



BANKING REGULATIONS DESIGNED TO PREVENT FAILURE OF THE BANKING SECTOR POST FINSAC

During the 1970's to the early 1980's, the legal regulatory framework permitted formation of merchant banks and building societies with much ease. The firewall between banking, insurance, money management and other financial services was eroded, giving rise to "groups" of companies. These groups often comprised an insurance company, commercial bank, merchant bank, building society and perhaps a mutual fund or unit trust.

The state of affairs encouraged laxity in decision making, reliance on too highly leveraged operations and too many intra-group loan accommodations. By mid 1996 the indigenous financial services sector collapsed. The following features were common among the failed financial institutions:

- failure to comply with proper internal control procedures;
- poor risk management and inadequate portfolio diversification;
- poor quality of management and strategic planning;
- failure to exercise due diligence and care;
- unusually high risk appetite;
- a high incidence of connected party lending; and
- breach of directors' fiduciary duties and fraud.

In 1997 the Financial Services Adjustment Company Limited (FINSAC) was formed by the government to intervene, rehabilitate and dispose of elements of the financial services sector that would, in the normal course of operations be unprofitable. Additionally, amendments were made to existing pieces of legislation and, in some instances, entirely new pieces of legislation were introduced. The objective of the new regulatory framework was to improve the soundness and reliability of the Jamaican financial system by increasing levels of probity, market discipline and better risk management.

The Legal Framework in the Post FINSAC era

Commercial banks, merchant banks, investment companies and firms, building societies and credit unions are supervised by the Bank of Jamaica and Financial Services Commission.

The legal regulatory framework for banks and other financial institutions includes:

The Banking Act for the regulation of commercial banks;

The Financial Institutions Act for the regulation of merchant banks and other licensees under the Act;

The Building Societies Act for the regulation of building societies

The Securities Act for the regulation of securities dealers, investment advisers and other licensees under the Act.

The Co-operative Societies Act for the regulation of credit unions.

The Bank of Jamaica also supervises the following money service businesses: cambios, bureau de change and remittance companies. The Proceeds of Crime Act introduced more stringent requirements in relation to effective monitoring and prosecution of money laundering through the financial sector.

The legislative framework designed to promote an effective and reliable financial sector includes several mandatory requirements that affect the operations of banks and other financial institutions. Under the Financial Institutions Act, merchant banks and other licensees are required to adhere to the following standards:

1. Capital Base: At least \$25,000,000
 2. Maximum Deposit Liabilities: 20 x Capital Base
 3. Limits on Lending Operations such as:
 - unsecured lending to connected persons except employees - not allowed;
 - unsecured credit to an employee - 1 year's emoluments;
 - unsecured credit to any individual or entity – not exceeding 5% of Capital Base;
 - unsecured credit to a connected group of companies – not exceeding 10% of Capital Base;
 - secured credit to any individual or entity – not exceeding 20% of Capital base; and
 - secured credit in aggregate to any group of companies – not exceeding 40% of Capital Base.
 4. Capital to assets ratio:
 - Capital Base to Total Assets – (Benchmark 6%)
 - Fixed Assets at Historical Cost to Capital Base – Maximum 1:1, i.e. not exceeding 100%
 5. Cash Reserve: At least 5% x Prescribed Liabilities
- The Banking Act requires that commercial banks adhere to the following:
1. Capital Base: Local bank - At least \$80,000,000
Foreign Bank - At least J\$250,000,000
 2. Maximum Deposit Liabilities: 25 x Capital Base
 3. Limits on Lending Operations such as:
 - unsecured credit to connected persons, except employees – not allowed;
 - unsecured credit to an employee - 1 year's emoluments;
 - unsecured credit to any firm or corporation which holds 20% or more of bank's capital;
 - unsecured credit to any firm or corporation in which the bank or a connected person has an interest as a partner;
 - unsecured credit to a shareholder holding or controlling 20% or more of the voting shares;
 - unsecured credit to any person who holds or controls 20% or more of the bank's shares; and
 - unsecured credit to any firm or corporation if the credit facilities are guaranteed by a connected person who in relation to that firm or corporation has an interest as a partner, or holds or controls 20% or more of the voting shares.
 4. Cash Reserve: At least 5% x Prescribed Liabilities
- Recent Supervisory Developments - Basel II

In June 2004, the Basel Committee of Banking Supervisors issued the New Capital Accord commonly referred to as Basel II. This is a revised framework for the computation of capital adequacy for internationally active banks and was being promoted for adoption by all G-10 member countries by 2007. The primary objective of this new Accord is to introduce a more risk sensitive capital requirement and by so doing, promote stronger risk management practices within the banking industry.

The Bank of Jamaica will be adopting Basel II under a four phased approach ending in full implementation by 2010.

Conclusion

The introduction of stringent regulatory monitoring and controls by the respective agencies subsequent to the financial markets meltdown in the 1990's provide the appropriate guidance and framework under which sound banking practices are enforced.

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