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REPORT AND RECOMMENDATION

OF THE PRESIDENT

OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A PROPOSED

BANK RESTRUCTURING & DEBT MANAGEMENT PROGRAM

ADJUSTMENT LOAN

IN THE AMOUNT OF US$75 MILLION

TO

JAMAICA

November 2, 2000

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

CURRENCY EQUIVALENTS

(as of August 31, 2000)
42.94 Jamaican Dollars = US$1.00

JAMAICAN FISCAL YEAR

April 1- March 31

ABBREVIATIONS AND ACRONYMS

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 Assets Ratio
CAS	Country Assistance Strategy
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 Finance 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
SC	Securities Commission
SMP	Staff Monitored Program

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JAMAICA
PROPOSED BANK RESTRUCTURING & DEBT MANAGEMENT PROGRAM ADJUSTMENT LOAN

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JAMAICA

BANK RESTRUCTURING & DEBT MANAGEMENT PROGRAM (BRDP) ADJUSTMENT LOAN

PROPOSED LOAN AND PROGRAM SUMMARY

BORROWER: Jamaica

AMOUNT AND TERMS: US$75 million. The loan is proposed to be a fixed-spread US dollar denominated loan with a maturity of up to 17 years including a 5-year grace period. The Bank's standard front-end fee of 1 percent and commitment fee of 0.85 percent for the first four years and 0.75 percent thereafter will apply.

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

Resolution and restructuring of financial institutions. This operation will support the sale of one large bank and progress in the restructuring of two other large financial institutions in Jamaica. As part of the restructuring and sale, Bank funds will be used to retire a part of the FINSAC bonds being held at intervened financial institutions and 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). The Government will also begin to service in cash the remaining FINSAC bonds that are held as assets in the intervened institutions.

Restructuring and management of the public debt arising from the resolution of the financial crisis. The Jamaican Cabinet has approved a write-down and restructuring of liabilities accumulated during the financial crisis. Specific measures include: (i) write off of J$19.4 billion in FINSAC debt held by public sector institutions; (ii) off-set of J$13 billion of FINSAC bonds held by the BOJ against deposits of the Government at the BOJ; and (iii) restructuring of about J$13.2 billion of FINSAC bonds held by the BOJ. These measures will permit a reduction in the outstanding stock of FINSAC debt to be serviced in cash by about a fourth. Beginning April 1, 2001, the Government will service all outstanding FINSAC obligations in cash.

Regulatory and supervisory reforms in the financial sector. The authorities have been taking several steps since 1997 to strengthen the legal, regulatory, and supervisory environment of the financial sector. Recent additional measures to make further progress in this area include giving strengthened powers of intervention in troubled financial institutions to the BOJ, improving the coordination between bank and non-bank supervisory authorities, creating an integrated supervisor for insurance, securities, and pensions in Jamaica, and committing to undertake an independent assessment of the Basle Core principles by the second quarter of 2001.

PROJECT RATIONALE: Jamaica's economy faces major challenges in the medium term. The Government's intervention of financial institutions affected by the crisis that occurred in the mid-1990s has generated a stock of public sector liabilities (FINSAC debt) of about 43.9 percent of (FY2000) GDP as of August 2000. Combined with an already high pre-crisis public debt level of over 100 percent of GDP, FINSAC debt has contributed to the creation of severe adverse debt dynamics. The intervention also led to Government ownership of over half of the country's banking system. A key factor in re-starting economic growth in Jamaica and thereby contributing to poverty reduction is a resolution of the financial sector crisis and reversal of the adverse debt dynamics. Bank assistance is proposed within the context of strong Government commitment to reverse the inappropriate policies of the past. This operation supports the Government's recently articulated Bank Restructuring and Debt Management Program (BRDP) which, while ambitious and subject to risks, is nevertheless necessary to revive the economy. The Government has also recently committed itself to a program of macroeconomic stability and financial resolution of the crisis which is being monitored by the staff of the IMF. If successful, this program carries with it a good chance that Jamaica will be able to get back on to a sustainable growth path and gradually reduce the high level of public debt. This loan supports the Government's efforts to begin paying the fiscal costs of the financial sector crisis in cash.

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 is being adopted which calls for two separate single-tranche loans (of which the proposed operation is the first), each of US$75 million, over the next two fiscal years. Each operation would support specific actions taken by the Government prior to Board consideration.

BENEFITS: The proposed first loan would have several benefits. First, it would contribute to moving the resolution of the financial crisis forward by supporting the sale to a foreign investor of one financial institution and making substantial progress towards restructuring two others. The Bank's loan would also support the provision of greater liquidity to the banking system. Strong and well capitalized banks 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 to credit, and employment. By contributing to the Government's financial restructuring program, the loan would also help the Government make explicit the fiscal cost of intervention and avoid additional and more costly delay. Second, the loan would support the 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. Third, it would support the Government's program of debt management by restructuring a part of the stock of high-cost domestic debt into longer-term, cheaper, foreign debt. This would modestly ease the Government's fiscal burden and reduce the pressure on domestic interest rates. Fourth, 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, the success of the Government's BRDP and the Bank's operation will assist in the completion of the Government's financial sector crisis resolution efforts which is key if the Jamaican economy is to move back on to a growth path.

RISKS: Both the Government's program and the proposed operation face several risks that are being recognized by the Bank, especially since it is not realistically possible for the proposed operation to address all of these risks and mitigate them adequately. While the Government's program faces many challenges, the Bank believes it is worth supporting, in order to attempt to restart growth in Jamaica. However, the Bank stands ready to re-assess its approach to assisting Jamaica, should macroeconomic and sectoral conditions warrant it.

The main risks facing the operation are the following: First, at a macroeconomic level, if interest rates do not decline as assumed in the Government's macroeconomic program (as reflected in the SMP), the Government's debt service burden will be higher than anticipated and the fiscal adjustment needed to achieve stabilization and reduction of the stock of public debt will be even larger. Given the extremely high level of overall public sector primary surplus (over 11 percent of GDP in the medium term) necessary even under the Government's relatively favorable base case assumptions, the room for further maneuver by the Government is limited. The Government has committed itself to mobilizing greater fiscal resources and to approaching the IFIs for further assistance in the event that unfavorable macroeconomic scenarios materialize. Second, the very tight fiscal discipline required to make the proposed program successful may not be sustainable and could create social tensions if economic growth does not resume. Third, it may be difficult for the Government to dispose of the remaining financial institutions that it proposes to sell as part of the overall financial sector restructuring program. FINSAC may also find it difficult to manage intervened financial institutions for substantial periods of time if buyers are not found soon. These risks could create problems for the Government's financial sector restructuring strategy. Fourth, expected inflows from sale of assets could be smaller than estimated. In this event, the debt service burden will be correspondingly larger, placing greater stress on Government finances. Fifth, while banking sector and non-bank financial institutions' regulation and supervision has been significantly strengthened, with substantially more progress in the banking sector, both areas are still not yet up to international best practice and therefore, could expose the financial system to additional risks. The Bank has addressed some of these issues in this operation and proposes to continue to address them in the second phase of its assistance to the Government under the proposed programmatic approach. Sixth, the Government's fiscal planning for FY2001 calls for substantial resources to be raised from privatization of state owned enterprises and international borrowings. In the event that these resources are not mobilized as envisioned, the Government may be forced to borrow from domestic markets, increasing the pressure on interest rates and consequently increasing its debt service commitments on existing public debt. Finally, external shocks to the economy would also adversely affect the Government's debt management program. Further increases in oil prices, fall in alumina/bauxite prices, or a decrease in tourism receipts are some of the external shocks that could negatively impact the macroeconomic framework.

SCHEDULE OF DISBURSEMENTS: The full amount of the loan is expected to be disbursed in a single tranche upon loan effectiveness, likely to be in December 2000.

CLOSING DATE: June 30, 2001

PROJECT ID NUMBER: P071112

REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED BANK RESTRUCTURING & DEBT MANAGEMENT PROGRAM (BRDP) 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 first phase of the Government's Bank Restructuring and Debt Management Program (BRDP). The program focuses on advancing the financial resolution of the crisis that occurred in the mid-1990s and involves three components: (i) restructuring of the financial sector, including sale of one large bank and progress towards sale of two other major intervened financial institutions; (ii) re-configuration of the domestic debt as a result of the Government's commitment to explicitly assume debt servicing obligations in cash of liabilities accumulated during the crisis; and (iii) strengthening of the legal, regulatory, and supervisory framework for the financial sector. It is expected that the Bank will provide continued support to the Government's BRDP through one additional single tranche loan of an equal amount. The current loan would be a fixed-spread loan denominated in US dollars with a maturity of up to 17 years including 5 years of grace and would be disbursed in a single tranche upon effectiveness.

I. MACROECONOMIC CONTEXT AND RECENT PERFORMANCE

A. The Context

2. Jamaica has had negative per capita GDP growth for much of the last 25 years. From the late 1970s up to 1996, Jamaica operated under a series of IMF programs and obtained several structural and sector adjustment loans from the Bank. The Bank's assessment of its own operations has been that, for a variety of reasons, they largely failed to achieve their objectives, while contributing to increasing Jamaica's official external debt burden[1]. The IMF resumed its involvement in Jamaica only recently after not having been involved since 1996. No Bank structural adjustment loans have been processed after 1993.

3. The Government initiated a series of economic reforms in the mid-1980s focusing on liberalization of the trade and financial sectors. During the mid-1990s, however, a severe financial sector crisis over-shadowed these efforts. The crisis was largely attributable to financial sector liberalization that was not complemented by a sufficiently robust prudential and regulatory infrastructure. A large number and variety of financial institutions emerged, enabling regulatory arbitrage. By late 1996, there were compelling signs of liquidity and solvency problems of

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[1] See Jamaica: Country Assistance Note (CAN) dated December 30, 1998. Report No. CODE98-80.

systemic dimensions 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 melt-down of the financial sector.

4. 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 through the issue of more FINSAC paper[2]. 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$127 billion (about US$3 billion or about 43.9 percent of GDP) as of August 2000[3]. 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 fiscal problem. Wages plus interest payments on all public debt (including FINSAC debt) would have required 111 percent of Government revenues in FY 1999 and 104 percent of Government revenues in FY2000[4].

5. Overall, while the Government has succeeded in stabilizing the financial sector and reducing inflation, the real effective exchange rate for the Jamaican dollar has appreciated, real interest rates have remained high, although recently on a declining trend, growth has remained weak, and public debt has been on an unsustainable growth path.

B. Recent Economic Developments and Prospects [5]

6. In the two most recent fiscal years 1999 and 2000, interest rates have shown a marginal decline. Real interest rates on six-month treasury bills, to which interest rates on FINSAC bonds are indexed, have been on a declining trend from 13.8 percent as of end-FY 1999 to 10.4 percent by end-FY-2000. Largely as a result of a conscious Government strategy to reduce public sector domestic borrowing, liquidity pressures on the domestic financial system have eased marginally.

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[2] As of August 31, 2000, the Government was servicing less than 0.5 percent of FINSAC paper in cash.

[3] FINSAC debt as of March 31, 2000 had been estimated at J$107 billion or 37 percent of GDP and this is the figure that forms the basis of the projections in the SMP and the CAS. This earlier estimate was based on data available as of July 2000. This document uses revised estimates of FINSAC debt based on data as of August 31, 2000, which became available in September 2000. Bank and Fund staff have agreed with the authorities on the revised estimates. Increases in the total FINSAC debt from J$107 billion to J$127 billion resulted mostly from: (i) about J$8 billion in FINSAC debt owed to MOF due to the issuance of LRS or provision of cash to cover asset gaps for the resolution of three insurance companies (mainly for Mutual Life with J$7.4 billion), (ii) J$2.3 billion in additional realized costs for the restructuring of Union Bank, (iii) J$1 billion in additional capitalization of LOJ, (iv) interest accrued and capitalized from March to August; and (v) other, relatively small, additional commitments.

[4] The reduction is due to additional government revenues in FY2000 and lower interest rates.

[5] For more details regarding the macroeconomic situation, see the Country Assistance Strategy for Jamaica being presented to the Board together with this operation.

Real weighted average lending rates declined from about 24.5 percent in March 1998 to 16.6 percent in March 2000. Real GDP growth is still flat, however, having increased from a negative 0.5 percent in FY 1999 to zero in FY2000.

7. Inflation (end-of-period) rose 2 percentage points reaching 8.4 percent by the end of FY2000 largely due to higher prices for oil imports. Unemployment is estimated to have remained high at about 15.5 percent with a growing informal sector that the Government has estimated at about one-fourth of the formal economy. The real effective exchange rate of the Jamaican dollar has appreciated by about 30 percent since FY1995-96, despite a modest reversal of this appreciation in FY2000.

8. The external current account deficit increased from 3 percent of GDP in FY 1999 to 4.5 percent in FY2000 in spite of strong bauxite/alumina prices, large private remittances, increasing tourism receipts (the largest source of foreign exchange earnings), and decreasing imports of capital goods. Total export proceeds decreased due to lower prices of many other items such as sugar, bananas, and non-traditional items together with many closures in the apparel industry. The external current account deficit and official debt amortization were largely financed by foreign borrowing as the government was able to raise about US$300 million a year in international markets. Gross official international reserves rose US$100 million to reach US$801 million as of March 31, 2000, equivalent to about 10 weeks of projected imports of goods and services.

9. The public sector primary surplus improved by 6.6 percentage points of GDP reaching 7.2 percent in FY1999, mostly because of strengthened tax administration and efficiency gains in the operation of the public enterprises. This marked improvement helped cover the growing interest bill on the large public sector debt, but the overall public sector deficit still expanded by one percent of GDP to reach 12 percent in FY1999. The improving trend in the overall public sector primary surplus continued in FY2000 as it rose by over 5 percentage points to an impressive 12.5 percent of GDP. This was achieved through increased consolidation efforts, largely arising from expenditure cuts and some revenue increases including the introduction of a withholding tax on interest. Notwithstanding these improvements, the stock of public debt increased from about 124 percent of GDP at end FY1998 to about 131.2 percent of GDP at end-FY2000 (excluding intra-public sector debt which is being written down).[6]

10. In terms of the short and medium term prospects for the economy, the Government faces two challenges to restart growth: (i) reversing the adverse debt dynamics due to the large stock of public debt combined with high interest rates; and (ii) strengthening the fragile financial sector and increasing its intermediation in the economy. The Government is committed to making strong fiscal adjustments in the current fiscal year, aimed at reducing the public sector borrowing requirement and bringing about a sustained reduction in interest rates. This fiscal stance will complement the monetary measures aimed at increasing liquidity in the banking sector through the lowering of the cash reserve requirements for banks. These measures are expected to have a positive impact on the debt dynamics as well as to encourage increased investment by the private sector in order to spur growth. However, given the size of the public debt, a sustained fiscal effort and the restoration of growth over several years will be needed to reverse the debt

[6] The total stock of public debt to GDP (including intra-public sector debt) is 144 percent, as of FY2000.

dynamics. The Government's own program is cautious on the outlook for the economy. As a base case, real GDP growth is expected to increase from zero in FY2000 to 3.5 percent in FY2005. An alternative scenario, discussed with the Government, arising from different assumptions about exogenous conditions and private sector responses within the context of a fundamentally similar policy stance, envisages real GDP growth to increase to only 2.5 percent in FY2005.

C. Recent Initiatives of the Government

11. The Government has recognized that resolution of the financial sector crisis and reversing the adverse debt dynamics is essential if the economy is to achieve significant recovery. Over the past few months, the Government has undertaken several promising initiatives, further building on the improved policy stance and performance of the past two years. First, it further tightened its fiscal stance, adopting a near-balanced central government budget for fiscal year FY2001 with an ambitious target of 14.1 percent of GDP for the public sector primary surplus. Second, at the time of budget presentation in March 2000, the Government gave a public undertaking that it would address remaining problems in the financial sector without delay, notably through a plan to deal with outstanding financial sector liabilities and complete the restructuring and disposal of intervened financial institutions. Third, the Government requested an IMF Staff-Monitored Program (SMP) that went into effect in April 2000[7]. The authorities see the adoption of the SMP as helping to: (i) give creditors and financial markets a strong signal of Government commitment to a sound macroeconomic framework and credible reform program; and (ii) pave the way for support for the completion of financial sector restructuring from international financial institutions (the Bank, the IDB, and the Caribbean Development Bank (CDB)). Within a supporting macroeconomic framework (which provides, *inter alia*, for continued maintenance of a very tight fiscal stance over the medium term), the SMP lays out a general plan for addressing the remaining financial sector problems and also sets structural benchmarks that the Government has agreed to meet[8]. In addition to financial sector reforms, other structural benchmarks established by the Government as part of the SMP include privatization of a power company and selected public enterprise reforms. All these actions, if implemented over the coming months, will represent significant progress.

II. THE BANKING CRISIS OF THE MID-1990s

12. Many of the root causes of the 1995-96 financial crisis can be traced to policies from the 1980s and early 1990s. In the mid-1980s, the Government's overall strategy was to reduce the size of the public sector in a widespread privatization process. Banks that had been acquired by the government in the 1970s were sold back to the private sector although the privatization was

[7] The SMP was formally approved by the IMF's management in July 2000. However, its benchmarks have been set retro-actively to begin on April 1, 2000. A copy of the SMP is available online: http://www.imf.org/external/country/JAM/index.htm.

[8] Bank and IDB staff contributed to the development of the financial sector resolution strategy as reflected in the SMP.

largely limited to domestic investors[9]. In the early 1990s, there was a rapid growth in variety and number of financial institutions and Jamaica experienced a credit boom. Management of most of these institutions was weak. The legal, regulatory, and supervisory environment was deficient and allowed regulatory arbitrage. Insurance companies, which were allowed to offer deposit-like products, raised funds through such products to finance longer-term investment projects in the real estate and tourism sectors. As a result, they increased their risks, and played a key role in precipitating the crisis. Government policy, which initially attempted to implement loss-sharing arrangements with depositors for the first few failed institutions, also contributed to erosion of depositor confidence.

A. Structure of the Financial Sector Prior to the Crisis

13. Prior to the crisis, the Jamaican financial sector was characterized by extremely rapid growth in assets and a large number and variety of financial institutions. Between 1990 and 1994, total assets in the financial sector grew at an average rate of 16.2 percent with a credit boom concentrated in the real estate and tourism sectors. Financial services increased their contribution to GDP from about 7 percent during the 1980s reaching 15.9 percent 1994. Commercial bank assets multiplied seven times between 1990-95, while merchant banks and building societies' assets grew four and ten times, respectively (Table 1). A large number of institutions emerged partly motivated by regulatory and tax arbitrage opportunities that surfaced in the system. From 1981 to 1990, the number of merchant banks increased from 6 to 21. After reserve requirements were raised on merchant banks, non-supervised building societies with no reserve requirements and lower prudential standards increased from 6 in 1990 to 32 in 1995 when BOJ assumed supervisory responsibility for the sub-sector.

14. FINSAC conducted an extensive study of the weaknesses that characterized the financial institutions that had to be intervened[10]. It found that most financial institutions were poorly managed and had inappropriate organizational structures with little or no strategic planning. In spite of being ill prepared to understand and control their risks, the re-privatized banks went into a lending-spree beginning in 1990, which previously credit-rationed borrowers eagerly absorbed. Institutions frequently undertook lending activities largely in the interest of their major shareholders and the obvious incentive problems led to poor supervision by their Boards of Directors. FINSAC found evidence of excessively high operating costs including inappropriately high compensation packages for certain executives. Almost all institutions were under-capitalized, especially given the large role that real estate played as collateral. Credit origination and evaluation techniques were weak as banks used largely illiquid real-estate collateral as security for loans instead of focusing on expected cash flow from projects financed. Financial institutions' asset portfolios were highly concentrated with substantial related party lending and consequently, there was little assessment or monitoring of loans. Non-performing loans were not adequately provisioned for and there was substantial mismatch in the maturity of assets and liabilities.

[9] The largest commercial bank, National Commercial Bank (NCB—formerly Barclays Bank International) that had been nationalized in 1977 was transferred to the private sector in stages, starting with the sale of more than 40 percent of the shares in 1986. Another large bank, Workers Savings and Loan Bank, was privatized in 1991.

[10] For more details, see FINSAC's website: http://www.finsac.com.

B. Policy Environment

15. The policies of the early 1980s of exchange controls, interest rate controls, and high reserve requirements, negatively impacted the decisions of the commercial banks. By the late 1980s, the authorities had initiated a process of financial liberalization and the Bank of Jamaica (BOJ) shifted to market-based instruments of liquidity management. By 1989, the BOJ had freed interest rates, removed credit controls, significantly reduced the liquid asset ratio (LAR), introduced a program to remunerate reserve requirements, and started open market operations to replace credit ceilings as the primary instrument of monetary control[11]. Between 1989 and 1991 a major policy reversal took place because of the surge in credit and exchange rate pressures, which led to the reintroduction of credit ceilings, an increase in LAR, and the discontinuation of payment of interest on a portion of the reserve requirements. The reform program was reinitiated in late 1991 when credit controls were abandoned. LARs, which continued to be prominent as instruments of monetary policy, were extended in 1991 to foreign currency deposits. Since then, open market operations have become a crucial component of a restrictive monetary policy which was implemented to contain high inflation experienced during 1991-1994.

16. Tight monetary policies instituted by the Government during the mid-1990s caused high real interest rates and a recession in 1996. Many of the large investments in projects financed by banks during the credit boom of earlier years did not provide the anticipated returns, widening credit defaults. As defaults increased, the maturity mismatch between assets and liabilities became evident, particularly at several insurance companies, increasing their liquidity needs. These companies then demanded more credit from their associated banks within the same conglomerate, which in turn affected the already fragile liquidity of the system. Many of the liquidity and solvency problems that caused the financial sector crisis thus originated in insurance companies and spread to the banks and other financial institutions.

C. Legal, Regulatory, and Supervisory Environment

17. The financial liberalization process of the early 1990s was not accompanied by the development and enforcement of an adequate framework of supervision and regulation and prudential requirements were inadequate. The distinction between deposit-taking institutions (traditional commercial banks) and other financial institutions was minimal because of the creation of unregulated instruments that mimicked deposits at lower regulatory costs. The number of institutions that were subject to lower reserve requirements and relatively lax supervision increased as market participants searched for ways to access cheaper funds and broaden their deposit base. This was particularly the case initially of merchant banks that had lower reserve requirements than commercial banks and later of building societies, which were not subject to any legal reserve requirements until 1996 after implementation of formal supervisory arrangements for the sector under the BOJ. The pattern of regulatory arbitrage continued as the liabilities of insurance companies increased mainly because they remained poorly regulated.

[11] In Jamaica, cash reserve requirements (CRRs) are a component of the liquid assets ratios (LAR). The difference between the latter and the former is the portion that is required to be maintain in eligible liquid assets, primarily government paper.

Table 1. Changes in the Financial System Structure: 1961-1999
(Total Assets, Deposits, Loans in J$ millions, figures as of December 31)

	1961	1971	1981	1990	1995	1996	1999
Commercial banks							
Number of banks	6	6	8	11	11	9	6
Number of branches	69	131	179	170	205	188	129
Assets	--	517	2,634	17,328	121,325	135,986	192,843
Deposits	--	406	2,103	12,098	89,135	94,103	126,814
Loans	--	330	1,495	8,997	45,864	54,563	36,719
Merchant banks							
Number of institutions	--	3	6	21	25	23	13
Assets	--	12	93	4,527	17,334	19,778	10,078
Deposits	--	2	35	2,843	6,868	6,760	4,545
Loans	--	10	38	2,863	6,024	7,349	2,704
Trust companies							
Number of institutions	2	6	10	3	--	--	--
Assets	--	24	163	109	--	--	--
Deposits	--	14	126	86	--	--	--
Loans	--	14	104	75	--	--	--
Building societies							
Number of institutions	7	16	7	6	32	14	5
Assets	17	57	388	3,058	29,084	35,926	40,412
Savings funds	14	53	367	2,667	25,217	28,765	32,577
Loans	14	46	271	1,596	9,714	15,570	14,709
Credit unions							
Number of institutions	110	127	96	80	82	77	66
Savings	2	10	185	694	3,516	4,681	9,436
Loans	1	9	184	652	2,831	3,652	6,680
Finance houses							
Number of institutions	--	--	10	5	4	4	2
Assets	--	--	59	266	639	530	724
Savings funds	--	--	47	157	210	236	393
Loans	--	--	33	168	206	185	205
Life insurance companies							
Number of institutions	16	20	13	10	12	12	7
Total Assets	61	129	403	2,072	n.a.	n.a.	24,000

Source: Bank of Jamaica
n.a.: not available

18. Lacking an adequate legal framework also complicated supervision, further undermining the soundness of the system. The eventual legislation that was approved in 1992 gave inadequate powers of intervention, sanction, and enforcement to supervisors. While the BOJ supervised the banking system, sanctioning powers were chiefly vested in the Minister of Finance and Planning[12]. Exemptions to legislation and to prudential requirements were

[12] By law, it is only the Minister of Finance and Planning and not the Ministry, that is vested with these powers.

sometimes granted, which undermined the ability of the BOJ to supervise the industry, because institutions were inclined to seek exemptions or delays as opposed to complying with particular requirements of the supervisor. Moreover, although the BOJ extended substantial amounts of unsecured overdraft facilities to institutions in difficulties, it did not have legal powers to intervene unless an institution was declared insolvent by the Minister. It could also not impose early corrective measures such as mandatory financial restructuring and managerial changes. The BOJ could not impose fines for violations of regulations, since the Jamaican legal system required (and still does) that all fines be levied only by the courts[13]. In addition, while the BOJ became more stringent in supervising deposit-taking institutions, the other financial regulators did not replicate this supervisory approach.

D. The Role of Insurance Companies

19. 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 (Annex V). As noted above, once the liquidity problems emerged, insurance companies tapped mostly their related banks for funds, triggering the problems that surfaced in the banking sector.

E. Financial Contagion

20. The Government initially attempted to implement loss-sharing arrangements with depositors for the first few failed institutions as demonstrated by the Government's intervention in the Blaise group in 1994[14]. In the aftermath of the bankruptcy of this group, the Government established the Financial Institutions Services (FIS), a wholly Government owned limited liability company (Box 1), to liquidate the group and implement a scheme of loss-sharing arrangements that were drafted in July 1996. The loss sharing arrangement limited payouts to depositors to 90 percent of deposits with a ceiling of J$100,000 (about US$2500). Despite the small size of this institution, there was significant negative impact on public confidence.

21. The second bank that ran into major liquidity problems was Century National Bank. The first signs of instability emerged in 1992, and by 1995, BOJ's on-site examinations revealed a shortfall in capital of more than J$1.5 billion. The liquidity problems were originally addressed with the provision of overdrafts by the BOJ for an amount of J$4.3 billion (close to 2 percent of GDP) by mid-1996.[15] When this support proved inadequate, the Government announced that it would assume temporary management of Century group[16]. It also announced that FIS would implement a loss-sharing scheme similar to the one adopted for Blaise. This action, combined

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[13] The only exception to this rule is fines on overdrafts, as this provision pre-dates the Jamaican constitution.

[14] The Blaise group consisted of the Blaise Trust & Merchant Bank, Blaise Building Society, and Consolidated Holdings Limited.

[15] There is an automatic and unsecured overdraft provided by the BOJ at penalty interest rates triggered by the banks' inability to cover their payment clearing obligations. This facility was widely used in the crisis.

[16] The Century group consisted of the Century National Bank, Century National Building Society, and Century National Merchant Bank.

Box 1. Financial Institutions Services

FIS was the first bank failure resolution entity established by the Government. While it continues to exist, its activities are limited and since 1997, FINSAC has taken over as the special Government entity to resolve the financial sector crisis.

FIS is responsible for paying creditors of the two intervened groups (Blaise and Century) – issuing debt in its own name to finance the payout – and for selling the assets acquired from these groups. In the case of Century Group, depositors are entitled to open accounts with National Commercial Bank (NCB), which in turn receives FIS notes as corresponding assets. This is an ongoing process with a few depositors still claiming their funds from Century at NCB, which results in increases in FIS' outstanding debt. As a result of this arrangement, most FIS bonds are held by NCB. FIS bonds are issued both in Jamaican dollars and US dollars with coupon rates ranging from zero to market rates linked to Treasury bills. All FIS bonds are serviced in cash. As of August 2000, FIS debt amounted to J$5.4 billion (about 2 percent of GDP).

FIS is also empowered to pursue civil litigation against shareholders and directors of the Century group and to assist the judicial system in its effort to investigate fraudulent behavior on the part of former managers and owners. If a judgement against the former owners and managers is issued, FIS would assist in identifying and obtaining the control of assets of the respective individuals.

with rumors of liquidity problems at a much larger bank–Citizens Bank– triggered a run on Citizens Bank in late 1996. A run later began on Eagle Bank in early 1997.

22. As confidence eroded, depositors shifted their funds into stronger institutions – particularly foreign-owned – in an extensive flight to quality[17]. 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 large risk of ongoing bank runs becoming systemic and increased possibilities for capital flight, coupled with evidence of increasing social turmoil.

III. THE GOVERNMENT'S RESPONSE TO THE CRISIS

23. Faced with the risk of systemic runs, the Government implemented a wide ranging intervention in the system, *de facto* insuring all depositors, life insurance policyholders, and pension fund investors for their total assets. In the process, the Government effectively became the owner of, or a major investor in most of the domestically owned financial sector. The Jamaican approach to the management of its financial crisis was similar to that taken by Mexico after its 1995 banking crisis (Box 2).

24. As mentioned above, Jamaica initially established the Financial Institutions Services (FIS) to wind down the operations of two failed groups – Blaise and Century. In 1997, the Government established another public sector limited liability entity, the Financial Sector

[17] As a result of the continuing flight to quality the largest foreign institution in Jamaica - the Bank of Nova Scotia (BNS) – increased its share of deposits in the banking system from 37 percent in March 1998 to 41 percent in June 2000 (Annex IV).

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[18]. FINSAC was originally envisioned to have a limited life of five to seven years. Recently, the Government publicly stated its intention to close down FINSAC, subsequent to satisfactory achievement of its objectives, by September 30, 2001. FINSAC assisted financial institutions and re-capitalized them by purchasing shares, making subordinated loans, and purchasing non-performing loans.

A. The Intervention Phase of FINSAC's Operations

25. 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[19]. FINSAC notes carried mostly floating interest rates usually indexed to the 6-month Jamaican Treasury bill rate[20]. The interest payment on almost all notes was capitalized in the form of fresh FINSAC notes (Annex VI). As of August 2000, FINSAC's gross support to the system amounted to about J$127 billion (43.9 percent of GDP). Several modes of intervention were used by FINSAC, as listed below.

- ***Acquisition of cross-holdings.*** FINSAC often acquired shares of one financial institution from another in return for payment of an agreed amount in FINSAC bonds and/or cash, and in some cases, acquisition of certain properties. Valuation of the acquisitions was largely done at book value, not reflecting appropriately the weakened financial position of the intervened institution and the lower market values of the acquired properties. This effectively transferred public resources to existing shareholders at some institutions.

- ***Purchase of non-performing loan portfolio.*** FINSAC purchased non-performing loans (NPLs, principal plus at least three months of accrued interest) from several institutions at par value. In exchange for the NPLs, the institutions received FINSAC bonds.

- ***Direct capital injection.*** FINSAC also attempted to restore liquidity and solvency to financial institutions directly. The intervened institutions issued new preferred or ordinary shares to FINSAC in exchange for FINSAC notes and/or cash. In some cases, the previous stockholders gave up control of the institution to FINSAC and management was substituted

[18] FINSAC has divided its activities into six major functional areas: Asset Management & Divestment (including non-performing loans); Liquidity Management; Institution Rehabilitation - Banks and Insurance Companies; Insurance Regulatory Reform; Monitoring and Evaluation; and Investigation of Claims for Fraudulent Activities.

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

[20] Only a few of the bonds carry 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 are a small fraction of overall FINSAC paper.

or institutions were sold or merged. Most preferred shares were cumulative and redeemable, and counted as Tier 1 capital.

- ***Provision of loans, subordinated loans, and advances***. FINSAC provided loans to financial institutions for liquidity and solvency support, and in some cases, for assumption of an institution's liabilities. These loans were also sometimes issued to cover earlier BOJ overdraft advances.

- ***Payoff of depositors through new accounts in other "good" financial institutions.*** In some cases, FINSAC provided assets to "good" financial institutions to back up liabilities of "bad" financial institutions that were assumed by the "good" financial institutions. This support was provided in the form of Treasury bonds (Locally Registered Stock or LRS), issued by the MOF to the intervened institutions. In return, FINSAC provided bonds to the MOF.

B. The Rehabilitation Phase of FINSAC's Operations

26. 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.

27. ***Rehabilitation of banks***. 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 a smaller merchant bank into NCB. As of June 2000, intervened FINSAC institutions consolidated into NCB and Union Bank held over half of the total commercial bank deposits of the Jamaican financial system (Annex IV). The restructuring process also involved a substantial reduction in the number of branches and staff of the two banks. UB has reduced its number of branches from the pre-merger level of 42 down to 23, while staff was reduced from 1,425 to 800. As of March 2000, NCB staff had been reduced from 3,110 to 2,614, while its number of branches was reduced to 49, with additional reductions pending. In contrast, the Bank of Nova Scotia, a foreign bank with a large and growing presence in the market, significantly increased the number of staff in 1999.

Box 2. Jamaica and Mexico: Comparison of Two Banking Crises

Two very different economies –Jamaica and Mexico– have many similarities in the causes, management, and effects of the financial crises that they faced in the mid-1990s.

1. Causes

Bank nationalization, followed by poorly implemented re-privatization, rapid financial liberalization, a large credit boom with substantial assets concentrated in real estate, poor standards of accounting and disclosure, and weak legal, regulatory, and supervisory frameworks, characterized the onset of crises in both countries. Both countries nationalized almost their entire domestic banking sectors during the 1970s and the early 1980s and subsequently re-privatized them in the context of a process of rapid financial sector liberalization. In both countries few new foreign entrants were allowed during the privatization process. Both Mexico and Jamaica experienced a credit boom in early 1990s. In both cases a boom in the real estate sector preceded the crises, and a large share of outstanding commercial credit had been extended either directly to real estate or with real estate as collateral. Tight monetary policies introduced by both governments in response to the credit booms caused interest rates to increase dramatically. As the real estate bubble burst, both financial systems were left with a large percentage of non-performing loans in such illiquid assets. Finally, both crises were characterized by weak legal, regulatory and supervisory systems that prevailed during the crises together with major issues in corporate governance that undermined the bank resolution process.

2. Crisis management

Both governments managed to contain systemic crisis through large interventions in the financial sector and provision of a full guarantee for all depositors. Mexico's FOBAPROA and Jamaica's FIS and FINSAC provided financial institutions with a broad range of support. Both countries' failure resolution mechanisms issued Government backed debt to re-capitalize banks and purchase non-performing loans. Both countries postponed the financial resolution of their interventions by allowing the debt to accrue interest in the form of fresh bonds. Mexico created a new institution – IPAB – to take over FOBAPROA's liabilities and undertake financial resolution of the crisis. In Jamaica, FINSAC has this responsibility.

3. Effects

Both governments allowed liabilities to accumulate for about three to four years and are now at the early stages of explicitly assuming liabilities created due to the crises and servicing them in cash. The "least-cash" as opposed to "least-cost" strategies employed by the two countries resulted in significant accumulation of crisis-related liabilities, which ultimately will translate into high fiscal costs. Mexico's support to the financial sector is estimated to cost the country over 20 percent of GDP, while the cost of Jamaica's FINSAC intervention is estimated at about 43.9 percent of GDP as of August 2000. The two countries have taken different approaches to dealing with the debt accumulated as a result of the crises. Mexico plans to service the real component of interest on crisis-related debt in cash while gradually assuming amortization responsibilities for some of the debt as individual financial institutions are sold. Jamaica plans to restructure and reduce its debt up-front and assume the responsibility for servicing all interest payments on the entire stock of outstanding debt as of April 1, 2001. Amortization of debt will depend on agreements between the Jamaican Government and the buyers of the intervened institutions. The real level of intermediation of banks in the financial sector in both countries has been severely curtailed due to the crises. In Mexico, growth of real credit to the private sector has been negative since 1995, while in Jamaica, credit to the private sector as a percentage of GDP is still below that in 1996. Since the crises, both governments have engaged in a major overhaul of their regulatory and supervisory frameworks to reduce the likelihood of future crises.

An important difference in the impacts of the crises on the two economies is that in contrast to the Jamaican economy, Mexico's economic growth has dramatically improved since the crisis. Mexico's close economic ties to the US economy due to NAFTA (which came into force just prior to the crisis) and the booming US economy since the mid-1990s have undoubtedly had a large role to play in Mexico's economic performance. Nevertheless, Mexico is estimated to have to pay about 1 percent of GDP per year for the foreseeable future to service its crisis related liabilities while the costs to Jamaica are estimated to be much larger - between 2-4 percent of GDP for the foreseeable future. It may be easier for Mexico to bear these costs with a rapidly growing economy, lower overall debt/GDP ratio, and a freely floating currency. Jamaica's future rate of economic growth will largely determine the sustainability of its crisis related debt management strategy.

28. ***Rehabilitation of life insurance companies***. Concomitantly with the advances in the banking sector, the Government has 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 transparency and soundness in 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 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 insurance companies and new foreign markets entrants (Annex V). FINSAC has essentially divested most of its insurance assets except Life of Jamaica (LOJ), in which it currently holds a 26.5 percent equity stake.

C. Reform of Regulation and Supervision

29. As FINSAC attempted to restore liquidity and re-capitalize weak institutions, the Government undertook 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. In the first quarter of 1998, Parliament approved the Deposit Insurance Act with limited protection to cover deposits up to J$200,000 (about US$5,000) of banks and near banks, 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 from the Inter-American Development Bank (IDB) and is being continued through technical assistance from the Caribbean Development Bank (CDB).

30. ***Reforms in the Regulation and Supervision of the Banking Sector.*** Since 1997 critical regulatory improvements have been introduced. These measures addressed the following issues: improved risk-based capital adequacy requirements; tighter credit classification and provisioning requirements; stronger sanctions based on the "ladder of enforcement" concept; more effective intervention powers by empowering the Minister of Finance and Planning to take control of the equity of a licensee; strengthening fit and proper criteria; stronger regulations regarding connected lending; tighter limits on unsecured lending; stricter requirements for external audit; preliminary steps at consolidated supervision through access to accounts of holding companies; and tighter procedures against money laundering (Annex III).

- *Definition of Regulatory Capital:* Prior to the crisis, capital requirements consisted of a minimum 6 percent primary capital ratio required for all deposit-taking institutions and gearing ratios (deposits/capital) of 25:1 for banks and 20:1 for near banks (merchant banks and building societies)[21]. In 1999, the authorities expanded the definition of capital base with the concepts of Tier-1 and Tier-2 to enable the implementation of a 10-percent risk-based capital adequacy requirement for deposit-taking institutions, compared to the Basle minimum standard of 8 percent, while maintaining the earlier gearing and primary capital

[21] Capital base includes paid-up capital, reserve fund, retained earnings, and share premium, less losses.

ratios. Although regulations to this effect have not yet been formally approved, there is *de facto* implementation and most institutions are already in compliance with these rules.

- *Asset Classification and Provisioning Guidelines*: A more conservative policy for the classification of non-performing loans was implemented by reducing the time period before a loan could be classified as non-performing from six to three months, in line with international best practice. Among other improved prudential measures, the BOJ has issued guidelines for the review of loan portfolios, the classification of loans, loan loss provisioning, loan renegotiation, the suspension of interest accrued on past-due loans, and write-off procedures.

- *Improvements in the "Ladder of Enforcement"*: A ladder of enforcement was issued clearly specifying the increasing levels sanctions that supervisors would impose in response to the progressively higher assessed levels of problems in the financial institutions. As a result, the enforcement powers of the BOJ were spelled out in a transparent and consistent manner.

- *Improvements in Effectiveness of Powers of Intervention*: Prior to the crisis, the only way for the Government to take control of a financial institution was after it was bankrupt. In 1997, the Minister of Finance and Planning was empowered to take control of the equity and subordinated debt of non-viable institutions and effect sales of assets and shares, or to effect other types of resolution in the interest of depositors. In addition, the BOJ was given new powers to adopt prompt corrective actions in the form of undertakings, supervisors' directives, or "cease and desist" orders.

- *Restrictions on Connected and Unsecured Lending*: Unsecured credit to any connected person has been prohibited. Secured lending to all connected parties along with investments in any connected parties have been limited to a maximum of 20 percent of the capital base, with no more than 10 percent in any one connected entity.

- *Restrictions on Investments and Fixed Assets*: Individual investments in unconnected parties/entities are limited to an aggregate of 50 percent of a bank's capital base, with no more than 10 percent in any one entity. Fixed assets are limited to 100 percent of the capital base.

- *Norms for Disclosure and Audit*: The BOJ was given power to issue accounting standards applicable to banking institutions and to examine the accounts of holding companies of supervised financial institutions. Auditors were required to report any significant issues and problems uncovered during their work to the supervisor and the Boards of Directors of the licensees. In addition, the BOJ is empowered to require special audits or order banks to expand the scope of an audit.

- *Changes in Reserve Requirements:* The authorities are reducing reserve requirements (cash reserves requirements (CRR) and other components of the liquid assets ratio (LAR)) following international trends, while leveling the regulatory playing field across banks and near banks (i.e., merchant banks, trust companies and finance companies), thus limiting opportunities for regulatory arbitrage. The CRR and LAR for commercial banks and near banks have been equalized. From August 1998 to June 2000, the BOJ reduced the CRR of commercial banks from 25 to 14 percent and the LAR from 47 to 32 percent, with further reductions of the CRR to 9 percent being planned by March 2002.

- *Self Assessment of Core Principles*: The BOJ has conducted a self-assessment of the Basle Core Principles, and concluded that Jamaica is largely compliant with many of the principles. This self assessment has been shared with the Bank on a confidential basis and shows that in some areas such as sanctioning powers, consolidated supervision, and information sharing, further enhancement is needed.

- *Strengthening of On-and Off-site Supervision*: The BOJ has taken steps to enhance on- and off-site supervision and to bring its supervisory methodology more in line with international best practices. These enhancements include: establishing an identification unit for troubled institutions; improving systemic risk analysis via the establishment of the Financial Stability Monitoring Committee; and enhancing the quality of the on-site examination process and examination reports. In addition, the BOJ has issued "Standards of Best Practices" in several areas such as credit risk management, cash flow analysis, asset/liability management, etc., which are checked for compliance by the supervisors during inspections. The staffing of the supervisory division has been increased and internal and external training initiatives have been expanded.

- *Regulation of Credit Unions*: The BOJ has also issued draft regulations in 1999 to start supervising credit unions. However, due to constraints on the number of supervisors the BOJ has thus far relied mostly on a self-regulatory agency to supervise credit unions. The BOJ is obtaining technical assistance from the CDB to strengthen this aspect of its functions.

31. ***Reforms in the Regulation and Supervision of Non-Bank Financial Institutions.*** The Government has taken several steps to improve the regulation and supervision of non-bank financial institutions.

- A new Insurance Bill has been drafted and has received Cabinet approval to be presented to Parliament. The Government proposes to repeal the existing Insurance Act and have the new one in place by early 2001. The proposed new Act corrects several deficiencies of the existing legislation and addresses issues such as solvency standards, accounting standards, early warning indicators, fit and proper criteria, and audit and actuarial requirements.

- A "Green Paper" on the pension system has been prepared proposing reforms to the pension system. Although supervision of pension funds is currently weak, it is expected that the proposed reforms will form the basis for strengthened supervision.

- The Government is aware that the multiplicity of regulatory agencies (Office of the Superintendent of Insurance (OSI) and Securities Commission (SC)) and weak coordination between them and the BOJ was one of the problems that led to regulatory arbitrage prior to the crisis. In April 2000, the authorities announced the formation of a new Financial Services Commission (FSC) that will be the single non-bank regulatory and supervisory agency responsible for securities, insurance, and pension supervision. It will be effective from April 1, 2001 and report via a board to the Minister of Finance and Planning. Its main objectives are to: (i) build institutional capacity on the basis of the OSI and the SC; (ii) strengthen securities market regulation and surveillance, including timely and proper risk identification; (iii) improve insurance analysis and supervision; and (iv) supervise pension funds in accordance with the proposed reforms mentioned above.

32. ***Deposit Insurance.*** The Government recognized that one of the major causes of the large stock of liabilities created in the aftermath of the crisis was that a full guarantee was provided to all depositors, irrespective of the size of the deposits. While the Government felt that this was necessary within the context of the systemic risks faced during the crisis, it has since established a mechanism for making explicit that only limited coverage of deposits will be available in the event of any future problems in the financial sector. The Jamaica Deposit Insurance Corporation (JDIC) commenced operations in August 1998 with compulsory enrollment for all institutions supervised by the BOJ. Coverage has been limited to J$200,000 (approximately US$5,000) to protect small depositors and to attempt to force large depositors to monitor the condition of banks. According to a September 1999 survey of insurable accounts, the JDIC covers 90 percent in number and about 34 percent in value of deposit accounts. The JDIC has no independent oversight capacity but has access to the BOJ's information on the financial status of its insured members. The Government originally transferred a nominal amount of J$1 million to capitalize JDIC and the institution funds itself through premiums of 10 basis points/year on total bank liabilities (excluding inter-bank liabilities and Government deposits). The resources available to the JDIC are still very small and cover a negligible fraction of total deposits.

33. ***Regulations against Money Laundering.*** Drug money laundering had been declared a criminal offense by virtue of the Money Laundering Act 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.

34. 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 15 non-cooperative countries or territories in the international fight against money laundering identified by the FATF in its report of June 2000. It has also not been identified by the OECD as a tax haven and is not included in its list of 35 jurisdictions with harmful tax regimes in its report issued in June 2000.

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

35. 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. As of August 2000, the estimated total stock of FINSAC/FIS liabilities amounted to J$127 billion, equivalent to 43.9 percent of GDP, almost as large as Jamaica's external debt. The main holders of this debt are the MOF, the BOJ, Union Bank, NCB, and others (mostly insurance companies) (Annex VI).

Table 2. Stock of FINSAC Liabilities due to the Financial Sector Intervention
(Figures as of August 31, 2000)

Program	Billion J$	percent of GDP
Ministry of Finance/NIBJ/JDB	19.4	6.7
Bank of Jamaica*	25.9	9.0
Union Bank	19.5	6.7
NCB	44.3	15.3
Others	12.3	4.3
FIS Liabilities	5.4	1.9
Total FINSAC/FIS liabilities (including net commitments)	126.9	43.9

Source: FINSAC

GDP for FY2000 is estimated by the IMF at J$289.4 billion

*Total FINSAC paper held as assets at the BOJ as of August 31, 2000 was J$25.9 billion. However, Cabinet approval was obtained on October 17, 2000 for restructuring J$26.2 billion of FINSAC paper at the BOJ - with J$13 billion being offset against Government deposits and J$13.2 billion being restructured into cash yielding Treasury bonds. The difference of J$300 million between the two figures is due interest accrued between September 1, 2000 and the date of Cabinet approval. The figure of J$25.9 billion has been used in this Table in order to maintain consistency with the rest of the computations in this Report, which are based on data as of August 31, 2000.

36. ***FINSAC paper held by the MOF and other public sector banks***: The origins of the FINSAC paper held by the MOF lie in the support directly provided by the MOF to certain "good" financial institutions in order for them to take over the liabilities of "bad" financial institutions. FINSAC then provided notes to the MOF. A small amount of FINSAC paper is held by public sector development banks in return for the support that they provided to troubled institutions at the behest of the MOF. FINSAC paper held by the MOF can be viewed as fiscal costs already borne in cash terms by the Government.

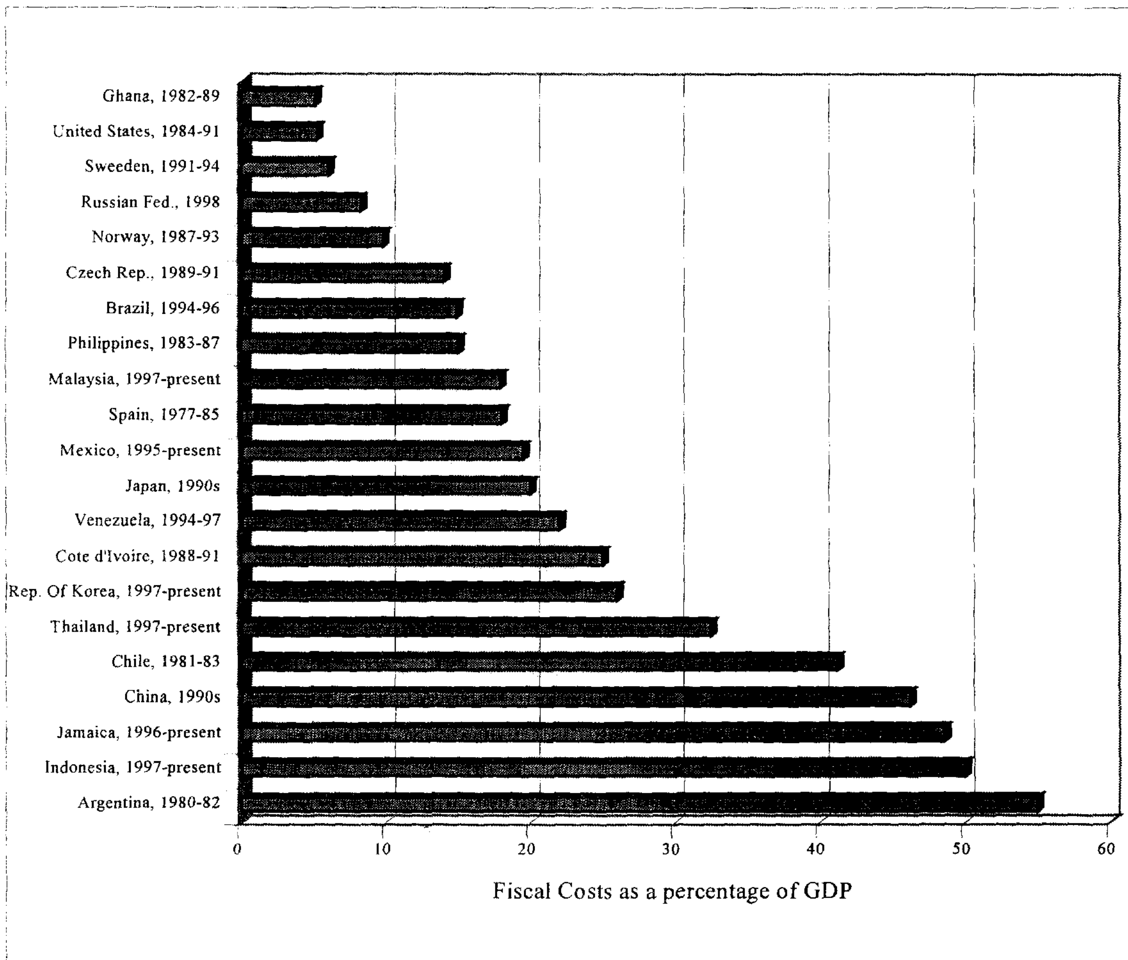
37. ***FINSAC paper held by the BOJ***: The BOJ provided overdraft facilities to several intervened institutions. Since these institutions could not repay these overdrafts, FINSAC provided the BOJ with notes as a settlement of the overdrafts and the intervened institutions converted their overdrafts from the BOJ into a loan from FINSAC.

38. ***FINSAC paper held by banks and other financial institutions***: As discussed above, financial institutions hold FINSAC paper due to interventions by FINSAC (Annex VI).

D. Evaluation of the Government's Crisis Management Program

39. The financial sector, hit hard by the crisis, has stabilized. The intervention and rehabilitation programs implemented by FINSAC were successful in preventing a financial sector melt-down while maintaining social stability. However, Jamaica has achieved this at substantial cost, which is among the highest when compared to 114 episodes of systemic banking crises in 93 countries that have taken place since the late 1970s (Caprio and Klingebiel, 1999) (Figure 1). The following factors played a major role in the Government's management of the crisis.

Figure 1. Cost of Banking Crises



Costs for Ghana and Spain are shown as a percentage of GNP.
Source: Caprio and Klingebiel. "Episodes of Systemic and Borderline Financial Crises", 1999.

40. ***Political Constraints:*** Political pressures restricted the range of crisis management solutions open to the Government. As in the case of many banking crises worldwide, the Government was unwilling or unable to force the shareholders of many of the troubled

institutions to accept a higher share of the losses. FINSAC acquired most assets at book value, indicating that there might have been insufficient write down of shares to reflect the real financial position of the distressed institutions. Removal of corporate owners and prior management has been slow. In some large institutions, such as NCB and LOJ, some shareholders and management that controlled the institutions prior to the crisis still do so. Due to contagion risk, the Government was also unable to adopt a solution in which there was some burden sharing with the depositors even though the structure of deposits was extremely skewed and there was evidence of widespread connected party transactions[22].

41. ***Constraints imposed by FINSAC's structure:*** FINSAC was established as a corporation under the Companies Act rather than as a special intervention agency with special powers. Since it had no legal power to intervene, FINSAC was required to obtain authorization from the MOF to intervene and to coordinate interventions with other institutions (BOJ and OSI). FINSAC also has had to rely on negotiated arrangements with the owners and directors of distressed institutions to acquire ownership and control in them. These constraints did not enable writing down of shares at the time of intervention and there was limited burden sharing with shareholders. Within the constraints, however, FINSAC has done a commendable job negotiating the purchase of ownership stakes of over 25 percent in all institutions in order to have veto power over management decisions, especially since in some cases the old management of the institution was retained.

42. ***Complex corporate structure***: Financial conglomerates in Jamaica had extremely complicated and intricate ownership structures. In some instances, it took FINSAC a substantial amount of time to unravel all of the connected institutions and assess the true extent of the financial support needed. This structure also led to periodic increases in the amounts of assistance that FINSAC had to provide.

43. ***Legal and regulatory constraints:*** The legal framework to deal with problems of this magnitude was clearly inadequate and magnified the other constraints facing the Government. Until the 1997 reforms, the only way for the Government to force loss-sharing by shareholders in Jamaica was to declare an institution bankrupt. In addition, bankruptcy proceedings had to be instituted in the courts, thereby delaying restructuring and increasing costs of intervention. Further, the exemptions to prudential requirements or forbearance in terms of additional time to meet prudential requirements that were sometimes granted complicated supervision and increased the overall costs of the intervention.

44. ***High level of public debt prior to the crisis:*** In March 1995, prior to the crisis, the Government already had a high level of public debt – 103 percent of GDP. Interest payments (excluding FINSAC paper) plus wages were about 59 percent of Government's revenue. This large pre-existing debt burden made it difficult for the Government to assume explicitly the cost of the intervention early on in the crisis leading to a structure of FINSAC paper that accrued interest resulting in both a postponement of the financial recognition of costs and a dramatic increase in the cost of the intervention.

[22] As of October 31, 1999, about 5.6 percent of deposits in number controlled more than 67 percent of deposits by value.

45. ***Impact of intervention on bank liquidity:*** The capitalization of interest on FINSAC paper strangled banks' liquidity, even as bank balance sheets were cleaned up. Intervened banks ended up having to fund a growing illiquid asset base through expensive inter-bank deposits and money market transactions leading to negative operational cash-flows, which further weakened them. These liquidity constraints were present even in the absence of new bank credit.

46. ***Impact of illiquid banks on the BOJ's balance sheet:*** Illiquid banks turned to the BOJ for liquidity support through overdrafts, which the BOJ provided by resorting to reverse-repurchase agreements to borrow money from the domestic markets[23]. However, given its emphasis on a tight monetary policy, the BOJ was forced to undertake compensatory open market operations to drain liquidity. When banks could not clear the overdrafts, FINSAC issued additional paper to the BOJ to settle bank borrowings. The BOJ was, however, saddled with expensive market borrowings. Therefore, the BOJ's balance sheet has taken on characteristics similar to some of the intervened banks wherein low yielding and non-cash paying assets (FINSAC paper) on the BOJ's balance sheet are being funded through high cost borrowings on which cash interest is due. The Government's debt management program calls for correcting this weakness on the BOJ's balance sheet.

47. ***Positive effects of the crisis:*** There were also some positive effects of the crisis. Bank balance sheets have been cleaned up. The BOJ reports that as of June 2000, commercial banks, near banks, and building societies had less than half the ratio of NPLs to total loans as compared to two years earlier, down to 12 percent, while provision for loan losses to NPLs increased from 51.3 in June 1998 to 102 percent as of June 2000. Better-managed international banks increased their market share in the flight to quality after the crisis. As mentioned above, there has also been a significant improvement of banking and insurance regulation and supervision. The legal changes implemented strengthened the regulatory framework for early intervention providing alternatives to liquidation that was the only possible choice under previous legislation. The general thrust of these measures has been to provide the BOJ with additional powers to act rapidly and effectively in cases of impending bank failure. In addition, over the last few years, the BOJ has experienced a significant institutional strengthening, which has been manifested in a broader and deeper pool of skilled staff, an enhanced capacity to process and analyze information, the reorganization of its operations, increased systematic training and more effective use of external consulting services supported by the IFIs.

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

A. The Structure of the Financial Sector in Jamaica after FINSAC Interventions

48. 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 (Table 1). Total financial sector assets as of June 2000 were

[23] BOJ reported no outstanding overdrafts as of the end of July 2000, although the use of this facility fluctuates widely intra-month.

J$257 billion (US$6.1 billion) with commercial banks representing 80.4 percent of total, building societies 16.2 percent and near banks 3.4 percent. Currently there are 6 commercial banks, 11 merchant banks, and 5 building societies. NCB and BNS together represent about 75 percent of total assets of commercial banks (Annex IV). The remaining 25 percent includes: Union Bank 16 percent; CIBC 6 percent; Citibank 3 percent; TCB Group (domestic) less than 1 percent. The assets of the remaining seven life insurance companies totaled J$24 billion (US$570 million) at year-end 1999. Of the large banks, BNS has the largest loan portfolio (Annex IV), while the assets of NCB and Union Bank are primarily tied up in FINSAC paper. NCB and Union Bank are also currently under Board Undertakings and Directions which specify conditions under which any new loan origination may be made.

B. The Government's Financial Sector Restructuring Strategy

49. 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 has also become the owner of numerous real estate assets such as hotels and residential property. The portfolio of problem loans bought in the restructuring process is also an important part of FINSAC assets. The divestment process is thus a crucial final component of the Government's financial restructuring strategy.

50. **Divestment of Financial Institutions**: At present, FINSAC has remaining equity stakes in two major financial institutions that need to be resolved. The resolution of the financial sector crisis from FINSAC's point of view involves sale of these institutions.

- **Union Bank:** FINSAC has sold the 99 percent of the equity of Union Bank that it owned to The Royal Bank of Trinidad & Tobago Holdings (RBTT Holdings). Total assets of UB as of June 30, 2000 were about J$33 billion (about US$779 million), of which about J$22 billion (about US$519 million and 67 percent of assets) were FINSAC bonds. As part of the transaction, the Government has agreed to replace the FINSAC bonds in UB with liquid Government securities that will pay interest at the same rate as Jamaican Treasury bonds.

- **National Commercial Bank:** NCB's two shareholders are the NCB Group and FINSAC with 60 and 40 percent of equity respectively. FINSAC, in turn, also owns 45.4 percent of NCB Group (Annex V). As of June 2000, NCB had J$78.3 billion in assets (about US$1.9 billion), of which FINSAC bonds represented J$42.2 billion (about US$1 billion and 54 percent of NCB's assets).[24] FINSAC is in the process of obtaining all necessary approvals to convert its holdings in NCB Group as well its holdings of preferred shares of NCB into equity of NCB so that FINSAC acquires a controlling stake (over 75 percent of equity) of NCB, which in turn will allow FINSAC to find a buyer for the institution. In order to achieve this, the following steps have been taken: (i) agreement has been reached with the Board of Directors of NCB on a proposal to convert FINSAC's disparate shareholdings in the bank and the group to consolidated bank holdings: (ii) an extra-ordinary meeting of NCB's shareholders has been held to inform and sensitize them to the proposed takeover of more

[24] As of August 31, 2000, FIS bonds to NCB amount to J$4.9 billion and receive cash interest payments.

than 75 percent of NCB's equity by FINSAC; and (iii) approval from the Jamaican Supreme Court has been obtained to hold a formal meeting of NCB's shareholders on November 8, 2000 to approve the proposal – referred to legally as the Schemes of Arrangements. If the shareholders approve the Schemes of Arrangements, the final step in the process for FINSAC to legally acquire more than 75 percent of the equity of NCB is a formalization of the shareholders' approval through obtaining clearance of the Jamaican Supreme Court. This is expected to occur within a few weeks after the shareholders' meeting. The Government does not anticipate any problems in the process of FINSAC obtaining control of NCB. NCB has also replaced its senior management. A new Managing Director (Chief Executive Officer), General Manager – Information Technology (Chief Information Officer), and General Manager – Finance, Planning & Risk Management (Chief Financial Officer) have been appointed. Beginning in April 2001, the Government plans to service the FINSAC debt held by NCB in cash. As soon as possible after obtaining control of NCB, FINSAC proposes to take steps to dispose of its shareholding in NCB.

- **Life of Jamaica:** LOJ is the largest insurance company in Jamaica with over half of insurance industry assets. FINSAC owns 26.5 percent of the equity of LOJ. This insurance company continues to have weaknesses in its balance sheet and illiquidity in some of the pension funds it manages and requires additional injections of capital in the form of FINSAC paper up to about J$2 billion. The Cabinet has approved FINSAC's proposal to provide this additional capital to LOJ. FINSAC currently controls more than 75 percent of the voting rights of LOJ due to its holdings of all of the preference shares of the company which have acquired voting rights since the company has not paid any dividends on the preference shares for the past two years. The Board of Directors of LOJ has agreed to call a shareholders' meeting to authorize a proposal by which FINSAC will obtain more than 75 percent of the equity of LOJ. At this meeting, which is currently expected to be held before the end of the year, a simple majority in terms of voting rights is necessary for the approval of the proposal to give FINSAC control of LOJ. Since FINSAC controls over 75 percent of the voting rights, the Government does not anticipate any significant problems in the approval of the proposal. Obtaining more than 75 percent of the equity of LOJ will allow FINSAC to take LOJ to the point of sale.

51. ***Asset Disposal (Portfolio of non-performing loans):*** FINSAC acquired a portfolio of non-performing loans of J$74 billion (face value of J$33 billion along with accrued interest) from intervened financial institutions[25]. FINSAC has established a workout unit to manage this portfolio and attempt recovery. By August 2000, this unit had recovered about J$3.9 billion. FINSAC has also sub-contracted with the workout unit of NCB to manage about 11 percent of the total amount of NPL's purchased. FINSAC hired an external consultant to provide a diagnosis of the NPL portfolio as a first phase. The consultant's report was received in September 2000 and of several possible disposal strategies outlined therein, FINSAC's Board adopted a resolution supporting the sale of the portfolio in bulk as the best alternative. FINSAC hired the same consulting company to advise it on the process of disposing of NPLs during the second phase. The NPL package is likely to be sold to a third party at a base price with some structure of sharing receipts beyond a threshold level. It is expected that the NPL portfolio will be ready to be marketed to potential buyers during the first quarter of calendar year 2001.

[25] J$13.5 billion of the face value of NPLs were acquired from NCB.

52. ***Asset Disposal (Portfolio of other assets)*:** FINSAC also has a large portfolio of other non-core assets acquired during the intervention process (hotels, commercial and residential real estate, furniture & equipment, artwork, and motor vehicles). As of August 2000, J$11 billion of these assets had been sold (of which about 10 percent are hotel sales in process).

53. ***Continued Strengthening of the Regulatory and Supervisory Regime:*** An integral part of the Government's financial sector restructuring strategy is to continue strengthening the regulatory and supervisory regime. In this context, the Government has taken the following specific actions:

(i) The Cabinet has approved tabling of legislation to Parliament empowering the BOJ to have powers of intervention without **prior approval** of the Minister of Finance. The BOJ is only required to **advise** the Minister at all stages of the intervention process. This will improve the BOJ's independence and empower it to act in a timely manner in resolving future problems. The BOJ will also be authorized to assess fines on regulated entities.

(ii) The BOJ is committed to undertaking an independent assessment under the Basle Core principles by the second quarter of 2001. It has also issued a revised "Ladder of Enforcement" that clearly spells out sanctions that will be imposed upon the industry by the supervisor.

(iii) In order to improve the coordination among supervisors of different financial institutions, the Government has announced the formation of a Regulatory Policy Committee and the Cabinet has approved tabling of amendments to relevant laws before Parliament to permit information exchange between supervisors. The Regulatory Policy Council will facilitate this sharing of information and will aid 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.

(iv) The Government has announced the formation of the Financial Services Commission (FSC), which will be the single regulatory agency responsible for the non-bank financial sector. The Government has also announced the formation of a preparatory body to undertake necessary activities to ensure that the FSC begins operations on April 1, 2001.

(v) Cabinet approval has been obtained for a new Insurance Act, which will be tabled in Parliament.

C. The Government's Debt Management Strategy

Government's Strategy to Manage FINSAC Debt

54. The viability of the Government's program of financial sector resolution calls for the issuance of "performing" notes, i.e. notes that would not only have to accrue interest at a market rate, but that would also have to provide liquidity, by paying interest in cash on a periodic basis,

and by being tradable in the market or, if designed to be held to maturity, by amortizing periodically. Recognizing the importance of providing liquidity to FINSAC notes, the Government has committed itself to servicing all outstanding FINSAC debt (net of certain adjustments described below) beginning April 1, 2001.

55. The Government has reduced the stock of FINSAC debt by taking the following actions:

- The Cabinet approved the write-off of FINSAC paper held by public sector entities (about J$19.4 billion)[26] on July 24, 2000. As of the date of Cabinet decision, interest on this amount of debt has stopped accruing. This amount represents fiscal cost of the crisis already borne by the Government in cash. Administrative actions to formalize the write-off are in process and will be completed through a supplementary budget to be presented to Parliament before March 31, 2001.

- As of October 17, 2000, there was J$26.2 billion of FINSAC paper held by the BOJ as part of its assets. On that day, the Cabinet approved the offset of J$13 billion of FINSAC paper held by the BOJ against the existing deposits of the Government at the BOJ. The debt will formally be removed from the books of the BOJ upon presentation of the supplementary budget to Parliament before March 31, 2001.

- BOJ and the MOF have also agreed on a strategy to restructure the balance of J$13.2 billion of FINSAC paper at BOJ and the Cabinet approved this strategy also on October 17, 2000. The MOF will issue to the BOJ an equivalent amount of special Treasury bills on which cash interest will be paid. The rate of interest will be set periodically to ensure that the BOJ incurs no cash losses.

- The Government will use the proceeds of the sale of Union Bank to buy back FINSAC bonds in UB.

56. On the basis of this strategy, the Government expects to reduce the overall stock of FINSAC debt that will have to be serviced in cash from about J$127 billion to about J$90 billion. The Government will use proceeds from the proposed loans by the Bank, IDB, and CDB totaling US$162.5 million[27] (about J$7 billion) to buy back FINSAC bonds from UB and NCB. Loans from international financial institutions will assist in restructuring about 7.5 percent of outstanding FINSAC debt and improving its maturity profile.

Government's Strategy to Manage Overall Public Debt

57. As of March 2000, the domestic (non-FINSAC) debt stock amounted to J$175 billion or 56.6 percent of the total debt outstanding. Locally Registered Stock, the Government's medium to long-term debt instrument, was the largest component of domestic (non-FINSAC) debt with a

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[26] Most of this amount is held by the MOF. The amounts held by NIBJ and JDB are negligible. This amount includes FINSAC paper issued to the MOF/NIBJ/JDB for both principal and interest.

[27] First tranche disbursements of the IDB of US$75 million (out of a total approved loan amount of US$150 million), CDB of US$12.5 million (out of a total approved loan amount of US$25 million) and disbursement of the Bank's proposed loan of US$75 million.

share of 72 percent of the total. The broad objectives of the Government's debt management strategy over the medium term are to meet its annual borrowing requirements, minimize borrowing and debt service costs, achieve a balanced maturity structure, and ensure continued or wider access to markets, both domestic and overseas. The Government has been decreasing its external debt from 142 percent of GDP at end FY1990 to 46 percent at end FY2000. No significant increase in total non-FINSAC debt (external plus domestic combined) is anticipated in FY2001. However, the Government plans to borrow J$28 billion less in FY2001 from the domestic markets as compared to FY2000, in order to encourage a further reduction in domestic interest rates. This will imply greater dependence on external borrowing and the Government plans to approach international capital markets for approximately US$300 million annually from commercial sources in the medium term. It has recently raised US$225 million from international markets through a bond issue.

Evolution of the Government's Debt to GDP Ratio

58. On the basis of the above strategy, the Government plans to reverse the adverse debt dynamics and put its public debt on a declining path. As per the Government's program, in the base case scenario, the total public debt (including FINSAC paper and excluding intra-public sector debt) is projected to decline from about 131.2 percent of GDP as of March 2000 to about 94 percent of GDP by FY2005. In case more adverse macroeconomic conditions materialize, the Government estimates that its debt may decline to only about 101 percent of GDP by FY2005. In order to achieve this reduction in public debt, the Government proposes a substantial fiscal effort, with a projected primary public sector balance of 14.1 percent in FY2001 trending down to 11.1 percent in FY2005 in the base case scenario and from 13.9 percent of GDP to 11.1 percent of GDP in the alternative scenario.

V. BANK ASSISTANCE STRATEGY

A. Overall Assistance Strategy

59. **Country Assistance Strategy (CAS):** The previous CAS for Jamaica (report no. R-93-41) was discussed by the Board on March 25, 1993. Concurrently with the proposed loan, a 2-year CAS for Jamaica is being presented which has preventing reversal of recent gains in poverty reduction and helping to lay the foundations for future growth as its immediate objectives. The CAS identifies 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 real GDP, 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.

60. **Past Lending to Jamaica:** In December 1998, the Bank's Country Assistance Note (CAN) for Jamaica (CODE98-80) concluded that "...taken as a whole, the Bank's assistance program over the past decade has had an unsatisfactory outcome". Total Bank commitments to Jamaica since 1965 amounted to over US$1.3 billion for 62 projects. Fifty-one of these projects, totaling about US$1 billion, have been evaluated by the OED. They rank low in all three indicators--outcome, sustainability and institutional development impact--compared to averages for both the LAC region and Bank-wide. Adjustment lending made up nearly 40 percent of the total, and less than half of it had a satisfactory outcome. The CAN's assessment of the Bank's past adjustment lending to Jamaica is that it has had modest impact and that its conditionality was often too vague and unenforceable as it called for studies or preparatory work, rather than actions. The macroeconomic framework prepared by Jamaica, and incorporated into the IMF programs, had been assumed by the Bank to be a reliable foundation for the adjustment programs. However, in general, the adjustment programs were not sufficient to correct fiscal imbalances as they relied more on increased foreign borrowing than on fiscal adjustment.

61. Bank technical assistance and investment lending to Jamaica have also had mixed records. Two of three technical assistance projects accompanying adjustment programs were rated unsatisfactory. Less than half (by value) of investment loans have been rated satisfactory. Problems reflect to some extent the same constraints as for adjustment lending: over-ambitious designs which did not reflect implementation capacity, and insufficient attention to risks in the funding and management of projects. Shortages of counterpart funds have also hampered project implementation, and the Government has pointed out that cuts in capital projects were often the only way to meet mid-year adjustments to IMF fiscal targets.

62. **Lessons learned in the Bank's past activities in Jamaica:** Based on the above record of Bank activities in Jamaica, the CAN makes several specific recommendations regarding future Bank involvement.

- Given the serious problems in Jamaica's financial sector, one of the critical steps toward the resumption of sustainable growth is to restructure and strengthen the financial sector.
- Measures designed to support macroeconomic stability must be a significant element of any future lending strategy.
- A flexible lending approach allowing the Bank to disburse only as long as the overall reform framework remains adequate is essential.
- Bank lending should take place only in response to a truly shared vision of reform reflected in up-front actions that would be difficult to reverse.

63. **Bank Strategy for Financial Sector Reform in Jamaica:** The Bank has had ongoing dialogue with the Jamaican authorities regarding the financial sector since the beginning of the crisis. Over the last two years, a substantial amount of preparatory work was done for a possible technical assistance loan. The Bank undertook analyses of the banking and insurance sectors and identified areas in which FINSAC could potentially utilize technical assistance. In the event, the Government chose to utilize a technical assistance grant from the IDB to finance certain activities of FINSAC as well as assist in the process of formulating some of the legal/regulatory

reforms for the insurance sector. The collaboration between the Bank and the IDB on all issues relating to the financial sector has been excellent (see below).

64. As agreed with the Government, the Bank's overall strategy in the financial sector will focus on all three components of the Government's BRDP to resolve the financial sector crisis and reduce the vulnerability of the financial sector to future crises: (i) restructuring of the financial sector including sale of intervened financial institutions; (ii) re-configuration of the domestic debt by converting currently illiquid paper in intervened financial institutions to liquid paper and lengthening the maturity profile of the debt; and (iii) strengthening of the legal, regulatory, and supervisory framework for the financial sector.

B. Rationale for Bank Lending to the Financial Sector

65. A confluence of circumstances provides the rationale for the Bank to provide assistance to 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. The continued capitalization of interest on FINSAC bonds is contributing to severe adverse debt dynamics, which if not resolved urgently could lead to a fiscal crisis. Second, the capitalization of interest on FINSAC bonds has created severe liquidity problems for banks, slowing the recovery of real levels of lending to the private sector, and thereby negatively impacting prospects for growth. Third, the Government has continued to strengthen its fiscal policy stance and has requested IMF staff to monitor its program under an SMP. Fourth, the Government has indicated its commitment and vision for the financial sector that involves a feasible program of up-front actions. These include divestment of intervened institutions controlled by FINSAC and commitment to convert all outstanding FINSAC debt into explicit Government liabilities and service it in cash. The feasibility of this commitment has been demonstrated, under the assumptions of the Government's economic program, in the macroeconomic projections underlying the SMP and the CAS.

C. A Programmatic Approach to Lending to the Financial Sector

66. 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 a programmatic sector loan, involving a number of sequential operations that can be approved based on the success of the previous ones[28]. This is especially relevant in the Jamaican context, given the record of previous Bank adjustment operations. Therefore, the Bank's strategy in the financial sector in Jamaica calls for 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. The proposed project is the first in a series of two proposed operations.

67. **Objectives of the overall program:** The broad set of objectives for the overall medium-term Bank Restructuring and Debt Management Program is the following:

[28] The Bank's most recent experience with a programmatic lending approach has been with the Bank Restructuring Facility for Mexico (World Bank Report No. P7347 ME).

- FINSAC to have substantially resolved all three remaining intervened financial institutions.

- FINSAC to have disposed of entire portfolio of NPLs and other assets.

- Government to have taken over all FINSAC obligations and be servicing them in cash.

- Government to have taken steps to strengthen the legal, regulatory, and supervisory framework for both banks and non-bank financial institutions.

68. **Benchmarks for the first operation:** The specific actions that have been taken by the Government and are being supported by the proposed operation are described in detail in Section VI. Within a programmatic approach, the objective of the first project is to make significant progress towards the ultimate achievement of the medium-term benchmarks set forth above. The benchmarks for the first operation are broadly the following:

- FINSAC has sold one intervened financial institution and made significant progress in restructuring the other two.

- FINSAC has disposed of a significant fraction of its portfolio of other assets and has developed a strategy, acceptable to the Bank, for disposing of its portfolio of NPLs.

- Government has completed restructuring of FINSAC debt and has undertaken to service all remaining FINSAC obligations in cash beginning April 1, 2001.

- Government has made substantial progress in strengthening the legal, regulatory, and supervisory framework for both banks and non-bank financial institutions.

69. **Proposed Government actions likely to be supported by a second operation:** The specific benchmarks for the second operation will be developed in the future in light of the experience with the proposed operation and the prevailing macroeconomic scenario. However, in broad terms the objectives of the second operation will be to support further progress towards the medium term benchmarks set for the BRDP. The Bank will, most likely, support the Government's plans that involve FINSAC resolving both the remaining intervened institutions and selling substantial portions of its portfolios of NPLs and other assets; continued satisfactory debt servicing of FINSAC obligations taken over by the Government; and further progress in moving regulation and supervision of the financial sector in Jamaica towards international best practice.

70. **Advantages of a programmatic approach:** There are significant advantages of a flexible lending instrument such as the single tranche loan under a programmatic approach. This approach would provide both the Bank and the Government with the capability to adapt to evolving situations instead of being tied down to a set of pre-determined actions that may prove difficult to execute at a later date. Rather than risk delays and failure in the achievement of the program's long term aims by locking the Government into an overly ambitious and politically sensitive policy agenda, a single tranche operation under a programmatic approach is a lending vehicle designed by the Bank specifically to protect the integrity of medium-term adjustment operations. The use of a single tranche operation over the traditional multiple-tranche option

has, in the past in other countries, provided the Bank with greater agility in the disbursement of the first loan, and enhanced efficiency and leverage in the formulation of conditionality under the subsequent loan[29].

71. **Impact of past experience on the proposed operation:** The operation has been designed to take into account the major recommendations of the CAN and the lessons learned from the Bank's past experience in Jamaica. It is being structured explicitly taking into account the capacity of the Government to take actions on various issues. The operation has also been designed to take into account lessons learned from other Bank projects involving restructuring of banking sectors – specifically the projects in Mexico and Argentina. The operation sets limited and specific objectives in terms of actions that the Government has taken prior to Board presentation. The Bank's analytical work has been done on the basis of sound information regarding the extent of FINSAC liabilities and financial condition of the institutions. Disbursements are being linked to specific policy actions and transactions.

D. Coordination with the IMF and the IDB

72. The Bank is working 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 (and the IDB) participated in IMF missions during the preparation of the SMP and provided inputs to the structural benchmarks regarding the financial sector. The Bank and the IDB have worked closely on all aspects of the proposed parallel financial sector operations of the two institutions. The IDB has approved a two-tranche loan for US$150 million in September 2000. The CDB has approved a two-tranche loan for US$25 million in October 2000. The actions being supported by the IDB's loan are consistent with and complementary to those being supported by the Bank.

VI. THE PROPOSED LOAN

A. Loan Objectives and Description

73. The Jamaican authorities have requested Bank support for the Government's Bank Restructuring and Debt Management Program (BRDP) described above. The proposed US$75 million loan would be the first of two loans in support of this program. It is expected that a follow up loan will be presented to the Board in 2001, to support the resolution of the rest of the financial institutions under FINSAC's control. Disbursements under the proposed operation would help the Government in restructuring and improving the profile of its debt. The Government will use Bank proceeds to retire a portion of the outstanding stock of FINSAC debt. The Bank's proposed loan would result in restructuring about 3.5 percent of FINSAC debt outstanding (after write-offs and offsets) 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

[29] For example, see Report No. 19676. Mexico: Implementation Completion Report for the Second Contractual Savings Development Program Loan No. 4343-ME, December 1999.

implementation of the bank restructuring/resolution program would be carried out by FINSAC with the support of the MOF.

74. The proposed loan is expected to be disbursed in full in a single tranche upon effectiveness, expected in December 2000, in support of up-front reform measures that have already been taken by the Jamaican authorities (Annex I). The loan closing date would be June 30, 2001.

B. Commitments under the Proposed Loan

75. **Letter of Sector Development Policy.** The authorities have submitted a Letter of Sector Development Policy 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 (Annex II). The Letter re-iterates the commitment of the Government to meet the structural benchmarks outlined in the SMP.

76. **The following actions have been taken prior to Board presentation:**

(i) **Union Bank:** The Government has sold Union Bank.

(ii) **National Commercial Bank:** FINSAC has obtained approval of the Supreme Court of Jamaica for a shareholders' meeting to be held on November 8, 2000 at which they will vote on a Scheme of Arrangement through which FINSAC will obtain more than 75 percent of the equity of NCB. The Government has committed to the Bank that it will take all legal and corporate steps necessary to ensure that FINSAC obtains control of NCB. The senior management of NCB has been changed with a new Managing Director (Chief Executive Officer), General Manager, Information Technology (Chief Information Officer), and General Manager, Finance, Planning and Risk Management (Chief Financial Officer) having been appointed. Beginning in April 2001, the Government has committed to service the FINSAC debt held by NCB in cash. FINSAC has submitted to the Bank an acceptable plan to address NCB's liquidity needs during FY2001 and FY2002 and a strategy to manage NCB during the time in which the bank is under FINSAC's control.

(iii) **Life of Jamaica:** FINSAC has provided the Bank with a legal opinion from an independent counsel that it currently controls more than 75 percent of the voting rights of LOJ. It has also obtained the approval of the Board of Directors of LOJ that a shareholders meeting will be held at which FINSAC will be authorized to acquire more than 75 percent of the equity of LOJ. It is expected that this meeting will be held before the end of the current calendar year. The Government has committed to the Bank that it will take all legal and corporate steps that are necessary to ensure that FINSAC obtains more than 75 percent of LOJ's equity. FINSAC has provided the Bank with an acceptable strategy to manage LOJ during the time in which the firm is under FINSAC's control.

(iv) **Write-off/Offset of FINSAC paper held by public sector entities:** The Jamaican Cabinet has approved the write-off of all the FINSAC paper held by MOF and other public sector institutions (excluding the BOJ) amounting to J$19.4 billion. The Government has also agreed with the BOJ that about J$13 billion of FINSAC paper held by the BOJ will be off-set against deposits of the Government held at the BOJ. The Government and the BOJ have agreed on a satisfactory scheme to restructure the balance amount of J$13.2 billion of FINSAC bonds held at the BOJ.

(v) **Portfolio of Non-Performing Loans:** FINSAC is in the process of disposing of the portfolio of non-performing loans. It has hired a consulting firm to provide it with a diagnostic of the portfolio. The consultant's report was received in September 2000 and FINSAC's Board adopted a resolution supporting the sale of the portfolio in bulk. FINSAC has hired the same consultant company to advise it on the process of disposing of NPLs as a second phase.

(vi) **Portfolio of Other assets including real estate:** FINSAC has disposed of non-core assets (real-estate, art work etc.) amounting to J$11 billion as of August 31, 2000. FINSAC has provided the Bank with an acceptable time bound plan to dispose of the rest of the non-core assets.

(vii) **Supervision and regulation of the financial sector:** The Government has obtained approval of the Cabinet to grant greater intervention powers to the BOJ, and amend bank secrecy provisions to permit exchange of information between regulatory agencies. A new insurance bill has been approved by the Cabinet before presentation to Parliament. The Government has announced the formation of a Regulatory Policy Committee and unified Financial Services Commission that will supervise the non-bank sector. The BOJ has issued the "Ladder of Enforcement" to regulated entities and has agreed with the Bank that an independent assessment of the Basle Core principles will be undertaken by the second quarter of 2001.

77. ***Subsequent Bank Operations in Support of the Government's BRDP.*** A second loan under the BRDP may be considered upon the authorities' request to support the resolution transactions of the other financial institutions still in FINSAC's hands and to support the continued strengthening of the regulatory and supervisory framework for the financial sector. While necessary actions for a second loan will be firmed up based on the experience of the first loan and the evolving macroeconomic and sectoral situation, an indicative list of follow-up actions discussed with the Government have been identified in Annex I.

C. Disbursements, Records and Auditing

78. 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 FINSAC bonds (para. 73)), 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.

79. The Deposit Account shall be audited by independent auditors acceptable to the Bank and such auditors have already been appointed. The Bank has approved the Terms of Reference of the auditors and the short list proposed by the Government. 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 to redeem FINSAC bonds. Receipt of a satisfactory audit report of the first operation would be a condition of the subsequent operation.

D. Impact, Benefits and Risks

80. **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. There are also some potential social risks to the proposed loan that are discussed below.

81. **Environmental Impact**. The bank restructuring program to be supported by the proposed loan is not expected to have any environmental impact. The loan is ranked C for environmental purposes.

82. **Benefits**. The proposed first loan would have several benefits. First, it would contribute to moving the resolution of the financial crisis forward by supporting the sale of one bank to a foreign investor and making substantial progress towards moving two other institutions to the point of sale. The Bank's loan would also support the provision of greater liquidity to the banking system. Strong and well capitalized banks 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. By contributing to the Government's financial restructuring program, the loan would help the Government to make explicit the cost of solving the bank problems and avoid additional and more costly delay. Second, the loan would support the 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. Third, 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. Fourth, it is expected that the Bank's support 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 positive growth path. If the Government's program supported by the proposed operation is successful, a major benefit would be resumption of economic growth and its consequent positive impacts in Jamaica.

83. **Risks**. Both the Government's program and the proposed operation face several risks that are being recognized by the Bank, especially since it is not realistically possible for the proposed operation to address all of these risks and mitigate them adequately. While the operation is being designed so that the risks to the Bank are minimized, the Government's program faces many challenges. The Bank stands ready to re-assess its approach to assisting Jamaica, should macroeconomic and sectoral conditions warrant it.

84. **Macroeconomic risks.** If interest rates do not decline as assumed in the Government's macroeconomic program (as reflected in the SMP), the Government's debt service burden will be higher than anticipated and the fiscal adjustment needed to achieve stabilization and reduction of the stock of public debt will be even larger. Given the extremely high level of overall public sector primary surplus (over 11 percent of GDP in the medium term) necessary even under the Government's relatively favorable base case assumptions, the room for further maneuver by the Government is limited. The Government has committed itself to mobilizing greater fiscal resources and to approaching the international financial institutions for further assistance in the event that unfavorable macroeconomic scenarios materialize.

85. **Social Risks.** The extreme fiscal discipline required to make the proposed program successful may not be sustainable and could create social tensions if economic growth does not resume.

86. **Implementation risks.** It may be difficult for the Government to dispose of the remaining financial institutions that it proposes to sell as part of the overall financial sector restructuring program. This is a particular risk in the case of NCB, since it is over twice as large as Union Bank and holds a substantial amount of FINSAC paper. FINSAC may also find it difficult to manage intervened financial institutions for substantial periods of time if buyers are not found soon. These risks could create problems for the Government's financial sector restructuring strategy. Expected inflows from sale of assets could also be smaller than anticipated. In this event, the debt service burden will correspondingly increase, placing greater stress on Government finances.

87. **Regulatory risks.** While banking sector and non-bank financial institutions' regulation and supervision has been significantly strengthened, with more progress having been made in the banking sector, both areas are still not yet up to international best practice and therefore, could expose the financial system to risks. The Bank has addressed some of these issues in this operation and intends to continue to address them in the second phase of its assistance to the Government under the proposed programmatic approach.

88. **Other risks.** The Government's fiscal planning for FY2001 calls for substantial resources to be raised from privatization of state owned enterprises and international borrowings. In the event that these resources are not mobilized, the Government may be forced to borrow from domestic markets, increasing the pressure on interest rates and its debt service commitments on existing public debt. External shocks to the economy would also adversely affect the Government's debt management program. Further increases in oil prices, fall in alumina/bauxite prices, increases in international interest rates, or a decrease in tourism receipts are some of the external shocks that could negatively impact on the macroeconomic framework.

VII. RECOMMENDATION

89. 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 Sven Sandström

Washington, D.C.
November 2, 2000
Attachments

ANNEX I

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

Issue	Objective	Actions taken by the Jamaican Government to date	Actions planned to be taken by the Government during FY2001/02
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. - Satisfactory implementation of the Government's macroeconomic adjustment program as outlined in the SMP. - Government has committed to undertake periodic, scheduled reviews of performance as agreed under the SMP.	- 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. - 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.
	Reduction of public sector debt	- Government has committed to ensure reduction of public sector debt in Jamaican dollar terms consistent with the base case scenario of the SMP. - 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.	- Government's public debt reduction plan consistent with the base case scenario in the SMP to be on track. - Completion of assumption of FINSAC's liabilities as public debt and continued satisfactory servicing in cash of the same.

Issue	Objective	Actions taken by the Jamaican Government to date	Actions planned to be taken by the Government during FY2001/02
FINSAC Debt	Reduce debt and pay interest in cash on remaining stock	- Government has committed to ensure that FINSAC will not incur additional liabilities over and beyond those identified in the Government's letter to the Bank dated August 31, 2000. - Government has committed that Bank funds will be used for reduction in stock of FINSAC debt. - Cabinet approval has been obtained for the write-off of FINSAC debt owed to the Ministry of Finance amounting to J$19.4 billion. - Cabinet approval has been obtained for off-set of 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 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 liabilities to be as per Government's letter to the Bank dated August 31, 2000. - Formalization of implementation of the write-offs/off-sets of FINSAC debt through necessary legislative actions (supplementary budgets). - FINSAC to be applying all proceeds from recoveries of NPLs and non-core assets, net of operating expenses, to reduce its outstanding liabilities.

Issue	Objective	Actions taken by the Jamaican Government to date	Actions planned to be taken by the Government during FY2001/02
Restructure banking sector	Restructure/sell intervened banks.	- Union Bank has been sold. - The following steps in the process of FINSAC acquiring an equity stake of more than 75% in NCB have been completed: (i) The Board of NCB has approved the Schemes of Arrangements (the Schemes) to restructure NCB's equity; (ii) Shareholders have been informed of the Schemes; (iii) An order from the Jamaican Supreme Court directing NCB shareholders to meet on November 8, 2000 to consider, and vote on the Schemes has been obtained. - 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 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.	- FINSAC to have acquired more than 75 percent equity of NCB. - 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 improvements. - NCB to be brought to the point of sale through the restructuring process with the ultimate objective of resolving and selling NCB.

Issue	Objective	Actions taken by the Jamaican Government to date	Actions planned to be taken by the Government during FY2001/02
		- 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.	
Divestment of FINSAC non-core assets	Early disposition of maximum amount feasible 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.
Divestment of FINSAC Non-performing loan portfolio	Maximize expected recovery of NPLs	- 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.
Insurance Companies – Life of Jamaica	Restructuring/re-capitalization of LOJ	- 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.	- Take necessary actions to resolve LOJ in order to sell the entity.

Issue	Objective	Actions taken by the Jamaican Government to date	Actions planned to be taken by the Government during FY2001/02
		- A plan, satisfactory to the Bank, to address LOJ's potential liquidity needs prior to conversion of FINSAC paper into cash-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 issues in the banking sector	Continue strengthening BOJ's supervisory and enforcement capabilities to ensure safe and sound banks in Jamaica. Ensure coordination of BOJ's supervisory activities with other supervisory agencies	- Cabinet approval has been obtained to enhance BOJ's intervention powers to deal early with financially distressed institutions. - BOJ has issued the "Supervisory Ladder of Enforcement" to take into account 1997 amendments. - BOJ has agreed to undertake independent assessment of Basle Core principles no later than second quarter of 2001. - Cabinet approval has been obtained to permit BOJ to share information on financial institutions with other regulatory/supervisory agencies.	- BOJ to have obtained greater intervention powers. - Independent assessment of Basle Core principles to have been completed no later than second quarter of 2001. - Revised capital adequacy norms to have been formally issued. - Amendment of BOJ Act to facilitate exchange of information among supervisory agencies. - Continued strengthening of BOJ's supervisory capabilities. - Regulatory Policy Council established.

Issue	Objective	Actions taken by the Jamaican Government to date	Actions planned to be taken by the Government during FY2001/02
		- Cabinet approval has been obtained to establish a Regulatory Policy Council, to coordinate activities of bank and non-bank supervisors. - Cabinet approval has been obtained for development and implementation crisis intervention policy. - Government has committed to make best efforts to obtain Parliamentary approval of above measures.	- Crisis intervention policy in place.
Legal/regulatory/ supervisory issues in 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.	- Financial Services Commission established and functioning. - New Insurance Act in place. - Continued strengthening of non-bank regulatory and supervisory capabilities.

ANY REPLY OR SUBSEQUENT REFERENCE
SHOULD BE ADDRESSED TO THE FINANCIAL
SECRETARY OR [illegible]ENCE
REFERENCE NUMBER QUOTED:-
Telephone No. 92-28600-16

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

October 19,2000

LETTER OF SECTOR DEVELOPMENT POLICY

Mr. James D. Wolfensohn
President
The World Bank

Dear Mr. Wolfensohn:

1. The Government of Jamaica is undertaking a series of actions in order to contain and reverse the adverse debt dynamics that arose from an unsustainably high ratio of debt to GDP, low rates of economic growth and high real interest rates. The Government is divesting FINSAC's shares in the commercial banks intervened by the Government in the aftermath of the 1996-97 banking crisis and selling the underperforming assets acquired in the process. These actions are being taken in the context of a major fiscal effort -- aimed at generating a primary surplus as high as 14 percent of GDP and an overall deficit of no more than 5 percent of GDP on an accrual basis in 2000/2001 -- combined with a continuous strengthening of the agencies responsible for supervising bank and non-bank financial intermediaries in Jamaica.

2. This Letter of Development Policy describes Jamaica's current economic conditions and its ongoing process of financial sector reforms. In support of these initiatives forming part of the Government's Bank Restructuring and Debt Management Program, the Government has requested a loan from the World Bank. The Government appreciates the Bank's intention to provide up to $150 million in programmatic support, of which the current loan will provide $75 million. The Jamaican authorities may request, upon demonstration of satisfactory progress in the implementation of the proposed program of actions, and consolidation of macroeconomic adjustment, additional Bank support for another $75 million.

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 being implemented will restore the financial sector to health and reduce 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 three objectives: first, the completion of the restructuring/resolution/sale of

banks and other financial institutions that were intervened by the Government; second, selling the large volume of non-performing loans and real estate acquired by the Government's restructuring agency (FINSAC) in the process; and, third strengthening and consolidating the legal, regulatory, supervisory, and enforcement framework for the safe and sound operation of the financial sector. The Government intends to achieve the first objective through the sale, merger, or closure of all intervened banks and non-bank financial institutions, depending on their viability. It is likely that foreign investors will be attracted to invest in Jamaica's financial institutions. The second objective will be attained through an aggressive program of sales of non-core assets and NPLs with the assistance of firms specialized in asset disposition, applying all the recoveries net of operating expenses to reducing FINSAC's debts. The third objective will be 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.

1. **Macroeconomic Framework**

5. Economic performance in the recent period of FY 1999 - FY 2000 was characterized mainly by weak output performance and high real interest rates. The output decline of ½ percent in FY 1999 represents the third consecutive year of contraction and output is estimated to remain constant in FY 2000. Real interest rates remain high and investment has not grown. Inflation rose from 6 percent in FY 1999 to about 81/2 percent in FY 2000, owing largely to higher prices for oil imports. Unemployment is estimated to have remained high at about 15 ½ percent during the period, with some new entrants into the labor force being engaged in the informal sector. The real effective exchange rate for the Jamaica dollar-based on relative CPI indices-which had appreciated significantly in the earlier years, depreciated by 4 percent in FY 2000.

6. Significant efforts at fiscal consolidation were undertaken during FY 1999-FY2000. The public sector primary surplus was raised by 61/2percentage points of GDP to 7 percent in FY 1999, mainly through strengthened tax administration and efficiency gains in the operation of the public enterprises. However, the growing interest bill on the large public sector debt more than offset this gain, and the overall public sector deficit moved from 11 percent of GDP in FY 1998 to 12 percent of GDP in FY 1999. Further consolidation efforts in FY 2000-relying mainly on expenditure cuts and some revenue measures, raised the public sector primary surplus by about 5 ½ percentage points to 12 ½ percent of GDP. However, the overall public sector deficit dropped by only 3 percentage points of GDP because of further increases in the interest bill. Consequently, the stock of public debt rose from about 127 percent of GDP at end-FY 1998 to about 144 percent of GDP at end-FY 2000.

7. Monetary policy has aimed at reducing inflation in a base-money targeting framework. Despite a reduction in the unremunerated statutory cash reserve requirement and a steady decline in the BOJ's repurchase rate-monetary policy remained tight during FY1999-FY2000. Base money is estimated to have decreased by an average of 3 percent a year during the period.

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

9. The Government's program as outlined in the IMF's Staff Monitored Program (SMP) targets steady restoration of real GDP growth, starting with 1.5 percent in 2000/2001, and going up to 3.5 percent in the period 2004/5,

as well as a steady decline in the benchmark 180 day T-Bill rate from levels close to 20 percent in 1999/00 to 14 percent and 13 percent, respectively, at end 2000/01 and end 2001/02. Under this scenario, the debt to GDP ratio is expected to decline from 144 percent of GDP in 1999/00 to 123 percent in 2000/01 after the write-off of MOF's holdings of FINSAC paper and netting-out of Government deposits at BOJ against FINSAC paper held by BOJ, and to about 94 percent of GDP in 2004/05. Under less favorable conditions of GDP growth and reduction of interest rates, the debt to GDP ratio would decline at a slower pace while still entailing sustainable although less favorable debt dynamics. Under either scenario, sustainable debt dynamics are a precondition for the resumption of growth, recovery of public and private investment, reduction of unemployment and poverty in Jamaica.

10. 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 all the resources obtained from the three international financial institutions supporting the program (IDB, CDB and the Bank), as well as those coming from the sale of all FINSAC assets and shares in intervened financial institutions 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. Towards this end, the Government is committed to ensuring a reduction of public sector debt in Jamaican dollar terms consistent with the base case scenario of the SMP.

11. The Government's primary objective is to contain the past adverse debt dynamics, restore real credit to the private sector and achieve healthier rates of economic growth. This will be achieved through the careful implementation of a comprehensive debt management strategy involving lower public sector borrowing and the service in cash of all FINSAC debt in the context of a sustainable macroeconomic framework aimed at reducing inflation and real interest rates. The Government has committed to undertake periodic, scheduled reviews of the economic performance under the SMP. A first review has been undertaken in September 2000 and the IMF has found the implementation of the Government's program to be on track. In case of deviation from the proposed program outlined in the SMP, the Government is committed to take the necessary actions to return to a sustainable long-term path.

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

12. 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 phase of FINSAC's operation has been completed and substantial progress has been made on the rehabilitation and divestment phases. FINSAC has restructured and disposed of some of the relatively smaller financial institutions and is now at a point where it needs to take this phase to its completion. The resolution of the crisis has come at a very high fiscal cost of about 37 percent of GDP as of March 2000.

A. The Government's Bank Restructuring and Debt Management Strategy

13. 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 is undertaking 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 to public sector entities (Bank of Jamaica, and other Government entities) has been restructured or offset against those entities' liabilities to the Government. This has been done in a manner that does not compromise the financial soundness of these institutions;

(iii) Union Bank Jamaica (UBJ) has been sold to RBTT Holdings Ltd. Proceeds from the sale have been used to reduce the stock of FINSAC debt held by the Union Bank by an equivalent amount. The balance of the FINSAC paper at Union Bank will be restructured to cash paying Government securities.

(iv) Efforts to recover value on FINSAC's non-core assets-including the sale of property and the portfolio of non-performing loans (NPLS) to a third party-are being intensified during 2000/01 and the proceeds will be used towards a reduction in the FINSAC debt held by the private sector;

(v) The Government will use all proceeds from World Bank, IDB, and CDB loans supporting its financial sector resolution strategy to reduce the stock of FINSAC debt during FY 2001-FY 2002;

(vi) All remaining FINSAC liabilities outstanding as of April 1, 2001 will be assumed explicitly by the Government, and full debt service will be made on FINSAC paper in cash beginning that date. The Government has provided the Bank with a comprehensive list of FINSAC's liabilities - including current, committed, and contingent claims on August 31, 2000. The Government intends to ensure that FINSAC will not issue further debt beyond the amount estimated above.

14. Preliminary estimates indicate that this strategy would require additional cash interest payment by the central Government of about 3 percent of GDP in FY 2002, trending downwards over the medium term to about 2 percent of GDP in FY 2005. It has been estimated that at this level of effort, and taking into account the reductions in the stock of debt through the measures outlined above to J$73.6 billion, the stock of FINSAC debt relative to GDP would decline from 37 percent at end-FY 2000/2001 to 23 ½ percent in FY 2001/2002 and 17 percent by end FY 2004/2005. Upon the assumption by the Government of FINSAC's debt, it is the Government's intention to dissolve FINSAC in 2001.

B. Union Bank

15. Union Bank Jamaica (UBJ) was created through the merger of four failed commercial banks, five merchant banks, and three building societies. The bank has been downsized, and the management structure, information technology and lending operations have been strengthened. FINSAC owned 99 percent of the shares, and the remaining one percent is widely distributed. UBJ has been sold to RBTT Holdings Ltd., the owner of the second largest bank in Trinidad & Tobago. The proceeds from the sale have been used to buy back a portion of the FINSAC paper which Union Bank Jamaica holds.

C. National Commercial Bank

16. NCB has assets of around J$79 billion (US$1.9 billion) as of June 2000, which makes it more than two times as large as Union Bank Jamaica. FINSAC owns 40 percent of the equity of the bank and 45.3 percent of the equity of the bank's holding company (NCB Group). Since intervention, NCB has been downsized and its operations and organizational structure strengthened.

17. A new management team has recently been put in place in NCB including, a new Managing Director, General Manager-Finance Planning and Risk Management, and General Manager-Information Technology. The new

management is in the process of developing a new strategic plan for NCB, which is expected to be finalized in the first quarter of 2001. The latter will form the basis for the actions to be undertaken by Management to prepare NCB for its future privatization. The strategy will address issues of liquidity management, information technology, cost reduction, customer service, credit policies, and risk management. Payment of cash interest on the FINSAC paper, which constitutes a large portion of NCB assets, will provide liquidity starting in FY 2001 and will be a key element in restoring the bank's franchise value and bringing it to the point of sale. The Government has no intention of retaining majority ownership of NCB. In the meantime, adequate provisions for assuring NCB's liquidity and solvency during the remainder of the current fiscal year are in place.

18. FINSAC has been advised by its legal counsel on a key set of actions necessary prior to obtaining a controlling stake (over 75% of equity) in the bank. As part of this process, the Supreme Court has issued an order directing NCB's shareholders to meet, consider, and vote on the proposal for the Scheme of Arrangement on November 8th. The Government is committed to ensuring that all legal and corporate actions are taken for FINSAC to obtain this controlling share of NCB's equity. Subsequent to the approval by shareholders and the court, FINSAC and the Ministry of Finance will take the actions necessary to move NCB to the point of sale. To assist in this process FINSAC has retained Hong Kong and Shanghai Banking Corporation (HSBC) as an advisor for NCB's future privatization.

D. The Insurance Industry

19. FINSAC has intervened in six insurance companies and has largely resolved five of them. FINSAC owns 26.5% of the common stock of the sixth company, Life of Jamaica Ltd. (LOJ) In addition, FINSAC has J$1 billion in preference shares. LOJ has approached FINSAC for assistance in the amount of J$1.9 billion to restore solvency to the company. In exchange for this assistance, FINSAC will obtain over 75% of the ordinary equity of LOJ. The Government is committed to ensuring that all legal and corporate actions are taken for FINSAC to obtain this controlling share of LOJ's equity. Thereafter, FINSAC intends to initiate the process of sale of its equity in LOJ.

E. Non-core Assets and Non Performing Loans

20. In addition to the banks and insurance companies, FINSAC has other non-core assets consisting of real estate investments in hotels, commercial, industrial and residential properties, and non-performing loans (NPLs) acquired from intervened banks and insurance companies. Since intervention, FINSAC has restructured its operations and established the capacity within two separate units to concentrate on the sale of the real estate and the NPLS. FINSAC will package the remaining loans and sell them to an international asset management company. A consulting firm has completed a diagnostic of the NPLs and has developed alternative disposition strategies as the basis for an integrated marketing plan. Packaging the NPLs for sale and market distribution is scheduled for January 2001. FINSAC expects to dispose of the substantial majority of its non-performing loans by June 2001. FINSAC has made substantial progress in the disposal of its portfolio of non-core assets such as real estate and works of art. An action plan has been prepared which calls for the disposal of the substantial majority of these assets by June 2001, using, the proceeds to retire outstanding debt.

3. Strengthening of Legal, Regulatory, and Supervisory Framework

A. Bank Supervision

21. The Government is committed to ensuring that all necessary legal and corporate actions are taken for FINSAC to obtain this controlling share of LOJ's equity. 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 Bank of Jamaica (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.

22. BOJ has undertaken a self-assessment of Jamaica's compliance with the Basel "Core Principles" and has committed to initiate an independent review of such principles during the second quarter of 2001. From these assessments BOJ intends to rapidly prepare an Action Plan to address the areas where full compliance may still be lacking at that point. In particular this assessment would review progress made in the evaluation of market risk, consolidated supervision of financial conglomerates, and enhanced ability to supervise related party transactions. Based on this assessment, the BOJ will, as necessary take steps to strengthen regulations. 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 during the inspection process.

23. The supervisory authorities had in 1995 responded to the dilution of management skills in the financial system by introducing "Standards of Best Practices" to the industry in eight areas including the following: credit risk management, focusing on cash flow analysis, asset and liability management, including liquidity, interest rate and foreign exchange risk. The industry is in the process of adopting these standards which are more in line with international best practices.

24. In order to improve the supervisors' ability to detect weaknesses early on in the financial cycle, the authorities have strengthened their supervisory processes, including on- and off-site supervision. Quarterly performance targets have been developed for the banking system and a Financial Stability Monitoring Committee was established to analyze the systemic risks in the system. The ongoing process for improving supervisory practices includes the recently updated "ladder of enforcement" (to include the 1997 amendments) which has been issued in October of this year. The Supervisory Ladder will be continuously updated to reflect changes in legislation. In order to better enforce these and other provisions, the authorities are examining ways to grant the BOJ authority to levy fines, according to a pre-established schedule, when certain infractions have been detected.

25. To further strengthen the autonomy of the bank supervisor, the Cabinet has approved granting necessary powers to the bank supervisor (BOJ) to allow for timely intervention via temporary management. The Government is committed to ensure that in case of future problems with financial institutions, a clear legal framework will be in place to allocate losses to shareholders and uninsured depositors in intervened institutions where deposits exceed insured limits. The Government will also act rapidly to revoke licenses should that become necessary. The Government will table the necessary legislation before Parliament to that effect and the Government is committed to making its best efforts to get the legislation approved. The supervisory authorities will continue to improve the transparency of the system of intervention which would include issuance of the updated "ladder of intervention" so that the market would have a clear statement of what actions may be taken by the regulators and when these actions are likely to be taken, as well as a clear understanding by institutions of the consequences of failing to rectify problems expeditiously. Recent actions by BOJ have enhanced its credibility in enforcing measures to guarantee the safe and sound operation of financial intermediaries in Jamaica.

26. An interagency 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 with support from a technical assistance program to be funded by the Caribbean Development Bank (CDB).

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 area the BOJ, JDIC (Jamaica Deposit Insurance Corporation), the FSC (a new non-bank supervisory entity-Financial Services Commission) and the Ministry of Finance are proceeding to strengthen formal inter-institutional mechanisms, through the establishment of a Regulatory Policy Committee for consultation and the systematic sharing of relevant information, which will 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 Regulatory Policy Committee will issue a semi-annual report to the Minister on technical guidance provided to the respective regulatory bodies. Amendments to existing legislation (BOJ Act) will be required to allow the exchange of information among supervisors and the Government is taking steps to formulate the necessary legislation. Cabinet approval on the required amendments have been obtained and the Government will table the legislation before Parliament.

28. The Regulatory Policy Committee will consider the following issues a priority: i) the harmonization of risk-based capital adequacy requirements for dually licensed entities; ii) the review of regulation and supervision of unit trusts, mutual funds, and similar products to ensure a level playing field and adequacy of investor protection; and iii) the adequacy of reporting requirements in respect 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.

29. An important element of supervisory co-ordination is the finalization of a Memorandum of Understanding amongst the members of the Regulatory Committee to address such issues as lead regulator and the coordination of examinations for dually licensed entities. The Government has taken steps to formalize this MOU through tabling of a Ministry paper in Parliament

30. One of the primary causes of the crisis of 1996/1997 was the commingling of financial and non-financial activities within the same corporate group. The Government has recognized this by enacting legislation that begins to deal with this potential problem such as tightening of investment limits and restrictions on connected lending. However, significant work still needs to be conducted in this area to limit the risk of contagion from non-banking businesses to the banks. The authorities are examining ways to separate financial and non-financial activities of banking groups on a phased basis. Furthermore, the authorities are also committed to strengthening legislation by requiring, merchant banks to establish a separate affiliate or subsidiary to conduct the business of broker or dealer in securities where such activities are assessed to be materially infringing on the primacy of the deposit-taking banking business.

B. Non-Bank Supervision

31. In the context of strengthening financial sector reform, the Government has announced the establishment of a new non-bank supervisory authority, referred to as the FSC (Financial Services Commission), which will be operational on April 1, 2001. Cabinet approval of the necessary legislation has been obtained. This entity 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, insurance industry (companies, brokers, agents and sales persons) and private pension funds. The Government understands the importance of having an autonomous supervisory entity. Therefore, it will ensure that the entity has adequate enforcement powers, including the power to levy fines, and intervention authority, comparable to that currently enjoyed by the Securities Commission. 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. The members of the governing board of the FSC shall not simultaneously serve on the Board of Directors of the Stock Exchange or other self-regulatory organizations, or be members of the ownership, board or management of entities licensed and regulated by the FSC.

32. Furthermore, in order to ensure that the new entity achieves full effectiveness in the shortest possible time, the Government will seek to recruit a CEO with knowledge of local financial sector conditions and demonstrated capacity to successfully manage the various stakeholders in the Jamaican financial sector. The Government would consider it advantageous if this individual also had experience in setting up or managing an integrated supervisory authority. In the event that the individual does not have such experience a suitable high-level consultant with experience in setting up and managing an integrated supervisory authority will be retained as a direct advisor to the CEO. The Government will, whenever necessary, employ additional advisors with the required technical expertise to act as advisors in other key positions in the new organization.

Securities Supervision

33. An important component of the program is to strengthen the supervision of non-banking activities. The Securities Commission (SC) has committed to move forward their legislative agenda. This agenda includes granting the SC the power to: i) introduce risk-based capital standards to engender investor protection; ii) enhance disclosure practices for listed and other public companies; iii) improve regulation related to "fit and proper" standards; and iv) create a level playing field for collective investment funds offered to public investors in the form of unit trusts, mutual funds or similar products. This would involve repeal or amendment of the Unit Trust Act. The regulatory authorities also have committed to enhance staff skills to conduct market surveillance.

Insurance Supervision

34. The Government will also improve insurance supervision by developing a legal and regulatory framework and building institutional capacity within the FSC. In doing so the Government will repeal and replace the Insurance Act with a new Act that has already been drafted to include measures to strengthen corporate governance, the rulemaking process and establish prompt corrective action. Regulations will be in effect with regards to solvency requirements, investment Guidelines, market conduct rules and actuarial standards.

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

Private Pension Supervision

36. Efforts are underway to reform the pension system in Jamaica. A Green Paper was prepared in January 1999 and industry comment was obtained. In order to implement the reforms recommended in the Green Paper and

to incorporate the views of the public, a new Private Pensions Act is being drafted and will include topics such as registration, licensing, investment limits, minimum solvency standards and information disclosure. It is also envisioned that certain amendments to the Income Tax Act will need to be drafted. Prior to the introduction of this legislation the Government will seek to build further consensus on this issue by means of obtaining comment from Parliament and the public on a more elaborated "white paper". The Government is also committed to strengthen institutional capacity within FSC by i) the design and preparation of policy and procedural manuals; ii) the development of a proper information systems and supervisory reporting; and iii) the development of a staff training program with emphasis on analysis of pension plan investing, and funding.

C. Conclusion

37. Jamaica has made significant progress in addressing the issues resulting from the financial crisis of the mid 1990s and in initiating structural reforms of the sector. As described in this letter, the Government is committed to making substantial further progress in these areas. The policies to be implemented during the next two years should strengthen the soundness of our financial sector. The Jamaican Government believes that the World Bank's assistance will be beneficial to the success of the proposed program.

Sincerely yours,

Omar Davies

Omar Davies
Minister of Finance and Planning

Annex III

Overview of the Supervisory Framework in Jamaica[1]

1. Introduction: Weaknesses Prior to the Crisis

Institutional Weaknesses

Imprudent banking and financial practices were common in Jamaica prior to the financial crisis of the mid-1990s, partly motivated by an inadequate regulatory and supervisory framework. The findings of a study undertaken by the financial sector restructuring agency (FINSAC)[2] - listed below - regarding the key institutional weaknesses prior to the crisis provides a background to understanding the regulatory weaknesses in the system.

- Generalized poor management practices;
- Lack of, or poor strategic planning;
- Inappropriate organizational structures/ poor standards of corporate governance;
- Inaccurate reporting, including illusory profits;
- Under-capitalization of institutions, and of subsidiaries involved in real estate;
- Inadequate credit/investment assessment and monitoring, conceding exceeding reliance to collateral;
- High level of non-performing loans in addition to ever-greening of loans where their non-performing status was masked by rolling over the loans;
- Mismatch of assets and liabilities' maturity dates;
- Excessive credit concentration with particular over-exposure to real estate lending or acquisition;
- Connected transactions, with high and non-income earning levels of related party exposure;
- Lack of, or non-compliance with proper internal control procedures and effective risk management principles;
- Frequent actions solely in the interest of major shareholders and/or their associates;
- Ineffective supervision of the management by boards of directors;
- Failure of regulatory bodies to insist in compliance with accepted rules and standards;
- High operating costs including excessive and inappropriate compensation packages; and,
- In certain instances, complex group contagion, insider dealing, and material fraud. Banks and insurance companies diversified away from core business leading to (i) potentially profitable businesses being managed by unskilled personnel, (ii) poor and biased credit decisions made at less than arm's length, and (iii) non-core businesses with inadequate capital structures relying on high-interest loans.

Regulatory and Supervisory Weaknesses

The structural reforms of the early nineties that included the privatization of banks and liberalization of financial and foreign exchange markets were not accompanied by improvements

[1] This Annex has been developed on the basis of previous work done by Inter-American Development Bank, a review of the legal and regulatory framework, and discussions with representatives from the Bank of Jamaica, and market participants.

[2] For more details, see FINSAC's website: http://www.finsac.com

towards an adequate regulatory and supervisory framework for the financial sector. The supervisory authorities lacked sufficient powers of intervention, sanction, and enforcement. Regulatory forbearance took place as technical supervisory recommendations were not executed in a timely manner, which also created moral hazard by sending accommodative signals to the market. As the authorities themselves have publicly stated, "the lack of legal power to intervene prior to absolute insolvency proved to be a major block to timely and effective supervisory action, resulting in a continuing over-reliance on moral suasion."[3]

Inconsistencies in regulations across financial sectors paved the way for regulatory arbitrage. Financial groups were permitted, but while the banking regulator required the licensee's own financial statements as well as group consolidated financial statements, they had no legal power to adequately facilitate the tracing of inter-group transactions and, subject to the accuracy of reporting, were not always able to detect and prevent abuse. Additionally, there was no consolidated supervision by any of the financial system regulators. While the deposit-taking entities under the supervision of the Bank of Jamaica (commercial banks and near banks – merchant banks and building societies) became subject to increasingly stringent prudential norms, other regulators did not replicate this approach.[4] Reserve requirements were set differently according to the class of institutions, not to the type and length of deposits; moreover, interest paid by building societies had a special tax treatment.

Contagion was another source of financial distress for banks. Insurance companies, which had the weakest regulation, were allowed to issue deposit-like policies by the insurance supervisor. However, they were not required to set aside appropriate levels of reserves. The proceeds of these policies with deposit-like features were invested in long-term investments (office buildings, hotels, and other real estate developments), which yielded insignificant cash flow. However, policyholders had been guaranteed fixed and continuous returns. This cash flow mismatch between assets and liabilities caused liquidity problems for insurance firms and they tapped their related banks for funds. Ignoring the statutory exposure limits and the requirements of the bank supervisor, banks were pressured into providing liquidity to their insurance company parents and affiliates and the banks themselves soon ran out of liquidity, triggering the crisis.

Prior to the 1992 reform, financial legislation lacked elementary provisions, such as a comprehensive definition of deposits, fit and proper criteria for management, limits on lending to related parties, limits on fixed assets, appropriate information requirements, proper loan loss reserve requirements, and appropriate powers to take remedial action. Thus, prior to the reform, not even the Minister had the power to intervene prior to actual or apprehended insolvency, and then, revocation of the license was the only disciplinary measure available.

2. Developments in the Regulatory and Supervisory Regimes: Response to Problems

Jamaican authorities have shown significant progress in the redesign of financial legislation to address the weaknesses outlined above. Two major legislative reforms took place in 1992 and

[3] Deputy Governor of BOJ. LXX Meeting of the Governors of Central Banks of Latin America and Spain, San Juan de Puerto Rico, May 31 – June 2, 2000.

[4] Near banks originally had a more lax regulation than commercial banks but were gradually improved. The BOJ has supervisory oversight over these institutions and since 1999, over credit unions.

1997.[5] Key financial regulations in Jamaica are now contained in the Banking Act, the Financial Institutions Act, the Building Societies Act, and the Bank of Jamaica (Building Societies) Regulations.

The 1992 Reform

This reform was aimed at synchronizing the provisions of the upgraded Banking Act and the new Financial Institutions Act. The reform comprised changes in the following areas:

- Increased powers of intervention. In addition to existing powers to revoke a license, the Minister was granted powers to take remedial action in the case of actual or apprehended insolvency, including requiring undertakings, giving directions, and issuing cease and desist orders; ability to assume temporary management; and ability to present to the Court a petition for the winding up or the reconstruction of a bank.

- Fit and proper criteria. The BOJ must state that directors and major shareholders are fit and proper for that purpose; that is to say, that they have not been convicted of an offence involving dishonesty, are not undischarged bankrupts, or individuals whose employment record gives the BOJ reason to believe that the person carried out an act involving dishonesty or impropriety in the handling of banking business.

- Definition of the word "bank" and revised definition of the word "deposits". Only licensed banks could carry on banking business and take deposits.

- Increased minimum capital requirements. Minimum capital figures experienced a twentyfold increase for banks, to J$80 million (J$25 million for financial institutions).

- Increased minimum to be reserved annually from net profits, from 10 percent to 15 percent; requirement of the BOJ approval for reduction of reserve fund; and prohibition to the payment of dividends in certain circumstances (previous losses not written off, required minimum reserves not met, etc.).

- Establishment of limits for fixed assets (one time capital base), exposures to groups (maximum forty percent of the capital base on a secured credit basis).

- Establishment of a requirement for an appropriate loan loss reserve and the non-accrual of interest after no payment for six months. However, the Minister was not empowered to issue regulations related to loan loss reserves.

The 1992 upgrading of the Banking Act established new powers for the BOJ and the MOF. A continuing requirement is for Bank of Jamaica to examine, at least once a year, every licensee to determine whether the institution is in a sound financial position and to ensure that the statutory requirements are being complied with. The results of these examinations are provided to the Minister of Finance. The BOJ may order special audits, and may use an auditor other than the licensee's auditor. The BOJ was granted power to vary the method of calculating the required

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[5] Also, in May 1998 a scheme for the protection of depositors was established by the Deposit Insurance Act and the Jamaica Deposit Insurance Corporation (JDIC) was established to manage the protection scheme.

cash reserves and liquid assets and the information to be submitted to the BOJ by the supervised entities was upgraded. These new information requirements included enhanced balance sheet and profit and loss account, both solo and consolidated, and auditors' reports as well as information about loans past due 6 months and over, contingent and prospective liabilities. In addition, auditors were obliged to inform the BOJ of reasons for their resignation or unwillingness to be re-appointed and banks were obliged to disclose to the BOJ the reasons why a licensee intended to terminate the appointment of its existing auditor.

The Minister was given a wide range of sanctioning powers, in addition to revocation of the license. If a licensee is or appears to be unable to meet its obligations, or when other problems are in place (submission of false or misleading information, refusal to permit inspections, contravention of a cease and desist order, etc.), the Minister may assume temporary management of the institution, suspend or revoke the license, present the Court a petition for the winding up, or initiate a reconstruction of the licensee.

Among the new and reinforced powers of the Minister are: requirement of ministerial approval for acquisitions of shares, or any other arrangement, resulting in change of control of the licensee, and to require the disposal of shares where acquired with no approval; power to obtain information on the shareholders; powers to take remedial action in the case of actual or apprehended insolvency (requiring an undertaking from the board of directors, giving directions to a licensee, issuing of cease and desist orders, assuming temporary management, suspending or revoking a license, etc.).

However, this reform fell short in solving certain issues, such as quality of information produced by banks, reporting requirements and disclosure; connected party lending and other prudential limits; risk-based capital criteria, including the imposition of higher capital for entities operating within volatile areas of activity; exclusion of certain institutions from deposit-taking activities; and, chiefly, did not improve the capabilities of supervisors to effectively supervise complex financial groups. Neither was the supervisor given adequate powers to deal expeditiously with problem situations.

A remarkable feature of the development of the Jamaican financial sector was the rapid formation of conglomerates, comprised of one or more institutions of various classes. The supervisory agencies were inadequately staffed and although the banking supervisor had long practiced on- and off-site examinations, this was not a feature of insurance regulation; furthermore, communication and co-operation between the supervisory agencies were inadequate. Flow of information, systemic or institution specific, was insufficient and led to duplication of work and incomplete or misleading information being given to the Minister and to delays and gaps in overall financial system policy development[6].

Reforms during 1992- 1997

The BOJ enhanced regulatory and organizational capacity under an IDB program. Thus, a "Ladder of Enforcement" was issued, clearly pronouncing to the industry the sanctions and supervisory actions that would be taken in response to assessed levels of problems within

[6] According to December 1996 M&A's report to the Task Force established by the Ministry of Finance and the BOJ to review Jamaican legislative and supervisory framework.

licensees; eight "Standards of Best Practice", including internal controls and management of the main risks in the banking business, were issued to the banking industry. In addition, the size of the supervisory division was restructured and increased; a Work Out Unit, with responsibility for identification and special monitoring of watch list entities was established; and the quality and frequency of internal reports, for both on- and off-site was enhanced. The on-site examination teams were strengthened and re-organized to start conducting simultaneous examinations of financial groups comprising different types of banking licensees. The staff complement was more than doubled during 1994 and 1995 and new appointments continued the following years; internal and external training initiatives were expanded. Building societies were brought under the BOJ umbrella in 1995. A Securities Commission was established to oversee securities trading and activities to initiate the strengthening of the Office of the Superintendent of Insurance were undertaken with support of the IDB.

The 1997 Reform and More Recent Changes

This reform empowered the Minister to take control of the shares and subordinated debt of a banking licensee that has ceased to be viable with the purpose of restructuring or selling the entity in the interest of depositors. The BOJ was empowered to take certain corrective measures in respect of financial entities experiencing problems, such as –unless directed otherwise by the Minister– to require board undertakings, give directions, and issue cease and desist orders, all of which previously could only be done by the Minister. The external audit regime was enhanced and the obligations of auditors were spelled out in greater detail in the presentation of findings and their reportage to the supervisor of problems or significant issues uncovered during their audit exercise; furthermore, since the reform the BOJ can also require special audits to be conducted at the cost of the licensee, if deemed necessary. The information submitted to the central bank improved, as well as introduced the requirement for senior bank management to attest to true and fair representation of quarterly published unaudited balance sheets; furthermore, the BOJ was given the power to examine the books of immediate and ultimate holding companies of supervised financial institutions. Concurrently, efforts have been made by the Institute of Chartered Accountants of Jamaica to improve accounting practices and disclosure requirements relating to the financial statements of banks and similar financial institutions. Accounting standards have been brought more in line with US GAAP, particularly in the areas of revaluation and recognition of unrealized profits, deferred expenses, and pension valuation disclosures.

Since 1997, the BOJ has implemented additional supervisory mechanisms to enhance its monitoring capabilities. These include the development of regulations on capital adequacy on a risk basis and credit risk classification, provisioning and non accrual requirements; the introduction of a program of quarterly performance targets encompassing capital, asset quality, profitability, and liquidity; the development and implementation of testing instruments to monitor compliance with the Money Laundering Act; and the establishment of an enhanced electronic data interchange system that enables the efficient transmission of information from all the licensed institutions to the BOJ. Credit unions were brought under the BOJ supervisory umbrella in 1999.

Under the Quarterly Performance Targets Regime, individual entities agree key target performance ratios with the central bank, and the banking system is monitored accordingly. This is intended to bring greater uniformity to the assessment of financial indicators with the objective of raising financial performance of all the players and the system as a whole. At the same time, a Financial Stability Monitoring Committee, comprising senior staff of the supervisory and research divisions of the central bank, was established, to put in place a set of financial system and macroeconomic indicators, which are reviewed on a regular basis.

3. Summary of Current Provisions in Financial Legislation

Licensing and fit and proper criteria

Licenses and acquisitions of shares entailing control over 20 percent or more of the licensees' authorized share capital must be approved by the Minister. The assessment process involves the application of fit and proper criteria in relation to shareholders, directors and management "by vetting players at the entry gate." The application of rigorous fit and proper criteria will diminish the risk of negligent or incompetent directors and management and will improve the standards of corporate governance.

Capital requirements

Minimum paid up capital and capital adequacy requirements are at present more in line with Basle standards though having more stringent definitions of Tier 1 and Tier 2 components. There is also a concept of "capital base" that provides the basis for limits on credit and other risk exposure (not explicitly for market risks, so far), fixed assets, and deposit taking capacities. In addition, a minimum of 15 percent of net profits must be transferred each year to a statutory reserve fund, until its balance is equivalent to 50 percent of the paid-up capital; thereafter, a minimum amount of 10 percent must be transferred, until the reserve fund equals the paid-up capital.

Banks' deposit-taking capacity is limited in relation to capital base: Commercial banks can hold deposits worth 25 times its capital and other licensed deposit taking financial institutions 20 times its capital. Conversely, there is not now a similar provision in the building societies regulations. Nonetheless building societies are subject to risk capital requirements. The Minister can vary each of those ratios, subject to the affirmative resolution of the Parliament. In addition minimum cash requirements and liquid assets are required for banks, financial institutions, and building societies, in relation to prescribed liabilities.

Controls and provisions on lending

Credit risk exposure limits for banks –and similarly for Building Societies– include the following prohibitions: (i) the acquisition, dealing in, or granting credit facilities on the securities of its own (or holding company or subsidiary) shares; (ii) the grant of any unsecured credit facilities to connected persons or to any company, or persons connected to such company, which holds 20 percent or more of the licensee's shares; (iii) the grant of credit facilities to any one person if the credit facilities exceed in the aggregate 20 percent (40 percent for a group) of the licensee's capital base, of which no more than 5 percent (10 percent for a group) may be unsecured. The Minister can authorize a bank to exceed these limits after consultation with the BOJ.

The regulation requires a one-percent general loan loss provision on standard and potential problem credits and specific provision against the estimated net loss (after consideration of collateral values pursuant to up to date expert valuations) of each credit classified as substandard (20 percent), doubtful (50 percent), and loss (100 percent). Additionally, a credit must be classified as non-accrual when a payment is three months or more in arrears. The regulation also establishes the conditions and criteria which would determine the timing and level of classification of a credit. Where a loan is non-performing in excess of 12 months, the value of collateral is further written down, regardless of valuation, and provisioning requirements increased until it is fully provided for.

Limits on fixed assets and investments

Fixed assets and investment in companies are limited as well. The former is restricted to 100 percent of the capital base (in relation to asset cost); however the Minister can authorize a bank to surpass that limit. In aggregate, investments in any company or undertaking are limited to 50 percent of the capital base and any such single shareholdings is limited to 10 percent of the capital base.

Information and disclosure

Entities are also required to submit financial information to the BOJ, including monthly returns showing information which includes data on contingent liabilities and past due loans; annual statements of earnings and expenditure; and audited financial statements of the licensed institution and its parent, subsidiaries, and affiliated companies. Additionally, each licensee is required to publish in a daily newspaper (and also to exhibit in its office throughout the year) a copy of its audited financial statements.

The BOJ is allowed by the law to publish information on the assets and liabilities of each bank, Under this authorization, the BOJ publishes the quarterly unaudited balance sheets of all banks, merchant banks, and, since December 1999, building societies; as well as aggregate system and sub-sector financial indicators on a trend basis.

Anti Money-Laundering Measures

The BOJ has recently issued the "Guidance Notes on Money Laundering for Banks, Licensed Financial Institutions, Building Societies, *Cambios*, and *Bureaus de Change* that intend to bring to the attention of financial institutions the minimum standards required of an effective program to detect and deter money laundering. By way of these Guidance Notes, BOJ emphasizes that the anti-money laundering policies and procedures of financial institutions should be developed in accordance with the law, the 40 Recommendations of the Financial Action Task Force, the 19 Recommendations of the Caribbean Financial Action Task Force, and the Guidance Notes themselves, giving consideration to each institution's own internal procedures, practices, and personnel structures.

These rules are applicable to every type of financial institution in Jamaica and, provided that Jamaican anti-money laundering provisions are more severe than those applicable abroad, also to branches or subsidiaries of Jamaican financial institutions operating overseas. Albeit the Guidance Notes do not have by themselves the force of law, a court will give consideration to the advice issued by the regulatory body that has jurisdiction over an entity that is charged with an offence. In addition, BOJ will consider noncompliance with anti-money laundering laws and regulations and with the Drug Offences Act, as well as failure to adhere to the Notes, as constituting unsafe and unsound practices, which could, in turn, trigger undertakings, directions or cease and desist orders.

Financial institutions are obliged, among other things, (i) to establish and implement programs, policies, procedures and controls as may be necessary for the purpose of preventing and detecting money laundering including appropriate staff training programs and the appointment of compliance officers; (ii) to impede money-laundering activities; (iii) to establish, and review annually, clearly defined policies to achieve such obstruction that should include certain minimum standards; (iv) to adopt adequate and effective know-your-customer procedures; (v) to keep records; and (vi) to report any suspicious transactions as well as all cash transactions above US$50,000 for commercial banks, financial institutions and building societies (US$8,000 for *Cambios*[7]).

These Guidance Notes represent an enhancement in money laundering prevention but implementation, in terms of establishment of policies and procedures by financial institutions will take time.

4. Pending Improvements in Bank Supervision

Although progress has been made on Jamaican financial legislation, the challenge remains to ensure effective implementations of the norms and regulations. More appropriate regulations are now in place and the supervisory authorities enjoy a larger set of tools to earlier detect and manage a crisis. There is still room for improvement in terms of (i) enforcement powers of the supervisor that would need to be enlarged; (ii) coordination among supervisors of different financial institutions; (iii) consolidated supervision; and (iv) refinement of capital provisions to introduce specific market risk based requirements.

In order to get a comprehensive picture of the supervisory legal and regulatory framework of Jamaica, an independent assessment on the Basle Core Principles for Effective Banking Supervision is highly recommended. The independent assessment would verify the results of the self-assessment carried out recently by the authorities, which depicts a supervisory system largely compliant with the principles.

Powers vested in the supervisor

The new legislation continues to vest significant power in the Minister to grant exceptions to legislation and to prudential requirements and to exercise final decisions on bank intervention and exit. This discretion over the financial sector weakens the ability of the BOJ to supervise the industry, because institutions are inclined to seek exceptions (or delays) as opposed to comply with particular requirements of the supervisor. While, according to BOJ officials, the Minister normally defers to and accepts the recommendations of the central bank in matters involving the supervision of deposit-taking institutions, the possibility nevertheless remains that arbitrary

[7] *Cambios* and *Bureaus de Change* are licenses foreign exchange dealers, mostly established in rural and tourist areas.

action (or non-action) is the consequence of the role of the Minister. In the case of bank exits in the very early stages of the crisis (relative to 2 entities finally intervened in late 1994 and mid 1996), the Minister's failure to act expeditiously on the recommendations of the BOJ has been seen as an unfortunate feature of the overall banking sector developments.

To adopt timely corrective measures supervisors should have the power to intervene at an early stage if the licensee's business is being conducted in a manner detrimental to depositors or other creditors or is not being conducted in accordance with laws and regulations and to prevent capital from falling below prudent levels. Albeit the Minister could retain the power of revocation and closure, the supervisory authority should have the capacity to take immediate control of a licensee, provided that certain grave circumstances are in place (negative capital, poor management detrimental for depositors or other creditors, refusal to submit to inspection of licensee's records or operations). The strengthening of BOJ's autonomy in terms of early intervention in distressed licensed institutions would serve to enhance the transparency of the system of intervention. This would include: (i) an early warning system in place to address the problems prior to complete insolvency; (ii) power of the regulatory authority to intervene based on a ladder of intervention, so that all players would have a clear statement of what actions may be taken by the regulators and when these actions are likely to be taken; and (iii) a clear understanding by the licensees of the consequences of failing to rectify problems expeditiously. Bank of Jamaica has recently updated the Ladder of Enforcement to reflect the 1997 legislative amendments.

The supervisor still does not have authority to directly impose fines (other than for failures to comply with the liquidity requirements), which currently are imposed through the court system. The BOJ has been in full support of having powers to assess fines in certain offences; however, legal issues need to be resolved.

Coordination among supervisors of different financial institutions

Another main issue is whether the new design of the regulatory and supervisory model for the financial system will achieve a sound financial system and minimize the risk of systemic crises. Major challenges are the harmonization of chief regulations (risk-based capital adequacy, reporting requirements, reserve requirements, crisis-intervention policies) to avoid and put an end to regulatory arbitrage; the coordination among supervisors; and the application by the other supervisors of the same strict supervisory standards applied by the central bank. The Regulatory Policy Council is being created to coordinate the regulation and supervision of banks and other financial institutions and non-bank financial entities under the authority of FSC. It should be clearly spelled out in the law the status of the lead supervisor and the arrangements for information sharing among the supervisory agencies. However, prior to the codification, a formal Memorandum of Understanding between the new agency (FSC), the BOJ, and JDIC, which would detail supervisory policy regarding lead regulator concept and crisis management issues, should be agreed.

Consolidated supervision

Prudential regulations should be set on a consolidated basis in terms of regulatory capital and credit risk exposure limits. Supervisors should be capable of assessing risk management at the group and affiliate level. Given the complex group structures that exist in Jamaica, supervisory policies need to be considerably strengthened in this area. This would involve strengthening the supervisory authority to ensure that corporate affiliates and structures do not hinder effective supervision, e.g. prohibit industrial groups and commercial banks in the same groups or require the establishment of a separate financial group/holding company that isolates the industrial enterprises from the rest of the group.

Refinement of capital provisions and market risk

At present there are no explicit capital requirements for market risk. Furthermore, the BCP self-assessment noted the authorities as materially non-compliant in the evaluation of market risk. Supervisors' ability to monitor and evaluate market risk should be improved, which includes receiving timely and relevant information from the licensees. Particularly important is to issue specific regulation introducing capital requirements for market risk and develop norms and standards addressing market risk. The Caribbean Development Bank is addressing technical assistance needed in this area.

5. Improvement in the Supervision and Regulation of Insurance Companies–IDB Project

Throughout fiscal 1999/2000, Insurance Regulatory Reform has continued to be a major work stream through a two-year special project jointly funded by FINSAC and the IDB.

This project has been specifically geared towards the management of FINSAC's investment in the insurance sector, the updating and strengthening of Jamaica's Insurance Act and Regulations, the strengthening of supervisory personnel and expertise in that area, the evaluation of the management of private pension funds in Jamaica, together with other reforms.

The project team is led by FINSAC's General Manager, Insurance Intervention & Rehabilitation. The team works closely with the Office of the Superintendent of Insurance (OSI) to ensure their training and support in the new methodologies.

The following deliverables have been successfully completed:

- Performance benchmarks (Early Warning Ratios) established for FINSAC-intervened insurance companies.

- Monthly reporting forms for life and general insurance companies formulated, showing key data indicating the companies' overall financial health. All FINSAC-intervened insurance companies now use these reporting forms.

- Report completed on all life and general insurance companies, showing the trends in the predictive ratios over a nine year completed period.

- In December 1998, working with analysts from the OSI, the project team completed a joint FINSAC/OSI examination of Island Life, using many of these newly developed benchmarks and analyses. An examination of Life of Jamaica began on June 28, 1999. These were the first examinations of life insurance companies in Jamaica. The examination report on Life of Jamaica was presented to the Board of Life of Jamaica in January 2000. The examinations focussed on the accuracy of accounting records, the suitability and consistency of accounting policies and procedures, solvency of the company, and the verification that statutory requirements were in compliance. Being the first on-site examination, a complete review of all books maintained by the company was done.

- New organization charts for the OSI were completed, with many job descriptions finalized, including educational, skills and abilities requirements. The structure also includes pension supervision and job descriptions have been developed for the necessary positions.
- Staffing structure and budget for the OSI as a statutory body established for submission to the Ministry of Finance.
- Prototypes for an automated insurance industry financial analysis program prepared.
- First drafts of new Investment Guidelines for insurance companies, and a new Insurance Act prepared for circulation in the industry.
- Draft provisions of the proposed new Insurance Act sent out for comments from all stakeholders and Caribbean law experts.
- Examination Manual and procedures finalized.
- Draft Accounting Standards for general and life insurance companies developed in conjunction with the Institute of Chartered Accountants of Jamaica, and issued to the industry as exposure drafts.
- New solvency standards developed for life and general insurance companies. The Minimum Assets Test for general insurance companies was submitted to the Jamaica Association of General Insurance Companies (JAGIC) for comment. The Minimum Assets Test is initially set at 100% of Required Assets for Test Purposes, and will vary in accordance with the Office of the Superintendent of Insurance regulations from time to time. The Minimum Continuing Capital and Surplus Requirement (MCCSR) for life insurance companies was also circulated to the industry for comment.
- Arranged for an initial review of the private pension system in Jamaica by a pension regulatory expert. Recommendations were submitted as comments to the Committee for Pension Reform.

The IDB project is scheduled for completion in January 2001. Once the proposal for the new Act and Regulations are with the Ministry of Finance & Planning, the Attorney General's Office, and the Office of the Chief Parliamentary Counsel, these bodies will control the formulation of a bill and the timing of the bill being presented to Parliament for its assent into law.

The IDB project plan contemplates the transfer of certain project staff to the Office of the Superintendent of Insurance. However, this is contingent on Government's finalization of its proposals for the re-structuring the Office of the Superintendent of Insurance.

Table 1. 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; not met completely yet
Safety net	Appropriate level of systemic protection—confidence; limited guarantee	Full guarantee	Limited guarantee
Supervisory powers	Operational independence and resources;	Not legally independent; no minimum period of appointment	Not legally independent; no minimum period of appointment
	Sufficient enforcement powers;	Not sufficient powers for the supervisor, nor for the Minister	Largely improved; not met completely yet
	Powers for effective resolution of problems in banks, including exit;	Actions to be taken by the Minister	No intervention powers; actions subject to ministerial approval
	Interagency cooperation and sharing of relevant information	No formal information sharing	No legal arrangements for information sharing. Legislation needed
	Clear criteria for lead regulator	No lead regulator	No lead regulator
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 reserved to licensed banks

Key Regulatory & Supervisory Issues	International Best Practice	Pre-Crisis Situation In Jamaica	Current Status In Jamaica
Ownership structure	Financial strength of major shareholders; effective supervision not hampered by group structures; transparency	Opaque groups	Structures of financial/mixed groups to be clarified; new legislation required
Fit and proper criteria	Stringent criteria applicable to owners, directors and senior management. Accountability and responsibility of managers and directors	Certain requirements for owners and managers	Requirements enhanced
Transfer of shares	Controlling interests approved by supervisors	Minister's approval	Minister's approval; requirements enhanced
Major investments	Approved by supervisors (to avoid undue risks and supervision hindrance)	Limits on fixed assets and investments in enterprises established in the law	Limits on fixed assets and more stringent limits on investment in enterprises established in the 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-base capital requirements Deposit-base, not risk-based capital requirements Only on solo basis	Risk-based <u>and</u> deposit-based capital requirements Only credit risk considered; market risk not yet considered Only on solo basis
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	Supervisor evaluates policies, practices and procedures for granting and monitoring of credit portfolio	Supervisor evaluates policies, practices and procedures for granting and monitoring of credit portfolio

Key Regulatory & Supervisory Issues	International Best Practice	Pre-Crisis Situation In Jamaica	Current Status In Jamaica
	Credit bureau; access to other intermediaries positions	No credit bureau; banks do not know other banks' exposures	No credit bureau; banks do not know other banks' exposures. Proposal being made by Bankers Association for establishment of Credit Bureau
CRM: (ii) Asset valuation	Asses quality; adequacy of loan-loss reserves	Not sufficiently prudent provision requirements	Prudent provision requirement
CRM: (iii) Concentration and large exposures	Identify and set limits (consolidated basis).	Prudent limits in place but solo basis	Prudent limits in place but solo basis
CRM: (iv) Connected lending	Arm's length basis, effective monitored and limited (consolidated basis)	Same limits as for unconnected parties	More stringent limits than for unconnected parties in place but solo basis
CRM: (v) Country and transfer risk	Identify and monitor country risk and transfer risk	No requirements	No requirements
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	No provisions for market risk. Arrangements being made for enhancement in this area through technical assistance from CDB
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	Enforceable "Standards of Best Practice"
Methods of ongoing supervision	Regular contact with bank management and thorough understanding of banks' operations (Both on- and off-site)	Initial strengthening and reorganization of staff.	Strengthening and re-organization of staff continue. Information improved
Off-site surveillance	Prudential reports both solo and consolidated and from non-financial companies of the group	Less-than-optimal information available	Monitoring capabilities enhanced: Quarterly Performance Targets Regime, Financial Stability Monitoring Committee.

Key Regulatory & Supervisory Issues	International Best Practice	Pre-Crisis Situation In Jamaica	Current Status In Jamaica
On-site examinations; external auditors	Means of validating information; clear guidelines related to frequency and scope of examinations; policies and procedures in place	Clear guidelines re frequency and scope of examinations	On- and off-site examinations enhanced
	Roles of auditors and supervisors clearly differentiated	Less-than-optimal external audit reports.	Requirements for auditors and audit reports were significantly improved
Consolidated supervision	Ability to review both banking and non-banking activities, both domestic and foreign.	Review only banking activity	Ability to review all group companies' activities
	Both (solo and consolidated) prudential requirements	Solo prudential requirements	Solo prudential requirements
	Information sharing among different supervisors	Insufficient	Improving
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 reporting	Determined by supervisor; some reports may be "event generate"	Scope and frequency stated in law and determinable by supervisor, however questionable timeliness and reliability	Determined by law and supervisor. Better quality reports

Key Regulatory & Supervisory Issues	International Best Practice	Pre-Crisis Situation In Jamaica	Current Status In Jamaica
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. Drafted regulation 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 require further disclosure
Formal powers of supervisors			
Corrective measures	Appropriate intervention to protect depositors, creditors, and prevent widespread contagion Graduated, and timely, supervisory response (restrict activities, restrict paybacks to shareholders, replace management, conservatorship) and vigilance	Minister can assume temporary management, suspend or revoke a license 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	Minister can assume temporary management, suspend or revoke a license or vest shares of licensee in himself to facilitate sale or restructuring BOJ can require undertakings, give directions, and issue cease and desist orders Minister can take temporary management, vest shares and present to the Court a petition for the winding up or initiate reconstruction
Liquidation procedures	Ability to close or assist in the closing	BOJ assists in closure	BOJ assists in closure

ANNEX IV

STRUCTURE AND EVOLUTION OF THE BANKING SYSTEM IN JAMAICA

Prior to the 1995-1996 crisis, the Jamaican financial sector was characterized by extremely rapid growth in assets and a large number and variety of financial institutions including: commercial banks, near banks (merchant banks, trust companies, and finance companies), building societies, credit unions, and insurance companies. Although these institutions engaged in similar types of activities, they were not equally well regulated or supervised. As a result of the crisis and the subsequent Government response, the financial landscape has dramatically changed both in terms of the number of institutions and types of businesses they are allowed to undertake. A significant flight to quality from domestic to foreign-owned institutions also took place. In addition, the large pressing needs of the Government because of fiscal constraints that were worsened by the consequences of the financial crisis, have crowded out private sector credit with adverse consequences for growth. Further, the composition of assets in banks' balance sheets has been dominated by Government securities and FINSAC bonds, to the detriment of financial intermediation in the system. Subsequent to intervention and restructuring of failed institutions, system prudential indicators are improving particularly in terms of asset quality and solvency, largely as a result of the purchase of NPLs and recapitalizations undertaken by FINSAC under its rehabilitation and restructuring mandate.

1. Financial System Structure

The financial liberalization process of the mid-1980s led to substantial growth in assets of the financial sector but was not complemented by a sufficiently robust prudential and regulatory infrastructure (Annex III). The distinction between deposit-taking institutions (traditional commercial banks) and other financial institutions was minimal because of the creation of unregulated instruments that mimicked deposits at lower regulatory costs. The number of institutions that were subject to lower reserve requirements and relatively less stringent supervision increased as financial intermediaries searched for ways to access cheaper funds and broaden their funding base, motivated by regulatory and tax arbitrage opportunities. This was particularly the case of merchant banks that had lower reserve requirements than commercial banks, and later of building societies, which, prior to supervision by the BOJ, were not subject to any legal reserve requirements.

Commercial bank assets multiplied seven times between 1990-95, while merchant banks and building societies' assets grew four and nine times, respectively (Table 1, p. 11). From 1981 to 1990, the number of merchant banks increased from 6 to 21. After reserve requirements were raised on merchant banks, there was a continuation of the pattern of regulatory arbitrage through building societies which, with no reserve requirements and weaker prudential standards at that time, increased from 6 in 1990 to 32 on register in 1995, when supervisory responsibility for these institutions was assigned to the BOJ. With the assessment and licensing procedures which commenced in 1995, the number of societies reduced to 14 by December 1996 and further to 5 licensed societies currently. The number of insurance companies also increased mainly because they remained poorly regulated. These companies raised funds through short-term deposits to finance longer-term investment projects in the real estate and tourism sectors, thereby creating a severe mismatch of assets and liabilities thus increasing their risks. As investment projects failed to perform as projected and investor uncertainty led to increasing non-renewal of short term funds, liquidity problems emerged and the insurance companies tapped mostly on their related banks for funds, triggering the problems that surfaced in the banking sector.

Faced with systemic runs, the Government intervened in the system, fully protecting all depositors, life insurance policyholders, and pension fund investors for their total assets. The Government's response also included the introduction of changes towards leveling the regulatory/supervisory playing field across institutions thereby reducing opportunities for arbitrage, together with the creation of FINSAC to intervene, rehabilitate and divest troubled financial institutions. In the process, the Government effectively became the owner of, or a major investor in, most of the domestically owned financial sector. FINSAC's strategy for the resolution of financial institutions in distress resulted in the merger of all intervened banks not otherwise closed down, into Union Bank (see below) and in National Commercial Bank. This merging process coupled with the regulatory changes substantially decreased the number of institutions in the system. For instance, the number of commercial banks decreased from 11 in 1995 to 6 by June 1999. The trend has been more evident at near banks, which went from 23 in 1998 to 13 in 1999.

2. Commercial Bank Market Participation: Flight to Quality

Financial sectors in developing countries tend to be bank-dominated and Jamaica is no exception. Commercial banks continue to have predominance with more than 70 percent of the total assets of the Jamaican deposit-taking system.[8] The main players are the two intervened (domestic) commercial banks –NCB and Union Bank– and chiefly among foreign banks, the Bank of Nova Scotia (BNS). The latter has particularly benefited from extensive flight to quality resulting from the crisis.

Although after the crisis NCB still has the largest share of **total assets** (38 percent) as of June 2000, it has decreased from 42 percent in 1998. In contrast, foreign banks and, in particular, BNS, have gained market share, thus strengthening their very important presence in the commercial bank market. As of June 2000 BNS has the second largest share in total assets (37 percent), increasing since 1998 (Table 1). Prior to the crisis, the main lender in the market was NCB, as evidenced by the large amount of FINSAC bonds in its balance sheet.[9] Since then, BNS has widened the gap in its now dominant **loan market** share of 39 percent in March 1998, increasing to 58 percent by June 2000, while NCB's share's decreased from 37 percent to 23 percent during the same period.[10] This trend has resulted in a more concentrated loan market as

[8] Total assets of the system include commercial banks, near banks, and building societies.

[9] The large share of FINSAC bonds in the balance sheet of NCB and Union Bank (currently more than 50%) was partly due to the purchase of non-performing loans resulting from the credit boom of earlier years. For instance, FINSAC acquired J$13.5 billion from NCB, which currently holds a (gross) portfolio of J$11.1 billion in June 2000 compared to J$20.6 billion at BNS.

[10] Citibank is also present in the market with a much lower participation (3-4 percent). Its lending rates are relatively lower, but mostly to select customers. The CIBC also had a small participation of about 6-8 percent until June 1998,

measured by the Herfindahl Hirshmann Index (HHI) (Table 2), which as of June 2000, reached 4,011 compared to 3,003 at March 1998.[11]

but since then, its loan market share dramatically increased (reaching between 10-11 percent after December 1999) as part of a new business strategy. A recently appointed managing director introduced a cut in the prime-lending rate by 40 basis points (announced in September 1999), following the lead started by the BNS and other banks.

[11] The HHI is the sum of the squares of the respective shares and lies between 0 and 10000. According to the merger guidelines of the US Department of Justice, a postmerger HHI of 1800 and over indicates a concentrated market, an HHI between 1000 and 1800 moderately concentrated and an HHI below 1000, unconcentrated.

Table 1. Participation in Total Assets, Total Loans, and Total Deposits of Commercial Banks from March 1998 to March 2000 (%)

Commercial Banks	0398	0698	0399	0699	1299	0600	0398	0698	0399	0699	1299	0600	0398	0698	0399	0699	1299	0600
	Total Assets						Total (net) Loans						Total Deposits					
Domestic:	57	57	55	57	56	54	50	43	40	37	31	28	53	55	48	50	48	48
FINSAC-banks	56	57	55	57	56	54	49	42	38	36	30	27	52	54	47	50	48	47
NCB*	42	44	40	40	39	38	37	32	27	26	25	23	41	44	36	37	36	36
Citizens**	6	6	9				2	3	4				4	5	6			
Eagle**	2	2	2				1	1	1				2	1	1			
Island Victoria**	2	2	1				3	3	2				2	1	1			
Workers S & L**	4	3	3				6	3	4				3	3	3			
Union**				17	17	16				10	5	4				13	12	11
Non-FINSAC	0	0	0	0	0	0	1	1	1	1	1	1	0	1	0	0	0	0
Trafalgar***	0	0	0	0	0	0	1	1	1	1	1	1	0	1	0	0	0	0
Foreign:	43	43	45	43	44	46	50	57	60	63	69	72	47	45	52	50	52	52
Nova Scotia	33	34	35	33	34	37	39	46	47	49	52	58	37	36	41	38	40	41
Citibank	4	3	3	3	3	3	5	3	4	4	6	4	3	2	4	4	3	3
CIBC****	6	7	6	6	7	6	6	8	9	10	11	10	7	7	7	8	9	8

Source: WB calculations based on data from the Bank of Jamaica.

* National Commercial Bank. FINSAC owns about 67 percent of NCB.

** Merger of Eagle Commercial Bank, Island Victoria Bank, Workers Savings & Loan Bank, Island life Merchant, and Corporate Merchant into Citizens Bank, which later changed names to Union Bank of Jamaica Limited, effective June 30, 1999.

*** Negligible market share.

**** Canadian Imperial Bank of Commerce.

Notwithstanding the flight to quality and the restructuring process taking place, the **deposits market** was marginally less concentrated as of June 2000 with a HHI of 3,050 compared to 3,141 in March 1998. The significant flight to quality that followed the crisis led BNS to increase its deposit market share from 37 to 41 percent from March 1998 to March 1999, compared to a decline in the NCB's market share from 41 to 36 percent during the same period.

Table 2. Herfindahl Hirshmann Indexes

COMMERCIAL BANKS	March 1998	March 1999	June 1999	December 1999	June 2000
Total Assets	2965	2965	2734	2735	2858
FINSAC	1824	1695	1600	1521	1444
Foreign	1141	1270	1134	1214	1414
Net loans	3003	3074	3195	3488	4011
FINSAC	1420	767	677	626	530
Foreign	1582	2306	2517	2861	3480
Deposits	3141	3089	2893	2986	3050
FINSAC	1714	1343	1369	1296	1296
Foreign	1427	1746	1524	1690	1754

Source: World Bank calculations based on the BOJ data.
* Non-FINSAC domestic banks have a negligible market share.

3. Private Sector Credit: Shift in the Composition of Bank Assets

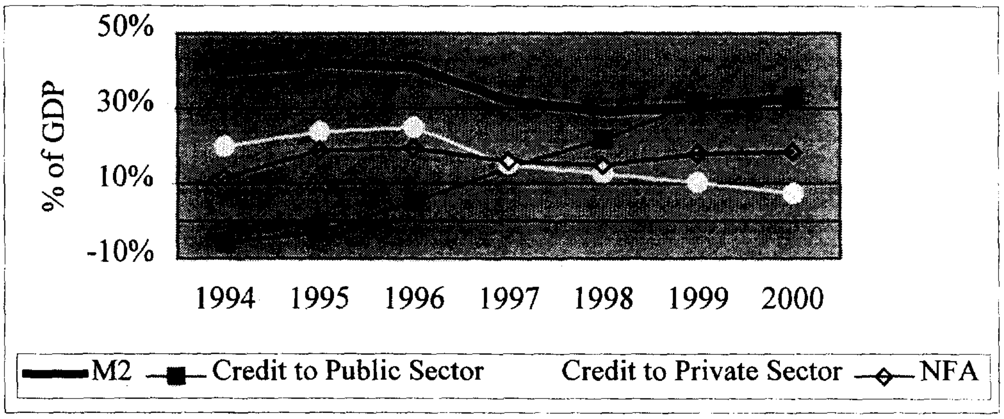
The pressing needs for the Government to finance its overall public sector deficit and service its large debt has crowded out **credit to the private sector**. This shift reflects the increased demand for credit by the Government due to its large fiscal needs, which were worsened by the crisis. Since 1997, credit to the private sector has been depressed relative to the predominant credit to the public sector and bank lending to the private sector has registered negative growth since the onset of the crisis. Loans to the Government have increased substantially both at commercial and near banks. In addition, the resolution of the crisis largely through the issuance of FINSAC bonds resulted in a shift in the composition of bank assets from loans to Government securities.

Government demands for funds are large even though interest on FINSAC debt is being capitalized. A large increase in credit to the public sector coupled with low GDP growth led credit to private sector to decrease as a percentage of GDP from more than 20 percent in 1996 to about 10 percent in 1999 (Figure 1). As of March 1999, the Government had already exhausted M2, thus squeezing funds in the domestic market. This trend has prevailed as of March 2000, although the rate of increase of public credit that slowed somewhat.

A breakdown of the loan portfolio of commercial banks indicates that by July 1999, Government loans accounted for the largest annual increase among all types of commercial bank loans, with a very rapid rate of growth of 25 percent (Table 3). The large growth likely resulted from the Government's decision in Summer 1999 to forego the raising of funds at unacceptable rates in the international markets and instead raised the required funds through the domestic market. The decrease in the annual growth rate of the loan portfolios of near banks was partly reflective of the Union Bank merger process effective April 1999. During 2000, particularly after the

Government was able to raise funds in the international markets early in the year, near bank lending to the private sector (particularly to the manufacturing sector) has increased.[12]

Figure 1. Main Sources of M2



Source: The BOJ.
NFA= Net foreign assets.
Figures as of March each year, as a percentage of previous December GDP.

The authorities expect that after the restructuring and sale process of NCB and Union Bank is complete, the environment for increased credit to the private sector that could boost growth would be enhanced. It is expected that post divestment, NCB and Union Bank –which currently operate under supervisory constraints—will be in a position to return to their roles as large players in the credit market.

As a result of the resolution of banks in distress since 1997, total bank assets are dominated by FINSAC bonds (about 33% for commercial banks as of June 2000) and asset composition has shifted from largely loans to significant holdings of Government securities. **Loans and advances** still have a larger participation than the latter but dramatically decreased in importance from 1996 when they accounted for 40.1 percent, to reach 19 percent as of December 1999. The reduction in the share of loans in total assets resulted partly from the transfer of approximately J$30 billion (J$17.8 billion done in 1998) in non-performing loans (NPLs) to FINSAC. This was accompanied by a shift in asset composition towards government securities, which moved from 12 percent of commercial bank assets in March 1998 to 16 percent in December 1999. This shift has been more evident at BNS, the current market leader in lending, with (net) loans to total assets ratio of 27 percent in December 1999, down from 34 percent in March 1998, while its ratio of Government securities to total assets increased from 23 percent to 31 percent during the same period.

A large increase in the BOJ advances to the banking sector was evidenced during 1999 (J$1.1 billion as of end-December 1999). This, when coupled with a 67 percent share of total **Government securities** held by commercial banks reported by BNS in December 1999 (increasing from 45 percent in March 1998) suggests that the Government may be mobilizing funds from BNS to channel liquidity through the system.

[12] Government loans from near banks had an exceptionally large annual growth of 1,416 percent in July 1999. Total near bank lending however is relatively small account for only about 6 percent of commercial bank lending.

Table 3. Shares and Rate of Growth of Loans by Type

	Annual percentage change					
Commercial banks	**06/99**	**07/99**	**09/99**	**12/99**	**02/00**	**03/00**
Net loans		-15.7	-19.8	-14.7	-16.11	-14.3
Agriculture		1.3	-4.7	-19.6	-19.90	-12.8
Manufacturing		-32.4	-34.1	-25.2	-35.10	-29.2
Construction		-22.7	-20.3	-20.1	-9.50	-22.6
Mining		-64.0	-40.4	-48.3	-25.59	-24.3
Tourism		-24.0	-28.3	-16.4	-14.44	-9.6
Transport		-39.2	-40.8	-24.0	-17.07	-8.7
Consumer-oriented		-10.4	-13.2	-9.8	-10.10	-11.1
Government Services		25.2	-10.2	3.8	-2.68	-4.1
Other		-50.2	-42.6	-47.0	-55.0	-34.1
Near banks						
Net loans	-58.3	-33.1	-25.7	-5.1	-26.0	-10.1
Agriculture	-64.4	-33.1	15.5	-6.7	-55.2	-55.8
Manufacturing	-72.9	-46.5	-25.7	96.9	113.0	200.0
Construction	-66.7	-45.7	-39.9	-26.7	-86.0	-83.1
Mining	-85.2	-81.4	-72.88	-25.6	42.0	0.4
Tourism	-55.6	-35.6	-23.8	146.9	1.0	7.6
Transport	-80.8	-77.8	-75.4	-71.9	-40.0	-41.1
Consumer-oriented	-48.5	-38.5	-30.8	-19.4	-29.9	-8.0
Government Services	-15.9	1,415.3	1,062.4	-32.4	-25.6	-22.5
Other	-9.0	-21.3	-3.1	-20.9	-46.3	-49.0

Source: BOJ data.

In contrast, from March 1998 to December 1999 NCB experienced the opposite pattern with a decreasing share of its holding of total Government securities in the commercial bank market from 30 to 22 percent, but it remains dominant in the holdings of Government securities in US dollars with 67 percent in December 1999, while BNS increased from no participation in 1998 to 19 percent in December 1999.

4. Asset Quality, Liquidity, Solvency, and Profitability

The prudential indicators of asset quality, liquidity, solvency and profitability of the financial system have improved since the crisis (Table 4). This has been partly due to FINSAC's interventions and partly due to improvements in regulation and supervision

Asset quality. The level of NPLs at commercial banks declined sharply and in June 1999 was less than half its level a year earlier, mostly because of the purchase of NPLs undertaken by FINSAC. NPLs at near banks fell steadily 79%, while at building societies the rate of decline was 49%, during the same period. The declining patterns continued as of June 2000. In terms of the ratio of NPL to total loans, it declined from 28 percent in June 1998 to 13 percent in June 2000 for commercial banks. Despite the decline in this ratio, it remains higher than the international standard of 8 percent.[13] However, the supervisory authorities expect this ratio to continue its declining trend because of tighter controls implemented by the system in response to more stringent supervisory requirements and guidelines as well as improvements in risk management techniques resulting from the introduction of stricter supervisory norms by the BOJ.

In line with the favorable trends in the ratio of NPL to total loans, the ratio of provisions for loan loss (PLL) to NPL increased. For commercial banks, this ratio went from 62 percent in June 1998 to 114.4 percent in June 2000. Therefore, banks are currently fully provisioned with *de facto* compliance with the BOJ's recently announced more stringent provisioning rules. Provisioning also improved at near banks and building societies. Despite the positive trends in NPLs and the PLL, there is a risk that the high interest rates in the system are attracting the higher risk customers that may eventually default. The NPL reported by some banks may thus not reflect the overall risks involved, which could potentially undermine the improvements in the ratio of PLL to NPL, unless adequate provisions are created accordingly. The interest rates, however, are on a declining trend, which together with enhanced/tightened credit systems and controls, mitigate such risks.

Liquidity. BOJ data show that liquidity ratios of commercial banks have improved from 46.1% in June 1999 to 49.9 percent in June 2000. However, the LARs in the system are somewhat misleading because of the large presence of FINSAC (illiquid) notes in the balance sheet of financial institutions (comprising 25 percent of total assets for the system as a whole, as of June 2000). FINSAC bonds issued in respect of capital injections in the rehabilitation and restructuring of entities, can be counted as liquid assets for regulatory purposes since May 1998.[14,15] As a result, liquidity problems in the banking system remain the focal point of the Government, which created a Cash Management Working group in January 1999 to deal with these problems by monitoring FINSAC institutions on a daily basis. This is a centralized working group that comprises representatives of the BOJ, MOF, FINSAC, and the Accountant General.

Solvency. As of June 2000, the degree of solvency in the system as a whole has sharply improved. For commercial and near banks, both the ratio of capital base to total assets and the capital to risk-adjusted ratio are above the respective 6 percent and 10 percent minimum ratios,[16] mostly as a result of the large capitalization process undertaken by FINSAC in intervened institutions.

Profitability. As of June 2000, profitability has improved, as measured by the ratio of pre-tax profit margin, from a loss of 18.9 percent in June 1998 for commercial banks, to profit ratios that averaged 14.6 as of June 2000. The return on assets of commercial banks has swung from

[13] The number of institutions with a ratio of NPL/total loans greater than 10 percent steadily decreased from 31 percent in December 1996 to 15 percent in July 1999.

[14] Provided the privatization of NCB and Union Bank results in the payment of interests on their large share of FINSAC notes, this issue would be negated.

[15] The process of capitalization at intervened institutions that enable them to fulfill liquidity requirements, however, has helped profitability to the extent that banks avoid large penalty rates charged at the BOJ for overdraft facilities provided for that concept.

[16] Capital base includes paid-up capital, reserve fund, retained earnings reserves, share premium, less impairment by losses. In computing the estimated capital to risk-adjusted ratio investments in subsidiaries are deducted from capital base.

negative 0.8 percent in June 1998 to a positive 0.6 percent by June 2000, with similar trends for the rest of the system. Profits, however, are calculated on an accrual basis and thus reflect the accrual of interest payments on FINSAC notes in the balance sheets of financial institutions.

Table 4. Quarterly Prudential Indicators: December 1997 to June 2000 (%)

	Commercial Banks			Near Banks			Building Societies		
	0698	0699	0600	0698	0699	0600	0698	0699	0600
Rate of asset growth*	13.2	19.0	12.5	-2.3	-35.9	-17.1	22.4	-5.9	1.3
Rate of deposit growth	10.3	9.6	11.9	2.0	-33.2	-1.9	-16.6	-0.7	0.8
Rate of loan growth	-26.2	-6.0	-4.4	-18.4	-54.3	6.2	-0.5	-8.2	-4.8
Rate of capital base growth	-65.7	675.4	4.9	-83.2	1,079.8	-45.5	-88.8	-9.4	189.7
Capital solvency									
Capital base/total assets*	1.3	8.4	11.2	1.9	34.4	22.6	13.1	3.0	8.7
Estimated risk asset ratio	0.9	17.5	7.6	-8.8	36.4	35.5	1.7	2.9	13.9
Asset quality									
NPL/Total Loans	27.9	13.8	13.3	53.8	26.9	12.7	17.1	9.5	9.2
PLL/Total Loans	17.2	9.5	15.2	22.1	14.6	6.4	3.1	2.9	5.9
PLL/NPL	61.6	69.0	114.4	41.0	54.2	50.3	18.3	30.9	64.2
NPL/Total Assets	7.9	2.9	2.5	18.5	6.3	3.5	6.6	3.6	3.3
Rate of growth of NPL**	-3.0	-57.6	-1.2	5.9	-79.1	-54.4	56.9	-49.0	-5.3
# of inst. above 10 %***	34	18	10						
Liquidity									
Average CRR	25.2	17	14.0	16.6	18.1	14.0	3.9	4.6	1.0
Average LAR	53.5	46.1	49.9	45.4	64.3	126.4	20.4	23.5	21.4
Profitability									
Pre-tax profit margin (quarterly)	-18.9	13.8	19.6	11.7	16.7	23.9	-5.6	7.9	15.0
Return on average assets (quarterly)	-0.8	0.6	0.8	0.8	1.8	2.7	-0.3	0.4	0.7
Income assets/expense liabilities	74.7	89.3	96.0	62.7	119.7	129.5	87.5	93.3	101.6
Number of (system) banks reporting losses	18	5	2						
Memo item:									
FINSAC paper/Total Assets	15.8	26.0	33.4	7.3	11.4	0	1.8	2.0	3.6

Source: Financial Institutions Supervisory Division, Bank of Jamaica. NPL: Non-Performing Loans; PLL: Provisions for loan losses; CRR: Cash Reserve Ratio; LAR: Liquid Asset Ratio.
* Total Assets net of Contingent Liabilities and Provisions for Losses. **Reductions in NPL and PLL resulted mostly from further purchase of NPL by FINSAC. ***Data for the system.

ANNEX V

FINANCIAL INSTITUTIONS UNDER RESOLUTION BY FINSAC

Since January 1997, FINSAC, in concert with the BOJ, executed intervention of troubled financial institutions and acquired a large ownership in more than 30 major entities in the financial system. These institutions were restructured through mergers, sales, and disposal/transfer of their assets, or withdrawal of their licenses and other interventions. After the intervention phase was complete, FINSAC consolidated intervened banks into Union Bank and National Commercial Bank. The remaining intervened institutions are mostly insurance companies, some of which were also merged before their disposal. Table 1 summarizes these steps and the associated cost to FINSAC, as of August 2000. The figures represent the cost for each fiscal year, as of the effective date in the FINSAC bond issued.[17] The total cost of J$89 billion represents the principal of FINSAC notes issued plus cash advances as of August 2000 and therefore, it does not coincide with the total FINSAC liabilities of J$127 billion that also include: capitalized interest and pending commitments estimated as of September 2000, plus MOF funds provided for the establishment of FINSAC.

Table 1. Summary of Interventions by FINSAC, Mergers, and Licenses Revoked (Amounts in J$ millions)

Institution	Nature of Intervention	FY1998	FY1999	FY2000	FY2001
Union Bank and merged institutions:					
Union Bank (UB)	Merger of Citizens Bank, Citizens Merchant Bank, Eagle Commercial Bank, Island Victoria Bank, Corporate Merchant Bank, and part of the business and selected assets of Workers Bank (June 1999). Ordinary shares (99%), acquisition of NPLs, and coverage of BOJ overdraft. **Sold**: November, 2000.			8,453.7	
Citizens Bank	Ordinary (85%) and preferred shares and NPLs. Merged into **UB**.	2,700	47.7		19.5
Caldon Merchant Bank	Depositors transferred to **Citizens** in March 1998. During September 1998, the court appointed a liquidator and issued a winding up order.		121.7		
Fidelity Finance and Merchant Bank	Depositors transferred to **Citizens** (March 1998). License surrendered. FINSAC bonds to NIBJ (J$14 million) and JDB (J$45 million).		89.1		
Horizon Group	Ordinary (100 %) and preferred shares. NPLs and under-performing loans of Merchant Bank bought at a nominal price. Assets and liabilities transferred to **Citizens** (March 1998).	4,010	1,400	132.2	

[17] Sometimes the actual date of issuance of FINSAC bonds differs from the effective date identified in the bonds due to technical reasons. In such cases, the bonds are issued at a later date but carry the interest accrued from the effective date

Institution	Nature of Intervention	FY1998	FY1999	FY2000	FY2001
Intercontinental Merchant Bank	Depositors transferred to **Citizens,** November 1998. License surrendered.		100.4		
Eagle Group	Loan and liquidity support, purchase of insurance company, merchant bank, commerciai bank, and building society for a nominal price, acquisition of shares in four hotels. Merged into **UB** (except for insurance company-Crown Eagle).	2,590	19.8		133.9
Island Victoria Bank	Purchased for nominal price by **Eagle Commercial Bank** (July 1998), 100 percent share. NPLs purchased. Merged into **UB**.		817.4		
Island Life Merchant	Purchase of total loan portfolio. Restrictions imposed on license and later merged into **UB**. Zero-coupon preference shares to cover asset gap on transfer to UB.		181.6		
Corporate Merchant	MOF vested the shares and subordinated debt (July 1998). FINSAC issued promissory notes to cover part of the asset gap of J$2.5 billion for its merger into **UB.**			1,392.5	
Corporate Ins. Brokers	Loans to facilitate balance outstanding to **UB**; settlement of outstanding payment to staff; loan for balance outstanding premiums to general insurance companies.			30.4	
Workers Savings & Loan Bank	Loan for overdraft support and placed under temporary management. Later, MOF vested the shares and subordinated debt in itself (July 1998). Merged into **UB**.	7,522.4	1,000	1,620.4	
NCB and related institutions (deposits transferred):					
NCB Jamaica Ltd.	Ordinary and preferred shares (45.4 percent share in NCB group and 40 percent share in NCB); acquisition of NPLs and two hotels. **Pending resolution**.		19,500		
Buck Securities Merchant	Depositors transferred to **NCB** during September 1998. License surrendered.		38.8		
Caribbean trust and Merchant	Depositors transferred to **NCB** during September 1998. License surrendered.		23.9		
Insurance Companies:					
Crown Eagle Life	Coverage of BOJ advances, accounted as a FINSAC bond to NIBJ. Additional cash/LRS to cover asset gap from the 1999 transfer of policies to BNS (interest sensitive liabilities) and Guarding Holdings Limited of Trinidad (individual life and pension).	14,384.3	7.7	914.1	
Dyoll Group/Dyoll Life	Ordinary (26.5%) and preferred shares. Promissory note (cash) to transfer policyholder liabilities to **Crown Eagle** in December 1998.	200	454	311.9	

Institution	Nature of Intervention	FY1998	FY1999	FY2000	FY2001
Jamaica Mutual Life	Ordinary shares in NCB group, liquidity support and loan to settle debt to NCB for J$8 billion and mutual 2000 bonds for about J$348 million. Portfolios sold to BNS (with FINSAC notes and Guardian assets). FINSAC purchased shares in five hotels.	8,447.8	2,347.5	5,122.8	
Island Life Insurance	Ordinary (26.5 percent) and preferred shares. Sold its shares in Island Life merchant (later merged with **Citizens**) to FINSAC. Insurance Co. sold to Barbados Mutual.	300		792.5	
Life of Jamaica	Acquisition of shares 26.5 percent; shares in Citizens and CIBC **Pending resolution**.	2,076.8		657.8	
Other intervened institutions in operation:					
Victoria Mutual Building Soc.	NPLs, purchase and lease back of building. Currently operating.		900		
Billy Craig Merchant	Ordinary and preferred shares, 49 percent holdings (June 1998). Remaining shares owned by Dehring Bunting and Golding Ltd (DB&G). Changed names to DB&G in June 25, 1999. Capital injection of J$231.8 February 1999.		148		
Total FINSAC principal (cash plus bonds) **As of August, 00*: J$89,010.6 million**		42,231.3	27,197.6	19,428.3	153.4
Memo item: FIS current liabilities to NCB J$4,756.2 million					

Source: Economic and Social Survey Jamaica 1998 and FINSAC

*About 35 percent was provided in cash from MOF and advances from BOJ.

Other Licenses Revoked: (i) Capital Assurance Building Society: Merged into Eagle Permanent Building Society. Deposits transferred to UB; (ii) Citifinance: Transferred its business to Citimerchant bank. License surrendered on June 2, 1999; (iii) Barclays Finance corporation: License revoked on June 22, 1998; (iv) West India Company of Merchant Bankers: Depositors transferred to BNS on October, 1998. License surrendered.

As a result of the strategies described in Table 1, FINSAC intervened institutions can be classified into four groups: (1) Union Bank, (2) NCB, (3) insurance companies and chiefly among them, Life of Jamaica, and (4) other smaller institutions most of which are in the process of liquidation/winding down. These four groups are discussed in more detail next.

1. Union Bank

Union Bank is the result of the merger of the ("good bank" portion of the) businesses and assets of Island Victoria Bank (IVB), Citizens Bank Limited, Citizens Merchant Bank, Eagle Commercial Bank (Eagle), Corporate Merchant Bank, and (part of the business and selected assets of) Workers Bank. Prior to this, the assets, liabilities and operations of a number of the failed merchant banks were merged into the operations of Citizens Bank Limited. The legal merger became effective April 23, 1999 and the name of Citizens Bank was changed to Union Bank of Jamaica Limited by a vote at the Annual General Meeting on June 29, 1999. FINSAC had gained control of the merged banks, and the groups of companies with which they were associated with the provision of financial assistance, as described in Table 1. The decision to merge their operations followed consultants' diagnostic reviews, which indicated that none of the banks was individually capable of survival in the prevailing and foreseeable economic environment. A merger to create a single larger profitable bank was recommended.

The first step was the formation of a holding company, Union Bank of Jamaica Holding Company, charged with effecting the merger. It was also recommended that an independent management team be given the responsibility of carrying out the transition under FINSAC's supervision into a single viable entity over an eighteen to twenty four month period, for which an overseas team was hired.

Rehabilitation

TransAmerica Financial Services (TFS), a United States bank management and consulting firm with extensive experience in the restructuring and rehabilitation of banks, was the chosen contractor to undertake the merge and manage the resulting institution. The TFS team assumed the management of Union Bank in January 1999.[18] The restructuring process has involved a substantial reduction in the number of branches from the pre-merger level of 42 down to 23, while staff was reduced from 1,425 to 800. Union Bank is under a voluntary cease and desist order and therefore makes no fresh loans.

Divestment

FINSAC sold its 99% share of Union Bank's equity Royal Bank of Trinidad Tobago Holdings in November 2000.

2. National Commercial Bank

FINSAC executed the intervention of NCB to avoid the imminent collapse of the bank in 1997. Between January and March 1998, NCB lost J$2.7 billion of core deposits, of which J$1.8 billion were savings accounts. These deposits have never been recovered from the system. FINSAC's financial assistance package for NCB totaling J$19.5 billion, together with a structured turn-around plan for the bank's rehabilitation, was finalized early in FY1999. It included the purchase without recourse of the NPLs of NCB and NCB Trust & Merchant Bank Limited. NCB's NPLs amounted to J$13.5 billion out of J$33 billion of NPLs bought by FINSAC at face value.

The financial assistance also included the injection of J$4.67 billion into NCB Group and NCB through FINSAC's acquisition of Preference Shares in exchange for FINSAC notes, and J$1.33 billion in ordinary and zero coupon preference shares in NCB (See Table 2). The capital injection increased NCB's capital base to approximately J$6.7 billion. It has also replaced senior management in the bank.

[18] Their mandate under the agreement included: Consolidation of the financial entities; Conversion of all operations to a single Year 2000 compliant IT platform; Stabilization of the loan portfolio; Reduction of operating costs through rationalization; Preparation and implementation of a strategic plan for the bank; Restoration and promotion of customer and employee confidence.

Ownership

NCB's two shareholders are the NCB Group and FINSAC with 60 and 40 percent of equity respectively, the latter acquired in February 1998. FINSAC, in turn, also owns 45.4% of NCB Group –arising from the intervention of Mutual Life of Jamaica. As of June, 2000, NCB had J$78.3 billion in assets (about US$1.9 billion and 38% of banking system assets), of which FINSAC bonds represented J$42.2 billion (about US$1 billion and 54% of NCB's assets).[19,20] Since the group holds 60% ownership in NCB, the total FINSAC ownership in NCB is effectively 67%, which is short of the over 75% share needed to give FINSAC controlling ownership in order to take the bank to the point of sale.

FINSAC designed a plan (in consultation with NCB) that allows for the conversion of its holdings in NCB Group. In order to achieve this, FINSAC has taken the following steps: (i) reached agreement with the Board of Directors of NCB regarding its proposal for conversion of its disparate holdings in the bank and the Group to consolidated bank holdings; (ii) held an extra-ordinary meeting of NCB's shareholders informing them of the proposed takeover of control by FINSAC; (iii) obtained approval from the courts to hold a formal meeting of NCB's shareholders on November 8, 2000 to approve the proposal – referred to legally as the Schemes of Arrangements. Subsequent to the approval by NCB's shareholders FINSAC needs to clear the Schemes with the Courts so that it can obtain more than 75% share in NCB.

Restructuring for its privatization

FINSAC has been monitoring NCB's progress under several agreed rehabilitation plans the first of which was internally prepared by NCB and later complemented by: (i) conditionality factors involved in the financial assistance agreement with FINSAC, (ii) Turnaround Plans prepared by McKinsey, and, (iii) the recent Strategic Plan in the Investment Memorandum prepared by Hong Kong Shanghai Bank Inc. Corporation (HSBC) as part of its role as advisors for the sale of the bank. In the restructuring process, the branch network has being rationalized from 69 in 1997 to 49 by March 2000 with additional reductions pending, with staff counts already down from 3,110 to 2,614. A consultant hired by the Bank has also undertaken an evaluation of NCB and a proposal to maximize the value in the resolution of the bank has been made to the authorities on this basis.[21] However, the final restructuring plan for NCB will be developed and implemented after the 75% plus ownership is acquired and after the new management comes in. A new Chief Executive Officer, Chief Information Officer, and Chief Financial Officer have been appointed. Beginning in April 2001, the Government plans to service the FINSAC debt held by NCB in cash.

[19] As of August 31, 2000 FINSAC bonds (including commitments) accounted for J$44.3 billion.

[20] Total FIS bonds currently represent J$5.4 billion and receive cash interest payments. NCB holds J$4.9 billion of FIS bonds.

[21] The restructuring proposal benchmarked the performance of NCB to that of BNS, its main competitor in Jamaica. On the basis of this analysis, the report was presented to the Government on strategic options for restructuring NCB.

Table 2. FIS and FINSAC Intervention on NCB[22]

Aspects of Intervention	Financial Impact (J$ million)	Remarks
(a) Subscription for 167 million new ordinary shares (of J$1 each) in NCB	167 (February 1998)	Payment of dividend permissible only to the extent that capital to assets and capital adequacy rations of 8% and 12% respectively are maintained.
(b) Subscription for 1,163 million zero coupon preference shares (of J$1 each) in NCB	1,163 (February 1998)	Preference shares, both zero coupon and 12.5% non-cumulative, are deemed to constitute Tier 1 capital. Coupon reverts to T-Bill rate after September 30, 2002.
(c) Subscription for 3,670 million non-cumulative 12.5% preference shares (of J$1 each) in NCB	3,670 (October 1998)	Preference dividend paid in any year where dividends on ordinary shares are paid.
(d) Subscription for 2,000 million non-cumulative 12.5% preference shares (of J$0.5 each) in NCBG	1,000 (October 1998)	One quarter of post tax profits (after requisite capital levels) to be used for redemption of preference shares in NCB
(e) Purchase of NPLs from NCB and NCB Trust & Merchant Bank with a total face value of J$13,500	13,500 (September 1997-February 1998)	All rights to loan collateral ceded to FINSAC who took all such portfolios on a non-recourse basis.
(f) Transfer of deposit liabilities of the Century Group (J$5,040) and Partner Merchant Bank (J$197.2) assumed by NCB. (FIS)	5,237	FIS Bonds are negotiable and guaranteed by the GOJ. They are issued in Jamaican dollar (Series B) and US$ (Series A) denominations. The former pay interest at 6-month TB+1, while the latter bear interest at 9.625% per annum. These bonds are regarded as liquid assets for regulatory purposes. Interest is paid in cash, semi-annually. Maturity is 6 years from the issue date.
(g) Promissory note (non-interest bearing) for redeemable convertible zero-coupon preference shares in NCB. (FIS)	450	The note matures in 2007. FIS may convert the shares into ordinary shares in NCBG. In this event, the shares will be converted at the price at which ordinary shares in NCBG last traded on the Jamaican Stock Exchange prior to the date of the notice by which the conversion right is exercise.

Source: FINSAC documents.

3. Insurance Companies in the Restructuring/Resolution Process[23]

The Insurance Intervention & Rehabilitation department is responsible for the restructuring, monitoring and rehabilitation of FINSAC-intervened insurance companies. The companies are

[22] As a result of intervention, FINSAC appointed six members to the Board of Directors of NCB Group.
[23] This section corresponds to the "Intervention & Rehabilitation Insurance" section in FINSAC Annual Report 2000.

Crown Eagle Life Insurance Company Limited (Crown Eagle), Dyoll Life Limited (Dyoll Life), the Jamaica Mutual Life Assurance Society (Mutual Life), Island Life Insurance Company Limited (Island Life), and Life of Jamaica Limited (LOJ).

FINSAC originally intervened in the insurance sector in fiscal year 1997/98 through the purchase of common and preferred shares and/or issuance of subordinated loans in all five insurance companies. In 1998/99 it became evident that further intervention would need to take place in Crown Eagle, Dyoll Life and Mutual Life. These companies were coming under increasing liquidity pressure from policyholders encashing their interest-sensitive policies.

Crown Eagle, Dyoll Life and Mutual Life

The rehabilitation and divestment strategy has resulted in a stronger and more profitable insurance industry. Over 200,000 policyholders with insurance coverage of over $91 Billion have been protected under FINSAC's efforts to resolve the problems of Mutual Life, Crown Eagle and Dyoll Life.

4. Interest-sensitive policies

Lump-sum interest-sensitive policies were characterized by minimal life insurance coverage and a large investment premium. Primarily investment vehicles, they were usually funded by a single lump-sum deposit. The interest paid on these policies was unrelated to the performance of any asset held by the insurance company.

The link to insurance came through a small amount of the deposit going into insurance coverage. In many cases the actuarial valuation of the insurance component was worth less than 1% of the investment component. For example, in the case of Mutual Life, out of a total lump-sum portfolio liability of approximately J$2,145 million only J$1.5 Million or 0.07% represented the liability of the insurance coverage for its 6,513 lump-sum policyholders.

In more than 90% of lump-sum interest-sensitive policies, the policyholder's life was insured for J$60,000 or less compared to average coverage of approximately J$250,000 in the savings-type interest sensitive policies.

In February 1999, a Judicial Manager –chartered accountant and FINSAC consultant–, was appointed by the Supreme Court to take responsibility for these policies. The appointment of the Judicial Manager allowed a court injunction, originally granted in December 1998, to be lifted. The injunction had prevented any activity from taking place with these types of policies. The lifting of the injunction created a more stable framework for the development and speedy implementation of a solution to the problem posed by these policies. The Judicial Manager's role was to examine the interest-sensitive portfolios of the companies, and to determine the best way of solving the problem and report on his findings to the Court. On April 29, 1999, the Judicial Manager filed a report with the Supreme Court regarding the lump-sum, interest-sensitive policies, following which the Court ruled that the FINSAC-pioneered scheme to pay out lump-sum, interest sensitive policies of Crown Eagle, Mutual Life and Dyoll Life was the best deal possible for policyholders. A copy of the report was filed with the Superintendent of Insurance and another was made available for public scrutiny. Once this Court Order was received, the decision of the Court was binding on all persons.

The details of the scheme that FINSAC entered into with the Bank of Nova Scotia Jamaica Limited (BNS) and Scotiabank Jamaica Trust & Merchant Bank Limited (Scotia Trust) for the divestment of the interest-sensitive policies are set out below:

- The liability for paying out proceeds of lump-sum type interest-sensitive policies was assumed by BNS and Scotia Trust, who received in return Local Registered Stock of sufficient value to back the liability represented by these policies. Policyholders would receive a savings account at BNS for their investment portion - up to a J$200,000 maximum.

- Policyholders with amounts over J$200,000 would be given a transferable Certificate of Participation issued by Scotia Trust, for the amounts over J$200,000.

- This Certificate in turn would be backed by a five-year term instrument issued by the Government of Jamaica with Scotia Trust as trustees. Interest is payable semi-annually to these policyholders, but no withdrawal of principal is permitted during the five years.

- Policyholders over 65 years old as at March 31, 1999 receive interest monthly. This scheme gave approximately 75% of interest-sensitive policyholders immediate access to all of their funds.

After implementation of this scheme, FINSAC secured the agreement of at least one financial institution to negotiate the Certificates of Participation issued by Scotia Trust, thus allowing holders of these instruments the option of obtaining immediately a discounted cash value for their Certificates.

In June 1999, the final tranche of Bank of Nova Scotia transfers was completed[24]. Some policies were not transferred, however, due to some policyholders' decision not to sign the agreements transferring these policies. The insurance portion and cash values up to $200,000 will now be assumed by Guardian Life Limited, the Jamaican subsidiary formed to assume the insurance portfolio acquired by Guardian Holdings Limited. Cash values in excess of $200,000 will be assumed by Union Bank, with certificates similar to the BNS issue being given to the policyholders.

Table 3 represents the details of the Bank of Nova Scotia transfers representing 52% of the policyholders and 90% of the total liability.

[24] Some of the payments to BNS resulting from the transfer have taken place in 2000 after asset valuations were completed. The funds were transferred from the MOF, which provided cash or issued LRS, the latter of which is therefore already reflected as part of the Government (non-FINSAC) debt.

Table 3. Bank of Nova Scotia Transfers

Fund Balance Size	No. of Policies	Liability J$ million
Less than or equal to $20,000	1,457	11.2
Between $20,000 and $200,000	1,127	90.3
Greater than $200,000	1,514	2,419.5
TOTAL	**4,098**	**2,521.0**

5. Traditional policies and pension funds

At the same time the negotiations were taking place with BNS, FINSAC offered the remaining Dyoll Life, Mutual Life and Crown Eagle portfolios for sale. These consisted of traditional life policies and pension funds. Offers for purchase were received from eight companies: Barbados Mutual Life Assurance Society, Blue Cross of Jamaica, Colonial Life Insurance Company (Trinidad) Ltd., First Life Insurance Company Ltd., Guardian Holdings Ltd., Life of Barbados Ltd., Maritime Life (Caribbean) Ltd., and Prime Life Assurance Company Ltd. Subsequently, Life of Barbados Ltd. and Barbados Mutual Life Assurance Society decided to bid for the portfolios as a joint venture.

Following acceptance of the Memoranda of Understanding by FINSAC, bidders were informed of the bid process, and the related requirements and the deadlines governing the process. They could submit bids for all or part of the portfolios and could make their bids contingent on a successful tender for other segments of the business. This approach allowed FINSAC to award the portfolios to one company or a combination of companies.

Bidders were not allowed to tender for the portfolio of just one of the failed companies, given a policy decision to combine like portfolios across the three companies and offer only the lines of business for sale.

Final bids were awarded points based on how well they measured up against a set of previously established criteria, with bidders with the highest point standing emerging as the winners.

6. Valuation

An important aspect of the process was the actuarial valuation of the portfolios. The valuation was conducted in three stages: group business - health and life; the pension business and the individual life business. At the end of each actuarial evaluation, a report was sent to the bidders and they were required to submit a bid for that particular portfolio. The valuation was based on the policy and experience data provided by the three insurance companies as of December 31, 1998. The first challenge of the valuation process is that there was no standard accounting or actuarial practice governing the insurance industry. However, the decision was taken to use the Policy Premium Method (PPM) for the valuation, and the related Minimum Continuing Capital and Surplus Requirements (MCCSR) to ascertain the required capital for the portfolio and to evaluate the financial strength of the bidding companies. The decision to use this methodology was based primarily on two factors: (i) these methods were likely requirements of the upcoming Insurance Act, and (ii) some companies already used these methods in Jamaica and Barbados.

FINSAC technical personnel evaluated the offers received as well as the financial state of the bidding companies in order to determine whether they were capable of financing the acquisition of the portfolios without suffering financial damage in the process. Another major criterion was "fit and proper" considerations for management and directors.

Based on this analysis, FINSAC made recommendations to Cabinet, which were accepted, and on May 19, 1999, it was announced that Guardian Holdings Limited of Trinidad had won the bid for the individual life and pension portfolios, and that First Life Insurance Company Limited of Jamaica had won the bid for the group life and health portfolios. The total price was J$1.3 billion (US$32.5 million).[25]

In order to shorten the transfer process, an application was successfully made to the Supreme Court for the Judicial Manager to be appointed over this portion of the business for all three companies. At a final hearing on July 29, 1999, the Supreme Court approved the Agreements for Sale, and ordered the transfer of business. First Life and Guardian Life assumed management of the portfolios on August 1, 1999. The pace with which this divestment has taken place is unprecedented.

Life of Jamaica

In June 1999, FINSAC acquired real estate and other assets from the investment funds of Life of Jamaica (LOJ). Also as part of the transaction, FINSAC further consolidated its ownership of Citizens Bank (now Union Bank) by acquiring a block of Citizens Bank shares held by the funds. The total price of the transaction was J$658 million.

The properties, which were owned by the pooled investment pension fund and the segregated policyholder funds, were sold as a part of the exercise to realign the portfolios managed by LOJ. The objective of the realignment was to provide liquidity to the funds and to reduce the levels of internal (inter-fund) debt.

LOJ continues to have weaknesses in its balance sheet and illiquidity in some of the pension funds it manages and requires additional injection of capital in the form of FINSAC paper up to about J$1.9 billion. The Jamaican Cabinet has approved FINSAC's proposal to provide this additional capital to LOJ. FINSAC will obtain a controlling share of equity of the company (over 75%) in return for its additional capital injection currently expected to take place by the end of 2000. This will allow FINSAC to dispose of LOJ.

[25] As of October 2000, an independent actuarial valuation is still pending for the life and pension portfolios of Crown Eagle transferred to Guardian life. This may result in further asset gaps that have to be paid to Guardian beyond recent transfers. However, FINSAC expects to transfer two hotels currently in its books (Boscavel and Terra Nova) to Guardian instead of issuing additional FINSAC bonds. This is currently in negotiations.

Island Life

In August 1999, after several months of extensive discussions between the parties, the Barbados Mutual Life Assurance Society, Island Life Insurance Company and FINSAC signed a Letter of Intent under which both Barbados Mutual and FINSAC would inject additional capital into Island Life. As a result of this injection, Barbados Mutual acquired a 64% interest in Island Life, while FINSAC maintained its approximately 26% stake. Other shareholders retained a 10% stake in the company. A Shareholders Meeting was held on November 25, 1999, where the transaction was approved. Details of the transaction are set out below:

- Island Life increased its issued share capital to J$622,122,448 from J$231,918,336 by issuing new ordinary and preference shares.

- Barbados Mutual injected J$260 million in capital and issued 46,080,000 ordinary shares representing 64% of the issued ordinary share capital of Island Life.

- FINSAC injected approximately J$340 million in capital and issued 16,124,082 additional ordinary shares, to keep its stake in the company at 26%. It also received 84,721,000 perpetual non-cumulative preference shares, yielding a dividend rate of 12.5%.

- FINSAC assisted Island Life in restructuring its asset base by acquiring the Island Life Centre from the company at book value, which is assessed to be J$430 million, based on a valuation done in October 1998.

- FINSAC would pay for this by transferring real estate worth approximately J$150 million to Island Life, and by issuing J$200 million in FINSAC notes, with the remainder of the purchase price being met by the transfer of negotiable Government of Jamaica securities from FINSAC to Island Life.

7. Smaller Intervened Institutions in the Final Stages of Resolution/Liquidation

These institutions belong to two groups:

- *Intervened institutions that will be wound down and closed*: These institutions no longer maintain operations with the public. Many of the institutions in liquidation were part of the merger into Citizens that later became Union Bank (See Table 1). The 10 remaining institutions in liquidation are: Buck Securities Merchant Bankers, Caldon Finance Merchant Bank, Caribbean Trust and Merchant Bank, Corporate insurance brokers, Eagle Permanent Building Society (*winding down*), Fidelity Finance Merchant Bank, Horizon Venture Capital, Intercontinental Merchant Bank, Jamaica Mutual Life Assurance (*winding down*), and NCB Trust & Merchant Bank.

- *Two other restructured institutions that are back in operations*: FINSAC has a 49 percent share in the ownership of Billy Craig Finance & Merchant Bank operating as Dehring Bunting & Goding, which owns the remaining shares. Additional liquidity assistance was provided recently and FINSAC purchased further shares to maintain its 49 percent ownership. FINSAC reports that assistance to this institution is now finalized. The second institution is Victoria Mutual Building Society. FINSAC owns property in this institution that is back in operations. FINSAC retains the right to nominate, remove and replace not more than two persons as member of the Board of Directors.

ANNEX VI

FINSAC FINANCES: CASH FLOW AND LIABILITY MANAGEMENT

At present, FINSAC debt holders are Union Bank; National Commercial Bank; insurance companies pending further capitalization and resolution (chiefly among them, Life of Jamaica); other smaller institutions (merchant banks, building societies) already restructured and back in operation; the Bank of Jamaica; and the Ministry of Finance (MOF/NIBJ/JDB).

1. Magnitude of FINSAC's Liabilities

The total liabilities of FINSAC are estimated at J$127 billion (about US$3 billion, or 43.9% of GDP) at end-August 2000.[26] The total in Table 1 includes the principal of the debt (See Annex V for details on the principal); accrued interests already capitalized minus bonds redeemed; start-up funds required for FINSAC in 1997 (J$1.4 billion) provided by MOF; and, estimated pending commitments as of June 2000.

Table 1. Total FINSAC Liabilities

FINSAC liabilities	Billions of J$
Principal (cash plus FINSAC bonds)	89.0
Interest accrued and capitalized minus bonds redeemed	37.6
Start-up capital for FINSAC	1.4
Net Pending commitments[27]	-1.1
Total liabilities as of August 31, 2000[28]	126.9

Most FINSAC bonds capitalize interest semi-annually at an average rate of 6-month T-Bill+1 percent. About 0.3 percent of the total pay interest in cash. If no reductions in the stock of FINSAC debt were to take place during FY2001, and interest were to be capitalized during this period, the stock of FINSAC debt would increase to roughly about J$137 billion by March 31, 2001. This figure differs from the original estimates included in the IMF's SMP of J$124 billion by March 31, 2001. The reasoning behind the larger estimate arises from recent events not known at the time of preparation of the SMP. The main items are about J$8 billion in MOF debt resulting mostly from MOF's issuance of LRS and the provision of cash to cover an asset gap in the deal with BNS and Guardian for the resolution of three insurance companies—chiefly among them Mutual Life (See Annex V). As of September 2000, FINSAC reports that, excluding contingent liabilities, it only expects to issue about J$2 billion in fresh bonds to complete the capitalization of LOJ and J$1.2 billion mostly to complete previous commitments for other insurance companies.

[26] Includes FIS liabilities for J$5.4 billion.
[27] Includes J$4.6 billion to be redeemed from UB before its sale. However, as of September 2000, this item was still a negotiation point between FINSAC and RBTT. All calculations assume this reduction. It does not include contingent liabilities.
[28] Total excludes interest accrued but not yet capitalized.

2. Current Structure of FINSAC Debt

While some bonds were issued in US dollars (about 4 percent), the bulk is in Jamaican dollars, at various maturities ranging from 3-15 years, mostly at floating interest rates. The total FINSAC debt can be classified in the following five categories, with structures described in Table 2:

Table 2. Structure of FINSAC Liabilities
(In J$ billions; estimated stocks as of August 31, 2000)

Type of liability	Amount	Comments
BOJ[1]	25.88	*For about 79% of this debt*: Maturity: in 2007-08 Interest rate: fixed at 10%; debt capitalizes semi-annually. *For the remainder*: Maturity in 2003. Interest rate: about half at 6-month T-Bill+0.5 and the rest at 6-month T-Bill+3.25. Debt capitalizes semi-annually.
MOF/NIBJ/JDB	19.4	MOF: zero-coupon bonds. NIBJ/JDB. Maturity: in 2008. Interest rate: 4 % fixed. Debt capitalizes semi-annually.
Union Bank of Jamaica	23.94	Maturity: most in 2004-06 with about 16 percent of the total maturing in 2014. Interest rate: average of 6-month T-Bill+1, has been capitalizing semi-annually. About J$1.1 billion was issued in US$ at 9% interest rate to cover short-position in the bank.
National Commercial Bank	44.07	About 60% of the total matures in 2012-13 and most of the remaining maturing between 2004-06. Interest rate: Average 6-month T-Bill +1, capitalizes semi-annually but could start paying in cash in FY01/02. About J$3.4 billion was issued in US$ to cover short position and accrues at 9%.
Others:[2]	9.38	*Mutual 200 bonds* (about 348 million): Maturity: 2002, Interest rate: 6-months T-Bill+1, currently paying interest in cash semi-annually (July/January). *Most of the Remainder:* LOJ (about 31% of total); maturity: 2007-09; Mutual Life (15% of debt), Maturity: 2012; Victoria Mutual (17% of debt, about half issued in US$), Maturity: 2005; Eagle Merchant Bank (14% of debt), Maturity: 2004. Interest rate for all: 6-months T-Bill +1.
Total issued	**122.67**	
Net Pending commitments:[3]	-1.1	(estimates as of September 2000)
FIS debt	5.4	About J$4 billion in Series B bonds in J$, of which J$3.6 bn are due to NCB. Series A bonds are in US$, mostly to NCB.
Total Debt	**126.87**	

Source: FINSAC. BOJ: Bank of Jamaica; MOF: Ministry of Finance; NIBJ: National Investment Bank of Jamaica; JDB: Jamaica development bank.

[1] Cabinet approval was obtained on October 17, 2000 for restructuring J$26.2 billion of FINSAC paper at the BOJ. The difference of J$300 million between the two figures is due interest accrued between September 1, 2000 and the date of Cabinet approval.

[2] Includes Insurance companies (mostly LOJ) plus remaining building societies and Merchant Banks.

[3] Includes the reduction of J$4.6 billion from UB. It does not include contingent liabilities.

The total FINSAC debt already issued as of August 31, 2000 thus includes:

- Notes issued for the capitalization/restructuring and sale of Union Bank amounting to J$23.9 billion (including J$132.9 million in pending commitments minus the J$4.6 billion bond to be redeemed before its sale will result in J$19.5 billion), of which 5% is in US$ at a fixed interest rate of 9%. Most of UB notes mature between 2004-06, except for about J$3.5 billion that mature in 2014. They capitalized interest at a rate of 6-month T-Bill+1 with no payments in cash.

- Notes issued for the capitalization/restructuring and resolution of National Commercial Bank, amounting to J$44.1 billion (J$255 million in pending commitments).[29] Notes issued by FINSAC in this category capitalize interest periodically at an average of T-Bill+1, with about 60 percent of the total maturing between 2012-13 and most of the remaining maturing between 2005-06. About J$3.4 billion was issued in US and accrues at fixed interest rates of 9 percent. Additional notes are expected to be issued to NCB for the capitalization of interest rates until it is restructure/resolve and its notes start paying interest in cash on April 1, 2001.

- Notes issued by FINSAC in order to complete the resolution of insurance companies and other financial institutions under FINSAC's purview amounting to J$9.4 billion (plus J$2 billion pending capitalization of LOJ and J$959 million in pending commitments). About J$348 million of this debt pays interest in cash, having maturity in 2002. The main debt holder in this category is LOJ with about 30 percent of the total and maturity between 2007-09, followed by, Mutual Life with about 17 percent and maturity in 2012; Victoria Mutual Building Society with 16 percent (issued in US$) and maturity in 2005; and, Eagle Merchant bank with about 13 percent and maturity in 2004. The authorities estimate that FINSAC will need to issue new notes for about J$1.9 billion linked to the resolution of LOJ, the largest insurance company, which was intervened in June 1999 (Annex V).

- Notes issued by FINSAC to BOJ in connection with the provision of liquidity to bank in distress through overdraft facilities, amounting to J$25.88 billion. About 81 percent of the debt accrues at fixed interest rates of 10 percent, another 10 percent at T-Bill+3.25, and the remainder at T-Bill +0.5.

- Notes issue to MOF/NIBJ/JDB to cover cash advances and Local Registered Stocks issued in connection with the resolution of intervened financial institutions for J$19.4. About 48 percent has been paid in cash. The notes issued to MOF do not accrue interest. Notes to NIBJ/JDB capitalize interest at a 4 percent fixed rate, the latter of which matures in 2008.

3. Government's Strategy to Manage FINSAC Debt

Recognizing the importance of providing liquidity to FINSAC notes for the restructuring of the financial sector, the Government has committed itself, as described in the SMP, to servicing all outstanding FINSAC debt (net of certain adjustments described below) beginning April 1, 2001. The strategy to reduce the stock of FINSAC debt by taking the set of actions described below will result in the issuance of cash-paying notes starting in April 2001 mostly for notes held by

[29] See Annex V for a list of NCB's intervention by FIS and FINSAC.

Union Bank, National Commercial Bank, and Life of Jamaica. The maturity, amortization profile, and interest rate conditions for the new notes are to be determined, possibly case by case, with a view to achieving successful resolutions.

The Government has taken the following actions to manage FINSAC's debt and complete the restructuring of the financial sector:

(i) **Write-off/Offset of FINSAC paper held by public sector entities**: The Jamaican cabinet has approved the write-off of all the FINSAC paper held by MOF and other public sector institutions (excluding the BOJ) amounting to J$19.4 billion.[30] This amount represents fiscal cost of the crisis already borne by the Government in cash, since these transfers from the MOF to FINSAC, came out of budgetary allocations, and the rest was issued as LRS and thus, is already accounted as part of the Government's domestic debt. The corresponding administrative actions to formalize the write-off are currently in process. The Government has off-set J$13 billion of FINSAC paper held by the BOJ against deposits of the Government at the BOJ. The Government has agreed with the BOJ that it will issue special bonds for the balance of approximately J$13.2 billion of FINSAC paper held by the BOJ.

(ii) **Portfolio of Non-Performing Loans**: FINSAC has advanced in the process of disposal of the portfolio of non-performing loans. FINSAC has hired an external consultant to advise it on the process of disposing of NPLs as a package to a third party at a base price with some structure of sharing receipts beyond a threshold level. The consultant's diagnostic was received in September 2000. The next phase of work in actual packaging of the NPL portfolio for sale will be completed by December 2000.

(iii) **Portfolio of other assets including real estate**: FINSAC has disposed of non-core assets (real-estate, art work etc.) amounting to J$11 billion as of August, 2000. It has also developed a time bound plan to dispose of the rest of the non-core assets.

(iv) **Union Bank**: The Government has sold Union Bank on November 2000. The sale of UB will require the Government to issue new debt to replace about J$19.5 billion of FINSAC paper on UB's books as of August 2000, including net commitments. The Government will use the proceeds to the sale of Union Bank to buy-back FINSAC bonds in UB.

(v) **National Commercial Bank**: FINSAC will obtain control of NCB (over 75% shareholding) to enable its resolution. Based on estimates as of August, 2000 about J$44.37 billion of FINSAC paper at NCB will be serviced in cash beginning April 1, 2001.

(vi) **Life of Jamaica**: The Board of Directors of LOJ has agreed to call a shareholders' meeting to authorize a proposal by which FINSAC will acquire control of LOJ (over 75% shareholding). At this meeting, which is currently expected to be held before the end of the year, a simple majority in terms of voting rights is necessary for the approval of the proposal to give FINSAC control of LOJ. Since FINSAC controls over 75 percent of the voting rights, the Government does not anticipate any significant problems in the approval of the proposal. Obtaining more than 75 percent of the equity of LOJ will allow FINSAC to take LOJ to the point of sale. About J$5

[30] Most of this amount is held by the MOF. The amounts held by NIBJ and JDB are negligible. This amount includes FINSAC paper issued to the MOF/NIBJ/JDB for both principal and interest.

billion (including the J$1.9 billion required for capitalization) of FINSAC paper at LOJ will be serviced in cash beginning April 1, 2001.

On the basis of this strategy, the Government expects to reduce the overall stock of FINSAC debt from about J$127 billion to about J$90 billion. The Government will use proceeds from the proposed loans by the Bank, IDB, and CDB totaling US$162.5 million[31] (about J$7 billion) to buy-back FINSAC bonds as well as service FINSAC debt. Loans from international financial institutions will assist in restructuring about 7.5 percent of outstanding FINSAC debt and improving its maturity profile.

4. FINSAC's Cash Flow Constraints

The main sources of cash income for FINSAC are the receipts from the sale/recovery of non-performing loans and other assets and transfers from the Government. The outflows are interest payments on FINSAC debt (currently only 0.3 percent of total bonds) and administrative expenses.

FINSAC's sources of cash income

Asset Disposal: FINSAC acquired a portfolio of NPLs with a face value of J$33 billion. The total purchase of the principal along with at least three months of accrued interest was for J$74 billion. FINSAC has established a workout unit to manage this portfolio and attempt recovery. By August 2000, this unit had recovered J$3.9 billion. FINSAC has also sub-contracted with the workout unit of NCB to manage about 11 percent of this portfolio. In addition, it developed a plan for the divestment of these assets over the next 15 months (June 2000-September 2001).

FINSAC also has a large portfolio of other non-core assets acquired during the intervention process (hotels, commercial and residential real estate, furniture & equipment, artwork, and motor vehicles). As of August 2000, J$11 billion of these assets had been sold (of which 10% are hotel sales in process). FINSAC has provided the Bank with a detailed plan for disposal of the rest of these assets.

Transfers from the Government. The Government has provided about J$9 billion in cash and J$10 billion in LRS to cover FINSAC cash flow to start operations, redeem FINSAC bonds, provide (cash) liquidity support, cover transfer of liabilities, and to a lesser extent, recapitalize financial institutions.

FINSAC's cash outflows: As of August 2000, FINSAC's main cash outflows are for general and administrative expenses and to service a small portion of the debt. The former accounted for J$433 million in FY2000 and J$355 million in FY1999.

Once the strategy to reduce FINSAC's debt is implemented, i.e. interest is paid in cash, as per the SMP, FINSAC's cash outflows would be dominated by debt servicing. The profile of FINSAC notes is likely to change according to the terms and conditions of the new notes that the Government/FINSAC will be issuing to replace existing FINSAC notes as of April 2001. As

[31] First tranche disbursements of the IDB (US$75 million) and CDB (US$12.5 million) and disbursement of the Bank's first operation of US$ 75 million.

outflows would vastly exceed inflows, this implies a need for the Government to implement a skillful program to manage its debt in order to smooth out the amortization profile of its liabilities and to adequately meet its debt refinancing needs.

The Government restructuring strategy, as described in the SMP, estimates cash interest payments starting in March 2001 (based on the stock as of March 2000) according to a base-case and downside scenario. The latter is based on more conservative assumptions about interest rates and GDP growth. The medium term projections 2000/01-2004/05 are presented in Table 3a.

Table 3a. Medium Term Interest Payments on FINSAC Debt, as Projected in the SMP

Interest payments (% of GDP)	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Baseline scenario	0.0%	0.0%	3.2%	2.6%	2.3%	1.9%
Downside scenario	0.0%	0.0%	3.7%	3.2%	2.8%	2.4%

Source: SMP

An IMF mission visited Jamaica during September 8-15, 2000 for an informal review of the macroeconomic developments prior presentation to the Board of this operation. The IMF reports that the Jamaica's adjustment program –that the authorities have asked the IMF to help monitor under the SMP— is broadly on track. The IMF mission together with the Bank's appraisal mission updated data on FINSAC liabilities which has resulted in a modification of the projections in interest payments for FY2001-FY2005, based on data as of August 31, 2000. Estimates of total FINSAC debt from J$107 billion (as of March 2000) to J$127 billion resulted mostly from: (i) about J$8 billion in FINSAC debt owed to MOF due to the issuance of LRS or provision of cash to cover asset gaps for the resolution of three insurance companies (mainly Mutual Life with J$7.4 billion), (ii) J$2.3 billion in additional realized costs for the restructuring of Union Bank related to an overdraft facility provided by BOJ, (iii) J$1 billion in additional capitalization of LOJ, (iv) interest accrued and capitalized from March to August; and (v) other, relatively small, additional commitments. Taking into consideration these changes, revised projections on interest payments are detailed in Table 3b.

Table 3b. Medium Term Interest Payments on FINSAC Debt, as per Revised Projections

Interest payments (% of GDP)	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Baseline scenario	0.0%	0.0%	3.9%	3.2%	2.7%	2.3%
Of which: private sector	0.0%	0.0%	3.4%	2.7%	2.3%	2.0%
Downside scenario	0.0%	0.0%	4.2%	3.6%	3.1%	2.7%
Of which: private sector	0.0%	0.0%	3.7%	3.1%	2.7%	2.4%

Source: Preliminary estimates as per informal review of the SMP and WB appraisal mission on September 2000.

ANNEX VII

Status of Bank Group Operations (Operations Portfolio)
As of 10/12/2000

Closed Projects 56

Active Projects		Last PSR Supervision Rating			Original Amount in US$ Millions				Difference Between Expected and Actual Disbursements[a]		
Project ID	Project Name	Development Objectives	Implementation Progress	Fiscal Year	IBRD	IDA	GE	Cancel.	Undisb.	Orig.	Frm Rev'd
P007485	PRIVATE INVESTMENT AND EXPORT DEVELOPMENT	S	S	1994	35	0	0	0	9.3	9	0
P007490	PUBLIC SECTOR MODERNIZATION	S	S	1997	28.4	0	0	0	22.8	17.1	6.9
P007479	REFORM OF SECONDARY EDUCATION	S	S	1993	32	0	0	0	5.1	4.9	0
P039029	SOCIAL INVESTMENT FUND	S	S	1997	20	0	0	0	1.4	-0.1	1.4
P038700	JAMAICA STUDENT LOAN	S	S	1997	28.5	0	0	0	6.1	4.2	0
P007489	TAX ADMINISTRATION REFORM	S	S	1994	13.2	0	0	0	1.1	1.1	1.1
				Total	157.1	0	0	0	45.7	36.2	9.4

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

Loans/Credits Summary in USD	As of September 20, 2000		
Original Principal	1,326,000,000	0	1,326,000,000
Cancellations	90,019,937	0	90,019,937
Disbursed	1,190,264,129	0	1,190,264,129
Undisbursed	45,715,934	0	45,715,934
Repaid	823,919,334	0	823,919,334
Due	364,767,931	0	364,767,931
Exchange Adjustment	-11,886,058	0	-11,886,058
Borrower's Obligation	352,881,871	0	352,881,871
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)

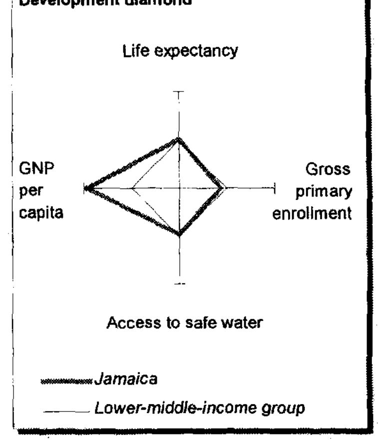
		Held				Disbursed			
FY Approval	Company	Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
1995	Jamaica Energy Partners Old Harbour Diesel Project	16.82	0	0	37.84	16.82	0	0	37.84
	Total Portfolio:	16.82	0	0	37.84	16.82	0	0	37.84

ANNEX VIII

Jamaica at a glance

POVERTY and SOCIAL	Jamaica	Latin America & Carib.	Lower-middle-income
1999			
Population, mid-year *(millions)*	2.6	509	2,094
GNP per capita *(Atlas method, US$)*	2,330	3,840	1,200
GNP *(Atlas method, US$ billions)*	6.6	1,955	2,513
Average annual growth, 1993-99			
Population *(%)*	1.0	1.6	1.1
Labor force *(%)*	1.5	2.5	1.2
Most recent estimate (latest year available, 1993-99)			
Poverty *(% of population below national poverty line)*	16.9	..	..
Urban population *(% of total population)*	50	75	43
Life expectancy at birth *(years)*	71	70	69
Infant mortality *(per 1,000 live births)*	25	31	33
Child malnutrition *(% of children under 5)*	10	8	15
Access to improved water source *(% of population)*	83	75	86
Illiteracy *(% of population age 15+)*	14	12	16
Gross primary enrollment *(% of school-age population)*	100	113	114
Male	100	..	114
Female	99	..	116

Development diamond*

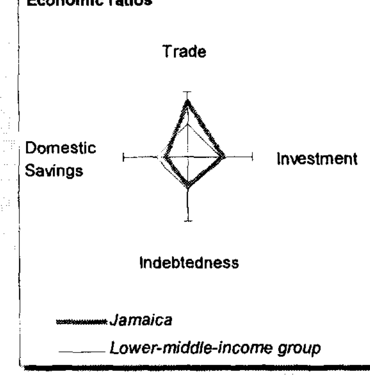


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1979	1989	1998	1999
GDP *(US$ billions)*	2.4	4.1	7.1	7.2
Gross domestic investment/GDP	19.2	28.5	29.0	29.6
Exports of goods and services/GDP	49.8	47.2	47.2	46.7
Gross domestic savings/GDP	18.4	19.0	21.9	20.6
Gross national savings/GDP	13.3	16.4	26.0	25.1
Current account balance/GDP	-5.8	-7.2	-3.0	-4.5
Interest payments/GDP	4.4	4.2	2.4	2.7
Total external debt/GDP	71.7	111.1	58.6	58.8
Total external debt service/exports	23.8	29.6	15.0	17.1
Present value of external debt/GDP	..	..	53.5	..
Present value of external debt/exports	..	..	106.5	..

	1979-89	1989-99	1998	1999	1999-03
(average annual growth)					
GDP	1.2	0.6	-0.5	0.0	2.5
GNP per capita	-0.6	0.6	0.1	-1.8	1.7
Exports of goods and services	4.0	0.1	7.9	-1.1	4.0

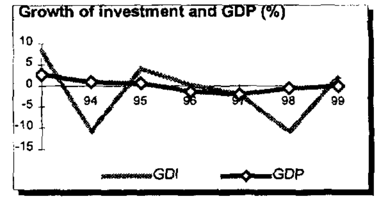
Economic ratios*



STRUCTURE of the ECONOMY

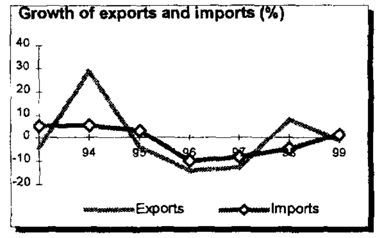
	1979	1989	1998	1999
(% of GDP at m.p.)				
Agriculture	7.2	6.9	7.1	6.9
Industry	40.3	42.7	29.8	27.7
Manufacturing	16.4	19.6	13.9	12.4
Services	52.5	50.4	51.6	49.6
Private consumption	62.3	67.0	60.4	62.3
General government consumption	19.3	14.1	18.6	17.4
Imports of goods and services	50.6	56.7	55.2	56.0

Growth of investment and GDP (%)



	1979-89	1989-99	1998	1999
(average annual growth)				
Agriculture	0.3	3.0	0.2	1.7
Industry	0.8	-0.2	-1.4	-0.1
Manufacturing	1.7	-1.8	-3.9	-0.9
Services	1.5	0.9	0.1	-0.1
Private consumption	3.5	-0.4	-7.7	3.2
General government consumption	5.2	-1.3	11.0	-6.8
Gross domestic investment	-1.1	4.6	-11.0	2.1
Imports of goods and services	7.7	0.0	-4.8	1.4
Gross national product	0.7	1.5	0.9	-1.0

Growth of exports and imports (%)

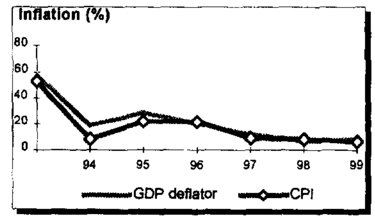


Note: 1999 data are preliminary estimates.

* 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.

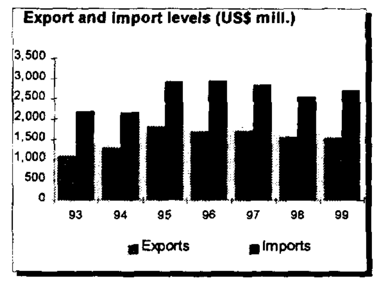
PRICES and GOVERNMENT FINANCE

	1979	1989	1998	1999
Domestic prices				
(% change)				
Consumer prices	28.7	23.8	8.1	6.3
Implicit GDP deflator	16.6	12.6	6.8	7.9
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	31.8	28.0	30.3
Current budget balance	..	5.6	-4.7	-2.4
Overall surplus/deficit	..	1.2	-7.3	-4.3



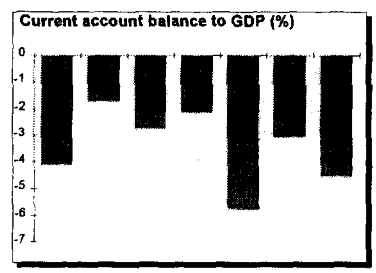
TRADE

	1979	1989	1998	1999
(US$ millions)				
Total exports (fob)	..	1,000	1,551	1,535
Alumina	..	475	588	672
Bauxite	..	111	83	48
Manufactures	..	69	43	44
Total imports (cif)	..	1,874	2,561	2,719
Food	..	160	280	328
Fuel and energy	..	274	293	429
Capital goods	..	565	516	472
Export price index *(1995=100)*	..	101	96	98
Import price index *(1995=100)*	..	85	112	116
Terms of trade *(1995=100)*	..	118	85	85



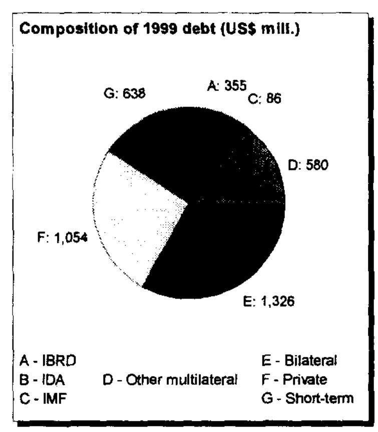
BALANCE of PAYMENTS

	1979	1989	1998	1999
(US$ millions)				
Exports of goods and services	1,165	1,941	3,353	3,366
Imports of goods and services	1,198	2,291	3,925	4,037
Resource balance	-32	-350	-572	-671
Net income	-187	-271	-283	-353
Net current transfers	80	323	638	698
Current account balance	-139	-298	-217	-326
Financing items (net)	-20	136	203	448
Changes in net reserves	159	161	14	-122
Memo:				
Reserves including gold *(US$ millions)*	..	..	700	801
Conversion rate *(DEC, local/US$)*	1.8	5.7	36.9	40.1



EXTERNAL DEBT and RESOURCE FLOWS

	1979	1989	1998	1999
(US$ millions)				
Total debt outstanding and disbursed	1,705	4,560	4,026	4,039
IBRD	127	650	410	355
IDA	0	0	0	0
Total debt service	302	643	537	614
IBRD	15	109	99	106
IDA	0	0	0	0
Composition of net resource flows				
Official grants	13	122	92	..
Official creditors	110	75	-144	-8
Private creditors	-39	-11	217	-73
Foreign direct investment	-26	57	369	..
Portfolio equity	0	0	0	..
World Bank program				
Commitments	60	75	0	0
Disbursements	19	52	31	25
Principal repayments	5	54	72	78
Net flows	15	-2	-41	-53
Interest payments	11	55	28	28
Net transfers	4	-57	-68	-81



ANNEX IX

Key Economic Indicators - Base Case Scenario

Indicator	Actual 1995/96	1996/97	1997/98	1998/99	Estimate 1999/00	2000/01	Projected 2001/02	2002/03	2003/04
National accounts (as % of GDP)									
Gross domestic product (factor cost)	100	100	100	100	100	100	100	100	100
Agriculture	9.1	8.4	8.0	8.0	8.2	8.3	8.3	8.5	8.6
Industry	38.8	36.8	35.4	33.7	32.8	33.0	32.4	32.3	32.1
Services	52.1	54.8	56.6	58.4	58.9	58.7	59.2	59.2	59.4
Total Consumption [a]	79.6	80.5	81.8	79.0	79.7	79.8	77.8	76.8	74.3
Gross domestic investment	31.8	32.3	32.4	29.0	29.6	30.0	30.5	31.0	32.4
Government investment	5.4	5.9	5.6	2.9	3.0	3.2	2.7	4.0	4.4
Private investment (includes increase in stocks)	26.4	26.4	26.8	26.1	26.6	26.8	27.7	26.9	28.1
Exports (GNFS)[b]	56.1	48.7	43.5	47.2	46.7	49.0	49.0	49.8	50.6
Imports (GNFS)	67.4	61.5	57.7	55.2	56.0	58.8	57.3	57.5	57.3
Gross domestic savings	25.0	24.3	22.7	21.9	20.6	20.2	22.2	23.2	25.7
Gross national savings[c]	30.0	30.7	27.7	26.0	25.1	25.2	25.1	25.6	27.9
Memorandum items									
Gross domestic product (US$ million at current prices)	5,239	5,864	6,653	7,109	7,210	7,376	7,761	8,161	8,574
GDP per capita (US$ at current prices)	2,077	2,310	2,605	2,760	2,775	2,815	2,938	3,066	3,198
Real annual growth rates (%, calculated from 1986 prices)									
Gross domestic product at market prices	0.7	-1.4	-2.1	-0.5	0.0	1.5	2.5	2.8	3.2
Real annual per capita growth rates (%, calculated from 1986 prices)									
Gross domestic product at market prices	-0.3	-2.0	-2.7	-1.4	-0.9	0.6	1.7	2.0	2.5
Total consumption	3.9	-0.9	-1.1	-4.7	0.0	0.5	0.7	1.3	-0.7
Private consumption	3.3	-3.9	-3.8	-8.5	2.3	1.5	2.1	1.7	-0.9
Balance of Payments (US$ millions)									
Exports (GNFS)[b]	3,435	3,369	3,399	3,353	3,366	3,615	3,804	4,060	4,339
Merchandise FOB	1,802	1,689	1,703	1,551	1,535	1,658	1,733	1,869	2,014
Imports (GNFS)[b]	3,807	3,888	4,080	3,925	4,037	4,337	4,450	4,696	4,916
Merchandise FOB	2,703	2,710	2,850	2,661	2,719	2,958	3,004	3,177	3,324
Resource balance	-372	-519	-681	-572	-671	-722	-645	-635	-577
Net current transfers	584	658	611	638	698	780	738	748	757
Current account balance	-123	-93	-386	-217	-326	-352	-415	-434	-392
Current account balance as % of GDP	**-2.3**	**-1.6**	**-5.8**	**-3.0**	**-4.5**	**-4.8**	**-5.4**	**-5.3**	**-4.6**
Net private foreign direct investment	88	104	169	309	249	365	319	350	367
Long-term loans (net)	-137	20	149	106	-81	262	232	-156	44
Official	-79	-175	-249	-144	23	38	11	-30	-24
Private	-57	195	398	251	-104	224	221	-127	68
Other capital (net, incl. errors & ommissions)	219	121	14	-213	281	15	25	25	25
Change in reserves [d]	-47	-152	53	14	-122	-290	-161	215	-44
Memorandum items									
Resource balance (% of GDP)	-7.1	-8.8	-10.2	-8.0	-9.3	-9.8	-8.3	-7.8	-6.7
Real annual growth rates (YR86 prices)									
Merchandise exports (FOB)	13.7	-6.9	-2.3	-7.2	-3.8	3.9	3.3	5.2	5.2
Primary	13.7	-5.3	2.0	-10.6	0.1	5.7	3.1	4.6	4.7
Manufactures	0.9	-13.3	-14.9	-4.2	4.7	6.4	6.2	5.8	5.2
Merchandise imports (CIF)	23.6	0.4	4.5	-1.4	-2.9	4.9	2.8	4.4	2.2

(Continued)

Key Economic Indicators
(Continued)

Indicator	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
	---------- Actual		----------		Estimate	---------	Projected		---------
Public finance (as % of GDP at market prices)[e]									
Current revenues (incl. grants)	31.4	28.6	27.7	28.0	30.3	32.7	30.5	30.2	29.8
Current expenditures	24.1	29.5	30.8	32.7	32.6	31.2	26.8	25.2	24.2
Current account surplus (+) or deficit (-)	7.3	-0.9	-3.1	-4.7	-2.4	1.5	3.7	5.0	5.6
Capital expenditure	6.1	6.2	5.5	2.9	2.9	3.2	2.7	4.0	4.4
Foreign financing	-2.0	-2.2	1.2	1.2	-1.8	2.7	2.9	-2.0	0.4
Monetary indicators									
M2/GDP	28.6	31.9	30.0	30.4	32.1	32.2	32.3	32.3	32.3
Growth of M2 (%)	24.4	31.8	2.5	11.9	16.4	8.8	10.0	9.0	8.1
Private sector credit growth / total credit growth (%)	197.7	23.4	-84.0	-68.3	-80.0	-75.9	77.4	19.9	40.7
Price indices(YR86 =100)									
Merchandise export price index	169.0	170.1	175.7	172.5	177.5	184.5	186.7	191.4	196.0
Merchandise import price index	141.4	141.9	131.2	119.5	130.7	157.9	156.6	158.6	162.0
Merchandise terms of trade index	119.5	119.9	133.9	144.3	135.8	116.9	119.3	120.7	121.0
Real exchange rate index[f]	1.08	1.35	1.45	1.48	1.42	1.42	1.42	1.42	1.42
Consumer price index (% change)	21.7	21.5	9.1	8.1	6.3	7.7	6.8	6.3	5.5
GDP deflator (% change)	25.2	17.7	10.5	6.8	7.9	6.8	6.6	5.8	4.9

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; negative denotes increase.
e. Budgetary central government.
f. An increase in the index denotes appreciation.

ANNEX X

Key Exposure Indicators - Base Case Scenario

Indicator	Actual				Estimate	Projected			
	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Total debt outstanding (TDO) (US$m) [a]	4,262	3,981	3,913	4,026	4,039	4,480	4,721	4,575	4,632
of which:									
Public and Publicly Guaranteed (PPG)	3,640	3,285	3,039	3,216	3,165	3,411	3,625	3,451	3,478
Short Term and Private Non-Guaranteed	622	695	874	810	875	1,069	1,096	1,124	1,153
Net disbursements (US$m) [a]	-122	-149	93	1	-70	245	215	-173	29
Total debt service (TDS; US$m) [a]	673	674	641	537	652	666	720	1,157	703
Debt and debt service indicators (%)									
TDO/XGNFS [b]	124.1	118.1	115.1	120.1	120.0	123.9	124.1	112.7	106.7
TDO/GDP [c]	91.7	63.8	59.8	58.6	58.8	62.0	62.0	56.9	54.4
PPG DOD/GDP [b,c]	78.3	52.6	46.5	46.8	46.0	47.2	47.6	42.9	40.9
TDS/XGNFS	19.6	20.0	18.9	16.0	19.4	18.4	18.9	28.5	16.2
PPG DS/XGNFS	18.5	18.8	17.4	14.4	17.9	15.7	16.4	26.1	13.9
Concessional/TDO	31.5	31.3	27.7	26.3	24.3	22.7	20.1	17.1	16.3
IBRD exposure indicators (%)									
IBRD DS/public DS	20.8	19.1	17.9	20.6	12.5	13.7	12.9	7.6	13.4
Preferred creditor DS/public DS (%)	50.8	44.3	42.0	40.2	32.1	38.0	37.5	22.3	37.9
IBRD DS/XGNFS	3.8	3.6	3.1	3.0	2.2	2.1	2.1	2.0	1.9
IBRD DOD (US$m) [d]	595	515	431	410	383	422	476	476	472
Share of IBRD portfolio (%)	0.5	0.5	0.4	0.4	0.3	0.3	0.3	0.3	0.3
IDA DOD (US$m)	0	0	0	0	0	0	0	0	0
IFC Commitments (US$m) [e]									
Loans	22.0	0.0	45.0	0.0	0.0	...	...	...	...
Equity and quasi-equity [f]	2.0	0.0	0.0	0.0	0.0	...	...	...	...
MIGA									
MIGA guarantees (US$m) [e]	42.2	38.4	0.0	0.0	0.0	...	...	...	...

Note: All debt and debt service data relate to external debt only

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

b. "XGNFS" denotes exports of goods and non-factor services.
"TDO" comprises PPG, Private Non-Guaranteed, and Short Term debt.
"DOD" denotes Debt Outstanding and Disbursed

c. External debt converted at end-period exchange rate.

d. Includes present value of guarantees.

e. World Bank fiscal year.

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