The Essential Elements of Financial Sector Stability and Sustainability. The Jamaican Context

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FINSAC was established by Government to effect are structuring of the financial sector following a collapse of a number of financial institutions. It is estimated that by 2002 it should complete its work, and divest itself of the assets taken over.

Our recent experience in the financial sector has resulted in many commentators and analysts seeking to determine the true causes of our past financial sector instability. A lot has been said on this subject and FINSAC (Financial Sector Adjustment Company of Jamaica) representatives have on many occasions both formally and informally articulated our own point of view. One thing is clear however, and it is that given the economic costs and social fallout of this experience we must endeavor to ensure that it never happens again.

It is against the background of this wish and the desire to minimize the chance of any recurrence that I wish to examine with you and present a point of view on what I consider the "Essential Elements of Financial Sector Stability".

I hope through this dissertation to outline to you the prerequisites of safe and sound financial system for Jamaica. It is my sincere belief that the adaptation of the suggestions made below will insist in preventing the recurrence of any major financial crisis in the future.

I will break my presentation in two segments. I will first examine the requirements for a sound financial system at the microeconomic level (that is the firm level) and secondly, focus on the macroeconomic requirements. Naturally there are points of overlap between the two.

Firstly, in financial institution management, as in any other business venture, one of the most essential requirements for success is sound management.

A well trained, properly oriented and highly motivated management team is critical in ensuring and maintaining financial viability of an institution. It is not sufficient for management to be able to perform only when things are going well. One of the responsibilities of management must be guiding and charting a safe course for their organizations during challenging times. <u>Management must therefore understand and be able to effectively manage all areas of the bank or insurance company</u>. Financial institutions must ensure that persons appointed to senior management have the requisite skill, knowledge, temperament and character to ensure proper conduct and a meaningful contribution to the company's affairs.

I would suggest that in terms of identifying the critical success factors a special focus be given to treasury – asset and liability management, risk management, technology and operations and human resource management. These are some of the areas where we have spent a lot of time assisting the institutions which were intervened by FINSAC.

Any consideration of management must also be geared towards ensuring that they meet and maintain the "fit and proper" standards established by our regulators. The guardians of our financial assets must be able to demonstrate a track record of honesty and good judgement.

Our financial institutions must also be properly capitalized. Adequate capitalization is essential for the maintenance and performance of financial institutions, particularly banks and insurance companies. these institutions are by their nature highly leveraged, thus requiring the buffer of capital to support the asset and liability portfolios and provide a cushion against any losses.

Jamaica's banking regulations require a minimum capital to risk assets ration of 10% in keeping with the Basle standard. The methodology adopted primarily uses the risk weighting of assets to determine capital adequacy.

The draft of the proposed new Insurance Act also establishes a new methodology and new requirements for the capitalization of those entities. The basis being promulgated is the MCCSR, which takes into account the risk asset profile of the business and cash flow considerations. These are important developments in ensuring financial stability going forward.

Another important agenda item for financial sector stability is the implementation of an appropriate corporate governance regime for each institution. I believe that many of the difficulties we have recently experienced could have been avoided if the boards of companies had played a more proactive role in the affairs of their organizations and acted in accordance with the standards imposed by the law.

Too often we hear the question being asked, "where were the directors?"

The implementation of appropriate corporate governance arrangements is a high priority in many financially sophisticated countries as well as some of those who have recently suffered from severe crises. Some such as Malaysia, South Africa and Hong Kong have taken the matter further than Moral suasion and mandated through legislation minimum standards of operating performance for directors and senior management.

The major points of my presentation this far have been focused on delineating those considerations at the institutional level, which impact performance and ultimately viability. I will focus on some issues at the macro-economic or policy level which are important influences on the viability of firms and the financial sector as a whole.

At this level one of the most important requirements is an effective, legal, regulatory and supervisory framework.

Not only should this framework allow for the effective monitoring and supervision of institutions; but it should also have checks and balances to ensure that regulations do not create incentives for perverse behavior by firms.

It is also important given the plethora of institutions and the interconnectedness within the industry that there is an effective coordinating arrangement between the various regulators.

Through this mechanism, attempts at regulatory arbitrage can be easily identified and the maintenance of a level playing field can be more easily achieved.

It is important for our regulations to ensure that a proper competitive framework/environment is created to ensure a level playing field and encourage financial prudence on the part of the individual players.

Having regard to the forgoing, I would suggest that regulators need to focus on the following:

(a) Capital Adequacy and the appropriateness of the risk weighting categories utilized.

(b) The appropriateness of the risk culture and risk assessment methodologies employed by the firms within the industry.

(c) Limiting closely monitoring insider lending.

(d) Asset valuation criteria focussing on asset quality and the appropriateness of the asset mix.

(e) The implementation of effective accounting and disclosure rules.

(f) The liquidity of the organization.

(g) The role and accountability of external auditors.

(h) The competent handling of banking or institutional failures where these occur

(i) Developing and maintaining the capacity to properly monitor and regulate new product issues.

(j) Understanding the nature of competition within the industry

(k) Ensuring that the major players in the sector are managed by fit and proper persons.

(l) Developing and implementing mechanisms for effective interagency cooperation on issues of regulation and supervision.

I know that some of these are prescribed in the recent amendments to the Banking Act, however they are of critical importance to tonight's main topic of financial sector stability, and are worthy of mention.

Also, closely aligned to the issue of regulatory and supervisory legislation is the need to promulgate commercial legislation that enables lenders to impose discipline quickly and efficiently on recalcitrant borrowers.

A stable macro-economic environment is also important for the maintenance of financial stability. Prudent monetary and fiscal policy is important in avoiding speculative bubbles. So are economic reforms that facilitate the creation of an environment <u>where real interest rates can be low and stable, and growth can be achieved, is key in maintaining long term stability in the sector.</u>

In the beginning, FINSAC's intervention was a means of stabilizing the financial sector. Another important role for FINSAC will be its approach to the divestment of core financial institutions. This needs to be done in a way that will in maintain and build on the stability we have achieved.

How will this be done?

As we at FINSAC focus over the next year on the divestment of some of our larger financial sector holdings, we intend to ensure their sale to institutions and persons that are:

- fit and proper
- have deep pockets
- and have the ability to properly capitalize the institutions.

In other words, divestment of FINSAC entities to solid, stable, well-run organizations will be an essential component of the wind-down phase of FINSAC.

In closing, I would like to say that FINSAC is committed to ensuring that we play our part through our suggestions, recommendations and actions in the industry, in the interest of maintaining a safe and sound financial sector for Jamaica.

This paper was submitted by member Joe Bailey, Secretary General, CASHFI – Caribbean Association of Housing Finance Institutions.