-marketable securities) in cash prior to April 1, 2003.

13. The essence of this approach is that it requires market remuneration on under performing assets. The financial results under this approach, while not restoring a profit position until 2006 and failing to eliminate cash losses, will lead to a significant diminution in the accrual and cash losses over the five-year period. Concurrently, it would place the BOJ on a more sustainable

path to profitability. Notably, further declines in interest rates can only augur well for improvement to the BOJ's finances.

Table 3. Effect of the Implemented Revised Proposal on BOJ Finances

In J$ million	2002	2003	2004	2005	2006
Cash Losses	12,301	11,961	10,012	7,811	6,147
Accounting Losses (P&L)	5,157	4,458	1,909	369	(860)

Source: Bank of Jamaica

ANNEX VIII. STATUS OF BANK GROUP OPERATIONS

Status of Bank Group Operations (Operations Portfolio)
As of 08/15/2000

Closed Projects 63

Active Projects

Project ID	Project Name	Last PSR Supervision Rating: Development Objectives	Last PSR Supervision Rating: Implementation Progress	Fiscal Year	Original Amount in US$ Millions: IBRD	IDA	GE	Cancel.	Undisb.	Difference Between Expected and Actual Disbursements[a]: Orig.	Frm Rev'd
P007490	PUBLIC SECTOR MODERNIZATION	S	S	1997	28.4	0	0	0	10.3	10.3	10.3
P067774	SOCIAL SAFETY NET	S	S	2002	40	0	0	0	38.6	-1.4	
P074641	HIV/AIDS PREVENTION AND CONTROL	S	S	2002	15.0	0	0	0	15.0	0	
				Total	83.4	0	0	0	63.9	8.9	10.3

a. Intended disbursements to date minus actual disbursements to date as projected at appraisal.

Loans/Credits Summary in USD	As of July 31, 2002		
Original Principal	1,531,000,000	0	1,531,000,000
Cancellations	100,589,479	0	100,589,479
Disbursed	1,365,906,376	0	1,365,906,376
Undisbursed	64,504,145	0	64,504,145
Repaid	921,264,592	0	921,264,592
Due	443,064,920	0	443,064,920
Exchange Adjustment	-12,492,860	0	-12,492,860
Borrower's Obligation	430,572,060	0	430,572,060
Sold 3rd Party	1,576,864	0	1,576,864
Repaid 3rd Party	1,576,864	0	1,576,864
Due 3rd Party	0	0	0

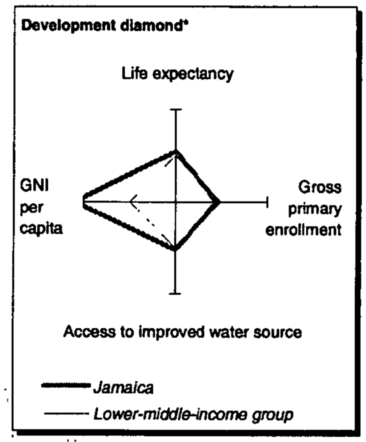
Statement of IFC's Held and Disbursed Portfolio
As of 08/31/00
(In US Dollars Millions)

FY Approval	Company	Held: Loan	Held: Equity	Held: Quasi	Held: Partic	Disbursed: Loan	Disbursed: Equity	Disbursed: Quasi	Disbursed: Partic
1995/97	Jamaica Energy Partners Old Harbour Diesel Project	13.24	0.00	0.00	29.35	13.24	0.00	0.00	29.35
2001/02	Mossel	42.00	8.00	0.00	5.78	42.00	8.00	0.00	5.78
2002	MBJA Limited	20.00	0 00	0.00	25.00	0.00	0.00	0.00	0.00
	Total Portfolio:	75.24	8.00	0.00	60.13	55.24	8.00	0.00	35.13

Jamaica at a glance

9/17/02

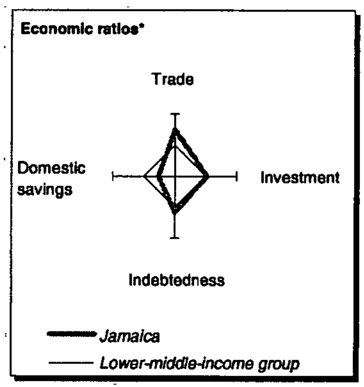
POVERTY and SOCIAL	Jamaica	Latin America & Carib.	Lower-middle-income
2001			
Population, mid-year *(millions)*	2.7	524	2,164
GNI per capita *(Atlas method, US$)*	2,740	3,560	1,240
GNI *(Atlas method, US$ billions)*	7.3	1,862	2,677
Average annual growth, 1995-01			
Population *(%)*	0.9	1.5	1.0
Labor force *(%)*	1.5	2.2	1.2
Most recent estimate (latest year available, 1995-01)			
Poverty *(% of population below national poverty line)*	17	..	..
Urban population *(% of total population)*	57	76	46
Life expectancy at birth *(years)*	75	70	69
Infant mortality *(per 1,000 live births)*	25	29	33
Child malnutrition *(% of children under 5)*	4	9	11
Access to an improved water source *(% of population)*	84	85	80
Illiteracy *(% of population age 15+)*	13	11	15
Gross primary enrollment *(% of school-age population)*	98	130	107
Male	97	131	107
Female	98	128	107



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

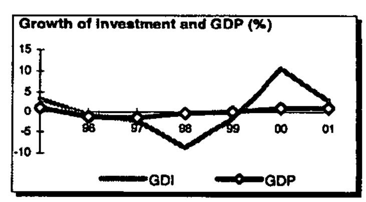
	1981	1991	2000	2001
GDP *(US$ billions)*	3.0	4.0	7.6	8.0
Gross domestic investment/GDP	20.3	24.6	28.3	28.5
Exports of goods and services/GDP	47.2	51.0	46.7	42.0
Gross domestic savings/GDP	11.7	23.4	17.2	15.8
Gross national savings/GDP	9.8	17.7	22.7	21.1
Current account balance/GDP	-10.5	-6.3	-5.7	-7.5
Interest payments/GDP	3.7	4.8	2.6	3.2
Total debt/GDP	77.6	109.2	55.9	61.3
Total debt service/exports	25.4	30.8	16.8	17.4
Present value of debt/GDP	..	..	..	..
Present value of debt/exports	..	..	..	..

	1981-91	1991-01	2000	2001	2001-05
(average annual growth)					
GDP	2.7	1.1	1.1	1.1	2.4
GDP per capita	1.6	0.5	-0.6	-0.2	1.7
Exports of goods and services	6.0	0.3	3.6	-4.3	3.0

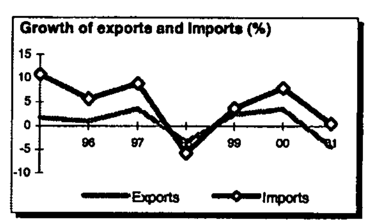


STRUCTURE of the ECONOMY

	1981	1991	2000	2001
(% of GDP)				
Agriculture	7.5	7.3	6.4	6.5
Industry	35.6	42.4	27.2	30.2
Manufacturing	16.7	18.0	10.1	12.9
Services	57.0	50.4	66.4	63.3
Private consumption	67.7	64.8	67.1	67.3
General government consumption	20.6	11.8	15.7	16.9
Imports of goods and services	55.8	52.2	57.7	54.6



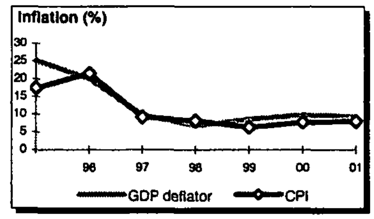
	1981-91	1991-01	2000	2001
(average annual growth)				
Agriculture	1.4	0.0	-7.3	3.0
Industry	3.2	-0.3	0.8	1.0
Manufacturing	2.6	-1.5	0.8	1.0
Services	2.4	5.2	2.1	1.0
Private consumption	3.3	4.6	0.8	3.9
General government consumption	5.8	4.8	-3.7	8.8
Gross domestic investment	2.3	3.1	10.7	3.0
Imports of goods and services	8.0	4.4	8.0	0.5



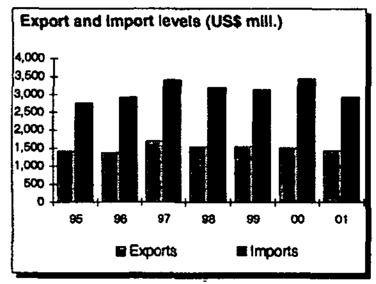
Note: 2001 data are preliminary estimates. Data prior to 1997 are in calendar year, data from 1997/98 are in Jamaican fiscal year (April 1 - March 31). Data for 2000 refers to 2000/01 and 2001 refers to 2001/02.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

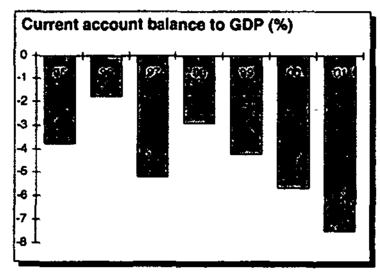
PRICES and GOVERNMENT FINANCE	1981	1991	2000	2001
Domestic prices				
(% change)				
Consumer prices	11.9	51.0	7.7	8.0
Implicit GDP deflator	8.4	49.2	9.9	9.3
Government finance				
(% of GDP, includes current grants)				
Current revenue	28.3	29.2	29.5	27.7
Current budget balance	-4.0	7.4	1.3	-2.9
Overall surplus/deficit	-16.0	4.3	-0.9	-5.7



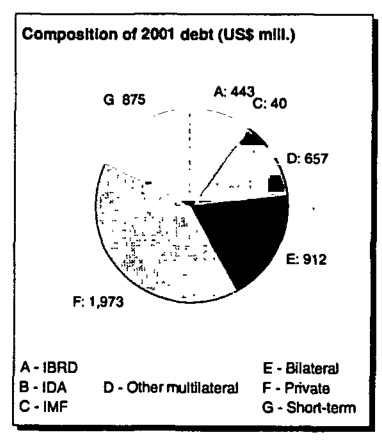
TRADE	1981	1991	2000	2001
(US$ millions)				
Total exports (fob)	974	1,151	1,515	1,436
Alumina	588	543	676	630
Bauxite	172	113	56	98
Manufactures	69	63	43	47
Total imports (cif)	1,471	1,829	3,451	2,949
Food	102	91	262	..
Fuel and energy	489	325	618	..
Capital goods	295	398	497	541
Export price index *(1995=100)*	58	90	118	116
Import price index *(1995=100)*	58	90	117	116
Terms of trade *(1995=100)*	100	100	101	101



BALANCE of PAYMENTS	1981	1991	2000	2001
(US$ millions)				
Exports of goods and services	1,406	2,183	3,562	3,360
Imports of goods and services	1,663	2,207	4,406	4,368
Resource balance	-257	-24	-844	-1,008
Net income	-179	-484	-414	-458
Net current transfers	124	253	831	879
Current account balance	-312	-256	-427	-587
Financing items (net)	224	402	1,010	985
Changes in net reserves	88	-146	-583	-398
Memo:				
Reserves including gold *(US$ millions)*	..	..	1,368	1,748
Conversion rate *(DEC, local/US$)*	1 8	12.1	44.1	46.5



EXTERNAL DEBT and RESOURCE FLOWS	1981	1991	2000	2001
(US$ millions)				
Total debt outstanding and disbursed	2,313	4,413	4,269	4,900
IBRD	212	664	415	443
IDA	0	0	0	0
Total debt service	382	692	643	645
IBRD	21	121	83	74
IDA	0	0	0	0
Composition of net resource flows				
Official grants	11	282	39	42
Official creditors	338	121	29	-112
Private creditors	-43	-63	442	773
Foreign direct investment	-12	133	529	448
Portfolio equity	0	0	-62	-54
World Bank program				
Commitments	45	42	75	185
Disbursements	43	43	98	91
Principal repayments	7	62	60	52
Net flows	36	-19	37	39
Interest payments	14	59	22	22
Net transfers	22	-78	15	17



ANNEX X. KEY ECONOMIC INDICATORS

Jamaica - Key Economic Indicators

Indicator	Actual 1998/99	1999/00	2000/01	2001/02	Projected 2002/03	2003/04	2004/05	2005/06
National accounts (as % of GDP)								
Gross domestic product[a]	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	7.3	6.7	6.4	6.5	6.7	6.8	6.9	6.9
Industry	27.4	27.1	27.2	30.2	30.3	30.0	29.4	28.8
Services	65.3	66.2	66.4	63.3	63.0	63.2	63.7	64.2
Total Consumption	81.3	82.7	82.8	84.2	83.6	82.8	81.8	81.4
Gross domestic fixed investment	26.2	25.7	28.1	28.3	28.2	28.3	28.2	28.0
Government investment	2.5	2.8	2.5	2.5	2.4	2.4	2.4	2.4
Private investment	23.7	22.9	25.6	25.8	25.8	25.8	25.7	25.5
Exports (GNFS)[b]	44.5	45.5	46.7	42.0	42.3	42.2	42.2	41.8
Imports (GNFS)	52.1	53.9	57.7	54.6	54.3	53.5	52.4	51.4
Gross domestic savings	18.7	17.3	17.2	15.8	16.4	17.2	18.2	18.6
Gross national savings[c]	23.4	21.6	22.7	22.5	22.6	23.0	23.4	23.7
Memorandum items								
Gross domestic product (US$ million at current prices)	7544	7532	7635	7996	8395	8914	9475	10052
GNI per capita (US$, Atlas method)	2730	2700	2730	2740	2840	3010	3210	3410
Real annual growth rates (%, calculated from 1986 prices)								
Gross domestic product at market prices	-0.4	0.1	1.1	1.1	2.0	2.5	2.5	2.5
Real annual per capita growth rates (%, calculated from 1986 prices)								
Gross domestic product at market prices	-1.2	-0.4	-0.6	-0.2	1.0	1.8	3.4	2.4
Total consumption	-0.3	1.2	-0.9	2.3	0.5	0.8	2.0	2.0
Private consumption	-1.1	0.4	-0.8	2.6	1.1	0.4	2.2	1.8
Balance of Payments (US$ millions)								
Exports (GNFS)[b]	3354	3423	3562	3360	3550	3763	4003	4207
Merchandise FOB	1552	1550	1515	1436	1498	1593	1712	1790
Imports (GNFS)[b]	3928	4063	4406	4368	4560	4765	4962	5170
Merchandise FOB	2665	2744	2969	2949	3080	3201	3334	3468
Resource balance	-574	-639	-844	-1008	-1010	-1003	-959	-964
Net current transfers	638	695	831	879	978	1019	1047	1086
Current account balance	-219	-317	-427	-587	-606	-609	-599	-590
Net private foreign direct investment	309	359	530	448	523	546	574	639
Long-term loans (net)	106	-111	492	603	240	182	180	171
Official	-127	-104	29	-112	189	110	178	185
Private	233	-7	463	715	51	72	2	-14
Other capital (net, incl. errors & ommissions)	-210	-52	-12	-66	-43	-45	-46	-47
Change in reserves[d]	13	122	-583	-398	-114	-74	-109	-174
Memorandum items								
Resource balance (% of GDP)	-7.6	-8.5	-11.1	-12.6	-12.0	-11.2	-10.1	-9.6
Real annual growth rates (YR86 prices)								
Merchandise exports (FOB)	-7.2	-9.5	-4.8	-3.9	4.8	2.6	3.6	1.0
Primary	-7.4	-9.4	-4.9	-4.3	5.1	2.7	3.7	1.0
Manufactures	-4.2	-12.6	-4.4	10.8	-2.7	1.3	1.4	1.6
Merchandise imports (CIF)	-1.4	-11.1	10.0	0.7	5.0	0.4	0.4	0.5

(Continued)

Jamaica - Key Economic Indicators
(Continued)

Indicator	Actual				Projected			
	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Public finance (as % of GDP at market prices)[e]								
Current revenues	26.4	28.9	29.5	27.7	29.1	29.4	29.5	29.4
Current expenditures	30.4	31.2	28.2	30.6	31.1	30.0	28.5	26.9
Current account surplus (+) or deficit (-)	-4.0	-2.3	1.3	-2.9	-2.0	-0.7	1.0	2.5
Capital expenditure	3.0	2.8	2.8	2.7	2.5	2.5	2.8	2.8
Foreign financing	1.6	-1.2	-3.2	8.7	4.7	1.5	3.3	2.4
Monetary indicators								
M2/GDP	28.6	30.7	30.1	29.0	29.2	29.3	29.4	29.4
Growth of M2 (%)	11.9	16.4	8.9	6.7	9.0	9.0	9.0	8.7
Price indices(YR86 =100)								
Merchandise export price index	172.7	190.5	195.6	192.9	191.9	198.9	206.2	213.4
Merchandise import price index	149.7	165.3	164.6	139.6	138.9	143.8	149.2	154.4
Merchandise terms of trade index	115.4	115.3	118.8	138.1	138.1	138.2	138.2	138.2
Real exchange rate (US$/LCU)[f]	0.85	0.86	0.86	..	..	..	..	..
Consumer price index (% change)	8.1	6.3	7.7	8.0	5.8	6.0	6.1	6.1
GDP deflator (% change)	6.8	8.6	9.9	9.3	6.0	6.0	6.0	6.0

a. GDP at market prices
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Central government.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.

ANNEX XI. KEY EXPOSURE INDICATORS

Jamaica - Key Exposure Indicators

Indicator	Actual 1998	Actual 1999	Actual 2000	Estimate 2001	Projected 2002	Projected 2003	Projected 2004	Projected 2005
Total debt outstanding and disbursed (TDO) (US$m)[a]	4024	3921	4269	4952	5188	5364	5548	5777
of which:								
Public and Publicly Guaranteed (PPG)	3100	2900	3356	3947	4269	4391	4664	4862
Short Term and Private Non-Guaranteed	810	927	853	965	897	964	883	915
IMF Credit	105	83	60	40	22	8	1	0
Net disbursements (US$m)[a]	78	-221	464	654	269	190	191	230
Total debt service (TDS) (US$m)[a]	524	732	643	644	797	810	885	1035
Debt and debt service indicators (%)								
TDO/XGS[b]	112.0	106.4	111.3	133.9	133.0	127.6	123.3	122.2
TDO/GDP	53.3	52.1	55.9	61.9	61.8	60.2	58.6	57.5
TDS/XGS	14.6	19.9	16.8	17.4	20.4	19.3	19.7	21.9
IBRD exposure indicators (%)								
IBRD DS/public DS	21.2	14.7	15.9	12.3	8.0	8.3	7.7	6.1
Preferred creditor DS/public DS (%)[c]	41.5	28.8	38.0	31.2	24.2	25.0	22.6	18.5
IBRD DS/XGS	2.8	2.7	2.2	2.0	1.6	1.6	1.5	1.3
IBRD TDO (US$m)[d]	409	393	415	443	495	497	517	565
Share of IBRD portfolio (%)	0.35	0.33	0.34	0.36	0.41	0.41	0.43	0.48
IDA TDO (US$m)[d]	0	0	0	0	0	0	0	0
Memo:								
IFC (US$m) /c	27.0	24.2	19.1	27.6	63.7	..	..	..
Loans	25.1	22.3	17.2	27.6	55.7	..	..	..
Equity and quasi-equity /e	1.9	1.9	1.9	0.0	8.0	..	..	..
MIGA								
MIGA guarantees (US$m) /f	..	98.6	97.3	93.8	135.0	..	..	..

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.

b. "XGS" denotes exports of goods and services, including workers' remittances.

c. Preferred creditors are defined as IBRD, IDA, IFC, the regional multilateral development banks, the IMF, and the Bank for International Settlements.

d. Includes present value of guarantees.

e. Includes equity and quasi-equity types of both loan and equity instruments.

f. Gross outstanding guarantees.

IMAGING

Report No.: P 7527 JM
Type: PR