ABSTRACT

At present, it is widely accepted that a well-developed, liberalized financial sector contributes significantly to a country's economic development (e.g., Mc Kinnon, 1973; King and Levine, 1993). Empirical work has show that this economic development occurs under specific conditions. These include the presence of a regulatory authority imbued with sound executing powers; clear and universally applied accounting standards and auditing practices; and a competitive banking industry that is more privately owned, significantly foreign owned, than government owned and controlled (Wachtel, 2001a). This paper examines the extent to which these conditions existed in Jamaica before its 1997 financial crisis. It also attempts to ascertain the prospects for the recurrence of another financial crisis. This paper suggests that if Jamaica is to avoid such a recurrence, policy makers need to urgently address several key issues. They are the need to ensure that policies are implemented, which do not adversely affect the liquidity of commercial banks; a re-examination of the capital requirements imposed on commercial banks by the Bank of Jamaica; the establishment of a clear and realistic time frame for the submission of the consolidated accounts of holding companies; and the continuous monitoring of the performance of shareholders of commercial banks.

1. Introduction

` It is at present widely accepted that a well-developed, liberalized financial sector - banks and capital markets - contributes significantly to a country's economic development (e.g., McKinnon, 1973; King and Levine, 1993). Recent empirical work has demonstrated that this economic development only occurs under specific conditions. These include a country possessing a regulatory authority with sound executing powers; clear and universally applied accounting standards and auditing practices; a legal framework for debtor-client relationships; and a competitive banking industry that is more privately owned, significantly foreign-owned, than government owned and controlled (Wachtel, 2001a). This paper examines the extent to which these conditions exist in the banking industry of Jamaica. To this end, it examines the evolution of commercial banking in Jamaica, chronicling the factors leading to the collapse of the financial sector in 1997. It also attempts to recommend policies to prevent its recurrence.

This paper is organized as follows: Section 2 discusses the extant literature on financial sector development and economic growth while Section 3 chronicles the history of commercial banking in Jamaica. Section 4 analyzes the factors contributing to the near-collapse of the banking sector in 1997. This section is based on interviews held with key industry leaders as well as the experience of one of the authors, who was actively involved in institutions that were affected by the financial crisis. Section 5 advances policy prescriptions to prevent the occurrence of another financial crisis, while the final section presents the conclusion.

2. Financial Sector Development and Economic Growth

It is now widely accepted that a well-developed, market-oriented financial sector plays a critical role in a country's economic development (e.g., McKinnon, 1973; King and Levine, 1993; Wachtel, 2001a). In fact, the theoretical link between financial sector development and economic growth can be traced to the work of Schumpeter (1911), who examined the services provided by financial intermediaries and postulated that they were critical for innovation and development. The work of later researchers attempted to ascertain the manner in which the development of the financial sector facilitates economic growth.

Wachtel (2001a) notes that the financial sector mainly functions to channel resources from savers to productive investment projects. A well-developed financial sector thus facilitates the improved efficiency in the mobilization and allocation of financial resources. It also encourages savings thereby resulting in greater capital formation, and thus, economic growth.[1] All in all, a well-developed financial sector facilitates the more productive allocation of financial resources.

The financial sector aids the efficiency of resource allocation in a country in several ways (*ibid.*). This sector enhances the screening of fund-seekers and the monitoring of fund-recipients. It also assists the mobilization of savings by providing attractive instruments and saving vehicles, and in so doing, increases the rate of savings. Further, the economies of scale achieved in financial institutions through their ability to consolidate small pools of private savings, not only results in a reduction in the costs of project evaluation and origination, but also facilitates the monitoring of projects through corporate governance. Lastly, financial intermediaries provide opportunities for risk

management and liquidity by promoting the development of markets and instruments with characteristics that facilitate risk sharing.

Yet, these efficiency-enhancing benefits are only realized in a fully liberalized financial sector. There seems to be an inexorable link between financial sector liberalization and investment efficiency, and thus, economic growth. Indeed, McKinnon defined economic development as:

> ….the reduction of the great dispersion in social rates of return to existing and new investments under domestic entrepreneurial control (McKinnon, 1973, p. 9 cited in Balassa 1990).

There are various means through which financial liberalization improves investment efficiency. These include a reduction in the self-investment at low and even negative rates of return; the rationing of loans by the interest rates instead of public authorities; the movement away from excessively capital intensive investments, the avoidance of excessive overbuilding by banks; and the lengthening of financial markets (Balassa, 1990).

It was researchers such as Bekaert and Harvey (2001) and Levine (2001), however, who made the direct connection between financial liberalization and economic growth. Bekaert and Harvey (2001) posit that financial liberalization positively influences economic growth in several ways. First, the foreign investor, capturing the benefits of global diversification, will increase the local equity prices permanently, thereby reducing the cost of capital. Secondly, financial liberalization results in an increase in investment. If this additional investment is efficient, then economic growth occurs. Lastly, international investors may demand better corporate governance to protect their investment, resulting in a reduction in the gap between external and internal

financial capital, and hence further increases in investment. Additionally, Levine (2001) *inter alia* notes that allowing the increased presence of foreign banks tends to enhance the efficiency of the domestic banking system. He argues that well-developed domestic banks facilitate economic growth primarily by accelerating productivity growth.

However, there are certain conditions that need to be fulfilled before financial liberalization (Balassa, 1990). Most importantly, inflation must be controlled since high and variable rates make both borrowers and banks extremely vulnerable. Further, there is need to establish an efficient regulatory agency to ensure that banks do not undertake unduly risky investments. Balassa further notes that there is need to establish "appropriate capital and reserve requirements to limit the proportion of the banks' portfolio that could be lent to any one borrower, and to make detailed inspection of the quality of banks' portfolios" (*ibid*., p. 66).

It is now widely accepted that financial liberalization rather than financial repression is more amenable to investment efficiency and thus, economic growth. However, the features of the liberalized financial sector and environment that facilitate the efficient operations of financial intermediaries are still under empirical investigation. Recent empirical literature has identified several key characteristics of this environment, and empirically shown their relationship to economic growth.[2]

It seems that clear and universally applied accounting standards and auditing practices, and a legal framework for debtor-creditor relationships are those aspects of the financial environment that encourage the efficient operations of financial intermediaries. These features of the financial environment facilitate the provision of more reliable information for decision-making by intermediaries and increase confidence in financial

contracting. Work by Levine *et al*. (2000) found that countries with better creditor rights, more rigorous enforcement systems and better accounting information had more developed financial intermediaries. Growth prospects are enhanced since a sound legal environment facilitates the development of financial intermediation.

In addition, there are certain characteristics in the structure of the banking industry that are conducive to economic growth. It appears that a banking industry, which is more competitive and less concentrated, may successfully target industries that are in need of external financial support and promote the growth of younger firms (Cetorelli and Gambera, 2001). Further, La Porta *et al*. (2002) found that a banking industry, which is more privately owned than government controlled or owned, enhances economic growth. La Porta *et al*. (2002) note that higher initial government bank ownership is associated with slower subsequent financial development, and lower growth of per capita income and productivity. Moreover, Wachtel (2001b) postulates that more foreign as opposed to local participation significantly facilitates economic growth and stability.

From the foregoing analysis, it appears that a well-developed, liberalized financial sector does result in economic development. However, as researchers such as Balassa (1990) caution, there are certain conditions that must be met before financial liberalization. Further, recent work by researchers such as La Porta *et al*. (2002) and Cetorelli and Gambera (2001) reveal that there are specific features of this liberalized financial sector, which are more conducive to economic growth. These include clear and universally applied accounting standards and auditing practices, and a legal framework for debtor-creditor relationships; a banking industry that is more competitive and less

concentrated; more privately owned and controlled; and has higher levels of foreign as opposed to local participation.

The following sections will analyze the extent to which the liberalized banking industry of Jamaica shared these stylized features. However, this analysis will be preceded with an examination of the history of commercial banking in Jamaica.

3. The History of Commercial Banking in Jamaica

The Pre-Independence Period, 1836 to 1961

Commercial banking began in Jamaica as early as 1836. British merchants, who had business interests in the country, established the Bank of Jamaica under charter from the Jamaican House of Assembly. This bank was closely associated with the sugar industry, and thus failed in 1864 with its decline.

The next century witnessed a wave of foreign banks being established in Jamaica. For example, the Colonial Bank commenced operations in 1837, one year after its incorporation in England. The main feature of this bank was that it became the first institution in Jamaica to introduce its own bank notes. In 1925, it merged with Barclays Bank and was renamed Barclays Bank DCO. The entry of Colonial Bank into Jamaica was swiftly followed by the short-lived Planters Bank in 1839. This Bank, which also issued its own bank notes, ceased operations in 1848.

This period was also marked by the entry of the Canadian banks into Jamaica. Their presence was mainly a result of the growing trade between Canada and Jamaica. The Bank of Nova Scotia, which began operations in Jamaica in 1889, was the first Canadian bank to enter the country. Its investment in the banking industry of Jamaica

was soon imitated by the Royal Bank of Canada in 1911 and the Canadian Imperial Bank of Commerce in 1920. It is noteworthy that the American banks entered the industry at a much later period. The first American bank to commence operations in Jamaica was the First National City Bank (now known as Citibank N.A.) in 1960. This period also witnessed the entry of the first government-owned bank: the Government Savings Bank, whose operations were later transferred to the postal service, was established in 1870.

Other features of this period included the 1904 passage of the Bank Notes Law, which authorized the issuance of Government notes up to 10 shillings. This law also established the Board of Commissioners, which was responsible for issuing the currency notes. The notes issued by the private banks, operating in Jamaica during this period, continued to be legal tender until 1940 when they were demonetized.

During these early years, monetary policy was passive. From the period of World War II to the 1960s, a currency board established under the 1939 Currency Notes Law dictated monetary policy, with the British pound used as the reserve currency (King, 2001). In addition, at this time, all commercial banks operating in the country were branches of foreign banks and their policies "in the absence of a central bank were determined primarily by their head offices overseas" (Lue Lim, 1991). A central bank, the Bank of Jamaica, was later established in 1960. Yet, its activities during these early years were limited to the maintenance of the external equilibrium of the currency. King (2001, p.6) notes that even after the dissolution of the currency board, the main role of the Bank of Jamaica continued to be maintaining the integrity of the exchange rate with the pound.

Further, while the central bank was authorized to inspect commercial banks under the 1960 Banking Law, it was not until the late 1960s that many of the commercial banks became incorporated locally as shown in Table 1. At the time of local incorporation, a percentage of the ownership of these institutions was sold to local investors, but ownership largely remained in the hands of foreign entities. Thus, despite the power of inspection conveyed to the Bank of Jamaica under the 1960 Bank Law, in reality, the policies of many of the foreign commercial banks operating in the country were still externally dictated.

PUT TABLE 1 HERE

The Years of Financial Repression, 1972 to 1991

The years, 1972 to 1980 ushered the advent of a new regime, the populist Manley administration in Jamaica. It also saw a dramatic reversal of the earlier government's policy of passive monetary policy. The Manley government, with its new ideology of state populism, sought to control the commanding heights of the economy. This control was also extended to the financial sector where significant portions of this sector came into government hands. For example, in 1973, the former Government Savings Bank was transformed into a commercial bank. In addition, in 1977, the largest existing commercial bank, Barclays Bank DCO was acquired by the government, and renamed the National Commercial Bank.

This regime also implemented highly stringent policies in the financial sector. Indeed, King (2001, p. 14) noted: "during the 1970s and 1980s, the Jamaican economy

was constrained by one of the more repressed financial sectors in the Caribbean." Restrictions were imposed on interest rates on savings deposits and lending as well as on the terms of various types of credit transactions. Quantitative credit controls were also employed, and reserve ratios were repressively high.

Interestingly enough, the restrictions on the financial sector were heightened by the Seaga administration that replaced the Manley regime in 1980. While the ideologies of these political parties differ: the Seaga regime that was in power from 1980 to 1989, adopted a philosophy of dependent capitalism, which represented "a pragmatically guided, state-directed development" (King, 2001, p.10), their policies related to financial sector development were distinctly the same. Hence, for example, in 1984, ceilings were placed on the issuance of private sector credit and the cash reserve ratio on commercial banks deposits was increased. Furthermore, in the following year, commercial credit by the commercial banks was frozen at existing levels. The only financial intermediary exempted from this policy was the government's development bank. In addition, during the years, 1984 to 1987, credit ceilings were imposed on trust houses, merchant banks and financial houses.

These restrictive measures continued into the late 1980s. King (2001) notes that in 1986, the cash reserve ratio was increased from 15 to 20 percent. Further, this period was marked by "several and frequent" changes to the interest rates that the central bank established for savings deposits and prime lending.

It was also noteworthy that during this period, institutions without any prior history in commercial banking became involved in this financial intermediary activity. In 1981, the First National Bank of Chicago was acquired by Jamaica National Building

Society; in 1984, the Royal Bank of Canada was purchased by Jamaica Mutual Life Assurance Society; and in 1986, the Century National Bank was acquired by local investors. Further, in 1988, the Eagle Commercial Bank was established by a wholly owned local merchant bank. Similar developments also occurred with the establishment of merchant banks. For example, in 1984 Blaise Trust was acquired by local entrepreneurs; in 1987 Partner Finance was set up by local entrepreneurs; and in 1989, Corporate Merchant Bank was established by the new owners of Workers Savings and Loan bank.

Financial Liberalization

It is important to note that the period of financial repression of the late 1980s actually coincided with initial attempts at financial liberalization. The first financial reform program was initiated in Jamaica in 1986 to 1988 as part of the structural adjustment loan agreement with the World Bank. The reform of the interest rate policies and the development of money and capital markets were the two areas of focus (Kirkpatrick and Tennant, 2002). To this end, credit controls were removed and the statutory reserve requirement was gradually reduced from 48 percent to 20 percent (Lue Lim, 1991). Further, the National Commercial Bank was privatized in 1986. However, the government maintained a significant shareholding (39 per cent) in this entity. Attempts to reform interest rate policies were realized by the introduction of an auction of Bank of Jamaica certificates of deposits.

Interestingly, there was a reversal of these liberalization policies in the late 1980s. The reasons for this reversal are myriad: the significant capital inflows arising from the

reinsurance claims from the 1988 Hurricane Gilbert resulted in increased bank liquidity (Kirkpatrick and Tennant, 2002). In addition, the increased fiscal expenditure arising from the 1989 general election (recurrent expenditure increased by 12 percent during the fiscal year 1989 to 1990) resulted in further increases in bank liquidity. Finally, it is argued that downward movements in the exchange rate (the Jamaican dollar devalued by 13 percent from August to December 1989) gave policy makers no option but to return to the repressive interest rate policies of the 1970s and 1980s.

The second phase of the liberalization of the financial sector began in the late 1990 and early 1991. Under imperatives of the International Monetary Fund (IMF), the use of quantitative credit controls such as credit ceilings ceased. Further, the ceilings on savings deposits along with other restrictions on consumer credit were lifted. Savings rates were totally deregulated, with commercial banks given the autonomy to set their own rates. At the same time, banks were initially allowed to hold foreign exchange savings accounts and keep a portion of their foreign exchange purchases. By 1991, foreign exchange controls were totally removed. Ironically, however, both the cash reserve ratio and liquid assets ratio once more resumed their upward climb. The cash reserve ratio increased from a low of 19 percent in 1991 to 25 percent by 1992. At the same time, the liquid asset ratio of commercial banks climbed from 20 percent in 1989 to 50 percent in 1992, where it remained until 1995 (See Table 2).

PUT TABLE 2

The Immediate Years following Financial Liberalization, 1991 to 1997

The most dramatic effect of financial liberalization in Jamaica was the unprecedented increase in the size and scope of the financial sector. By 1992, there were 12 commercial banks; a 33 percent increase from 1980. The rate of growth of merchant banks and building societies over the years, 1986 to 1996 was phenomenal. The number of merchant banks tripled while there was a six-fold increase in the number of building societies (Planning Institute of Jamaica, 1998).

Another feature of this period was the implementation of a new banking act, the Banking Act, 1992. The implementation of this Act had multiple effects on the financial sector. It increased the (nominal) capital requirements of commercial banks. It also prescribed the accounting policy, specifically for loans, which should be adopted by all commercial banks. In addition, it increased the limit of commercial banks' investment in fixed assets and related companies. Finally, it increased the regulatory powers of the Central Bank and the Minister of Finance.

Financial liberalization was also accompanied by significant increases in activity on the stock exchange. At the end of 1990, the stock exchange index was 2,539. By January 1993, it had increased by 1,176 percent to an astonishing 32,421 (Bank of Jamaica, Statistical Digest, February 1994). Interestingly enough, many non-bank financial intermediaries such as insurance companies, which owned commercial banks, were active participants in the stock market with their equity-linked products.

Yet, all was not well. By July 1996, the stock exchange market had lost 60 percent of its value, dropping from its peak of 32,421 in January 1993 to 12,847 (Bank of Jamaica, Statistical Digest, June 1997). The effect on commercial banks was two-fold.

First, in instances where stocks and shares were used as collateral for loans, more than 60 percent of the value of this collateral was lost. Secondly, in the insurance companies that had offered equity-linked policies, there was a rush by clients to encash these policies to prevent further deterioration in their investment. The insurance companies, which owned commercial banks, resorted to borrowing from the commercial banks to meet their cash shortage, thus creating liquidity problems in the commercial banks. These events increased the solvency problems of the commercial banks, as they had to seek higher cost deposits, which negatively impacted on their profitability.

By 1996, the financial sector was clearly in crisis. This was demonstrated by the fact that at that time, the insurance companies had no recourse but to approach the Ministry of Finance for financial support (Kirkpatrick and Tennant, 2002). The difficulties faced by the insurance companies had a contagion effect on other financial intermediaries operating in the country (King, 2001; Kirkpatrick and Tennant, 2002). Evidently, public confidence in the financial sector was under threat. In its attempts to resolve this potential crisis, the government established the Financial Adjustment Sector Company (FINSAC) in 1997.

FINSAC adopted a three-phased approach that was to be implemented within 5 to 7 years. These three phases were intervention, rehabilitation and divestment. To this end, the measures employed by this institution involved the closure of insolvent banks, the merger of financial intermediaries, liquidity support, the purchase and later divestment of subsidiary holdings and real estate, financial support in the form of bonds issued in exchange for non-performing loans, and the acquisition of equity through the purchase of

shares. By late 1998, the cumulative costs of FINSAC's initiatives were estimated at 37 percent of the GDP (King, 2002; Kirkpatrick and Tennant, 2002).

One could attribute several factors as contributing to the 1997 financial crisis. These are as follows:

1. The management cadre at the commercial banks;
2. Improper banking practices;
3. Capital requirements of the commercial banks;
4. The interest rate regime; and
5. The role of the regulatory authority.

In the following section, we will discuss the role that each of these factors played in financial crisis.

4. The Factors Contributing to the 1997 Financial Crisis

4.1 The Management Cadre at the Commercial Banks

In the pre 1970 period, the foreign commercial banks operating in Jamaica all had comprehensive programs for worker training. All workers employed by these banks received on-the-job training. In addition, many middle and senior level workers were trained at overseas branches of the parent bank. Moreover, at times, senior level professionals with specialized skills were drawn from other overseas branches to work in the Jamaican subsidiary. The advantages of being part of an international network of banks also meant that if there were critical shortages of highly qualified staff in Jamaica, the local subsidiary could resort to hiring workers from other companies within the

network. These practices allowed for significant cross-fertilization of skills and inculcated operating practices that were of international standard.

With the unprecedented increase in the number of deposit-taking institutions during the years, 1984 to 1992, the demand for management workers with specialized training and experience in the banking industry soared. At the same time, there was a limited number of available trained staff since the foreign banks were unable to train the quantum of workers required by the growing needs of the industry in a timely manner. [3] In addition, the newly created, local financial intermediaries, which did not belong to an international network of banks, did not have ready access to a pool of highly qualified staff. Thus, they resorted to poaching workers from the foreign commercial banks or hiring inexperienced staff. Further, the newer, locally owned commercial banks did not place much emphasis on training as was the case of the foreign commercial banks. Their preoccupation was with merely securing an immediate supply of functioning workers. These factors all led to a dilution of managerial expertise in the financial system (Bussieres, 1995).

The period 1976-1996 also was marked by double-digit inflation (See Table 3). Thus, a generation of bank managers had emerged with the knowledge of operating only in an environment of high inflation. In this environment, the prevailing philosophy was that to protect one's wealth, mangers must hold hard assets, such as real estate. Hence, it was a normal banking practice to use real estate as collateral security for lending purposes. However, by 1996, the levels of inflation had dramatically declined with the accompanying decline in the real estate market. This not only meant that the banks

suffered from critical solvency problems, but also they possessed managerial workers who were inadequately trained to operate in the new low inflation environment.

PUT TABLE 3 HERE

In addition, there were problems at the directorate level of the newly created financial intermediaries. First, until 1992, the entry requirement for establishing a financial intermediary was low. For example, only J$ 20 million was required to set up a commercial bank, while J$ 200,000 was needed to establish a merchant bank. This low entry barrier facilitated the significant growth of these institutions in the pre-1992 period. Indeed, practically every 'significant group of companies' had their own financial intermediary.[4] More importantly, however, was that the main shareholder of these new companies solely determined the composition of the board of directors. In many instances, he chose individuals who were either employed in his own enterprise or persons with whom he was closely connected (See Table 4). This obviously impacted on the independence of the board of directors, who was legally responsible for overseeing the operations of the entity.

PUT TABLE 4

Secondly, given the limited availability of persons with the specialized training and experience in the banking industry, the unprecedented increase in the number of financial intermediaries also militated against them securing directors with an in-depth

understanding of the intricacies of banking. This meant that in a number of cases, the appointed board of directors was unable to give the requisite guidance to the newly created financial intermediary.

The cumulative effect of weak management was the lowering of the standards of banking practices in a number of local commercial banks. This issue will be discussed in the subsequent section.

4.2 Improper Banking Practices

In the pre 1992 period, all the foreign banks in Jamaica as well as the locally owned Mutual Security Bank adopted the international standard of ninety days for non-performing loans. This ninety-day standard meant that loans, in which interest payments were in arrears for more than ninety days, were classified as non-performing loans, and no longer earned income for the commercial bank. The effect of this was that profits were not overstated by income from non-performing loans. It also forced managers to take preemptive actions before the ninety-day deadline. This preemptive action ensured that the value of collateral security was maintained; facilitated frequent contact with clients; and became an objective measure by which managers could assess loan performance.

By contrast, during this period, the other locally owned banks in Jamaica adopted standards that varied from 1 year to over 2 years. This positively influenced their profitability by increasing their book profits despite the increase in the number of ‘non-performing loans’. The adoption of standards in excess of ninety days thus had negative effects on their liquidity.[5] Indeed, these liquidity problems often compelled the locally owned banks to seek high cost term-deposits to fund their operations.

It is significant to note that in 1992, the proposed Banking Act initially adopted the international standard of ninety days for non-performing loans. However, in response to the lobbying of local pressure groups, the Jamaican government compromised (Bussieres, 1995). The Banking Act, 1992 established a standard of 6 months for non-performing loans. However, this was later changed to the international standard of ninety days after the 1997 financial crisis.

Another lending practice, which affected some of the commercial banks was the over reliance on asset lending as opposed to cash flow lending.[6] With Jamaica having high inflation rates from 1976 to 1996 (See Table 3), the dominant thinking was that real assets such as real estate were the perfect hedge against inflation. In addition, as discussed in Section 3, the stock market soared by over 1000 percent during this period. Further, as was previously mentioned, the value of real estate escalated. Concomitantly, the quantum of private sector lending by commercial banks increased phenomenally. For example, in March 1990, private credit lending by commercial banks was J$ 7.2 billion; five years later this had risen almost five fold to J$ 32.5 billion and by March 1996, it was a remarkably J$ 45.9 billion (Bank of Jamaica, Statistical Digest, June 1997).

However, by the late 1990s, macroeconomic stability was partially restored: inflation rates dropped and exchange rates were stabilized (See Table 5). Moreover, the real estate market collapsed. The lack of demand for real estate made most of the asset-based loans unviable, and in a number of cases, banks were left with worthless assets to recover loan balances (Table 6). These developments coupled with the prevailing high interest rates adversely affected the profitability of a number of commercial banks. The

high level of non-performing loans also created a liquidity crisis in many of the local commercial banks, which no recourse but to seek high cost, term-deposits.

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The third banking practice, which later proved to be problematic, centered on the 1991-1992 debate on the use of the Euro-Japanese commercial banking model as opposed to the Anglo-American one. The Anglo-American model stipulates that banks should engage only in traditional banking activities, while the Euro-Japanese model allowed for commercial banks to invest equity in other industries.

The Euro-Japanese model was implemented in Jamaica during this period. In fact, the pre 1992 Banking Act allowed banks to invest up to 40 percent of their capital in non-financial investments. This stipulation was changed by the 1992 Banking Act, which allowed commercial banks to invest as much as 100 percent of their statutory capital in non-banking activities. Further, the 1992 Act also allowed them to invest a maximum of 100 percent of their statutory capital in fixed assets, which do not earn income. This therefore meant that if a bank were to invest the equivalent of its capital in non-banking investments, then its total investments in both non-banking activities and fixed assets would have comprised more than 100 percent of its statutory capital. Thus, investments would have been made out of depositors' funds.

Some local bank owners were therefore of the perception that it was perfectly legal to use depositors' funds for non-bank investment activities. After all, they were no longer margin gatherers[7] as was the traditional banking practice, but investors. However,

with a limit of 20 percent of statutory capital imposed on any single investment, these commercial banks needed to have a multiple of investments in order to maximize investment potential. The quantum of investment needed to be managed, evidently posed further challenges to the managerial skills of workers in the local commercial banks.

In addition, most local commercial banks adopted a model of a holding company, where the commercial bank was the main subsidiary providing equity to the other companies within the group. This model implied that the commercial bank had to generate sufficient capital to fund its own operations *as well as* those of its affiliated companies. This obviously increased the challenges faced by the bank. It not only had to be profitability for its own sake but also for the viability of its other companies.

However, many of these companies incurred losses. As their losses mounted, so did their level of borrowings from their affiliated commercial bank. This situation was also was aggravated by the prevailing high interest rates. When the borrowing limits established by the 1992 Banking Act were reached, off-balance sheet funding was then used. It seems that the prevailing perception was that if an affiliated company, which was managed by the commercial bankers were seen to fail, it would reflect adversely on the entrepreneurial skills of these bankers. Thus, affiliated companies were allowed to remain in operation despite their escalating losses.

4.3 Capital Requirements of the Commercial Banks

The main purpose of capital in commercial banks is to provide liquidity and to act as buffer against potential losses. In recognition of this, the 1960 Banking Act and its subsequent amendments required commercial banks to hold capital of J$ 20 million.

However, by 1992, it was clear that this capital requirement was inadequate. Hence, the 1992 Banking Act increased the capital requirements to J$ 80 million for local commercial banks and to J$ 250 million for foreign commercial banks. Further, to ensure that liquidity was maintained, the Act also required that at least J$ 60 million be paid in cash.

As was discussed in the previous section, in the post 1992 period, commercial banks were permitted to engage in non-banking activities and to acquire fixed assets up to a maximum of 200 percent of their statutory capital. Interestingly, these activities formed the "capital requirements" imposed on the banking industry under the 1992 Banking Act. Yet, as earlier mentioned, the purpose of capital is to provide liquidity and to act as a buffer against potential losses. This was not realized in the post 1992 period. The use of non-banking investments and fixed assets as part of statutory capital negated the stated purpose of capital. Hence, these commercial banks did not have the requisite capital to provide liquidity support or to act as a buffer against potential losses. The commercial banks thus had no recourse but to use customers' deposits to meet even their operational expenses.

The 1992 Banking Act also universally applied its principle of capital requirements. No distinction was made between long established commercial banks and new entrants. Further, this Act allowed commercial banks to take deposits up to 25 times their statutory capital. New, less experienced commercial banks were therefore permitted to undertake risks as great as the long established ones. These actions only heightened the vulnerability of the banking industry to potential collapse.

4.4 The Interest Rate Regime

As discussed in Section 3, during the period 1992 to 1995, the Bank of Jamaica used the mechanism of a high liquid asset ratio together with a high cash reserve ratio as tools of monetary policy. The high liquid asset ratio required a significant spread between interest earned on loans and interest costs on deposits for commercial banks to merely recover their costs incurred on deposits. This situation drove the weaker commercial banks, with higher deposit costs to seek clients, who were willing to pay a high rate of interest on their borrowings. Simultaneously, the Bank of Jamaica employed a regime of high interest rates. The implementation of a high interest rate policy regime together with the high liquid asset ratio during this period simply exacerbated the solvency and liquidity problems of the commercial banks, and increased the vulnerability of the banking sector to potential collapse. The weaker banks were particularly prone to failure since they were forced to lend at even higher rates[8] but possessed weaker clients, who were the first to become non-performers.

The banking sector was indeed vulnerable to collapse. First, the rate of increase in the interest rates was much greater than the rate of appreciation of the value of the collateral held by the commercial banks. In a number of cases, the value of this collateral was declining because of the combined effects of the decline in the stock market, the fall in real estate values, and the lowering of inflation rates. Thus, the value of the collateral held by commercial banks was steadily decreasing in value within the context of a high interest rate environment. In addition, the high interest rate regime meant that commercial banks needed to expeditiously take preemptive actions to recover loans. Yet, the prevailing standard for non-performing loans was in excess of

international best practices of ninety days. This resulted in significant growth in the banks' bad debt portfolio. However, this was not all. Banks also boosted their profits by assuming income on these 'bad loans'. These activities actually masked the gravity of the financial situation facing many of the weaker locally owned commercial banks.

4.5 The Role of the Regulatory Authority

Ironically enough, the 1992 Banking Act gave the Bank of Jamaica substantial regulatory powers over the commercial banks operating in Jamaica. However, the exercise of this regulatory power left much to be desired.

While Section 19 (2) of this Act stipulated that the audited consolidated accounts of the holding company of a commercial bank should be submitted to the Bank of Jamaica, it failed to stipulate the time frame required for this submission. Hence, in many instances, holding companies did not submit the requisite accounts in a timely manner. Surprisingly, these banks were unfailingly granted annual operating licenses with the same owners in place.

In addition, the 1960 Banking Act empowered the Bank of Jamaica to examine the books of commercial banks. The 1992 Banking Act, further stipulated that this exercise was to be carried out at least once per year. However, with the unprecedented growth in the number of financial intermediaries, there appeared to be little increase in the numbers of workers employed at the Inspection Department of Bank of Jamaica. Thus, it seems that this Department was not endowed with the requisite number of personnel to operate with efficacy. As a result, the Inspection Department was physically incapable of coping with the volume of work generated, with extended time

periods elapsing between inspections. In fact, the Department never was able to achieve the stated objective of annual inspections.

The implications of this situation were evident as early as 1995. The Governor of the Bank of Jamaica cautioned:

> "The capacity of the supervisory authorities at the Bank of Jamaica, at the office of the Superintendent of Insurance as well as at the Securities Commission **must** be strengthened considerably and quickly". (Bussieres, 1995, p. 12) [Authors' emphasis].

Finally, the only regulator in the country, the Bank of Jamaica lacked moral authority. This was manifested in several ways: First, there was an instance of one commercial bank, the National Commercial Bank, which was publicly in breach of Jamaican banking laws. It infringed these laws as early as 1977, and continued every year, with the exception of 1986. Yet, its license was always renewed. This behavior created the perception that a breach of the Banking Act was of little significance. Moreover, as far back as the late 1980s, the Workers Savings and Loan Bank operated with a deficiency in assets: its accumulated losses were greater than its capital and reserves. However, the Bank of Jamaica appeared to take no remedial actions, which were discernible to the industry. In addition, there were industry-wide rumors that fines for breaches such as failure to meet liquid assets requirement were waived for selected commercial banks.

When a financial intermediary flagrantly breaches the regulations governing proper banking practices of a country and still continues to operate each year with impunity, it undermines the moral authority of the regulatory body. It is noteworthy that the Bank of Jamaica's position was also undermined by the actions of the government.

Indeed, the government was a major shareholder of the above-mentioned banks. It is evidently difficult for one arm of the government to regulate the operations of another.

5. Recommendations

As earlier noted, the government of Jamaica created FINSAC to resolve the crisis facing the financial industry in 1997. FINSAC was successful in restoring stability and confidence to the industry (Kirkpatrick and Tennant, 2002). However, there are still several glaring issues that need to be resolved to ensure the long-term viability and stability of the industry.

As discussed in Section 3, the Bank of Jamaica made extensive use of the liquid assets ratio as a tool of monetary policy during the period, 1992 to 1995. [9] However, there are several difficulties inherent with the use of this policy tool. First, with the high liquid assets ratio used during this period, the commercial banking system as whole required a 15 point spread on loans over deposits in order to break even on funds (which does not include their operational costs). It therefore meant that whereas the foreign banks, which traditionally had a better mix of funds and enjoyed low-cost deposits, could breakeven on funds with a spread of -4.71 percent, locally owned banks that had higher cost deposits would require a spread of 26.5 percent. [10] Hence, local commercial banks had no option but to resort to higher risk, marginal loans in order to maintain profitability. Secondly, with liquid assets being determined by the amount of prescribed liabilities[11] existing over the previous month, institutions in need of cash for survival had no recourse but to seek further deposits (half of which had to be turned over to Bank of Jamaica) thereby increasing their deposit to capital ratio, further

driving them into insolvency. This situation was compounded in 1997 as even borrowings from other commercial banks were deemed to be prescribed liabilities. Thus, all commercial banks were compelled to go to the Bank of Jamaica for funding should they desire to maintain their solvency. It is thus patently clear that the p*rolonged* and *excessive* use of the liquid requirement ratios as a tool of monetary policy had deleterious effects on commercial banks and the long-term viability of the financial system.

Secondly, an amendment to the 1992 Banking Act limited investments that commercial banks could hold in other companies to 50 percent of the statutory capital of the commercial bank. This means instead of having 200 percent of capital in fixed assets and investments, banks are now only allowed to hold 150 percent. Is this desirable? As noted earlier, the basic function of capital in commercial banks is to act as a buffer against potential losses and to provide liquidity. Could these functions be effectively carried out with the present provisions for fixed assets and investments? Clearly, the level of 150 percent is still too high. The Bank of Jamaica needs to urgently revisit this issue.

Thirdly, as earlier discussed, Section 19 (2) of the 1992 Banking Act requires consolidated accounts of the holding company of commercial banks to be submitted to Bank of Jamaica. However, it failed to stipulate the time frame for submission. As was discussed, during the 1990s, the effectiveness of the regulatory body was severely constrained by delayed submissions. There is evidently need to establish a clear and realistic time frame for submission of these accounts.

Finally, there should be continuous assessment of the performance of shareholders in commercial banks that obtain their deposits from the public. At any point in time, depositors will have a much greater financial stake in the commercial bank than the shareholders because deposits are multiples of share capital. Hence, the main shareholder/s should not be given unilateral authority to appoint all board members as was the case in the pre 1997 period. We suggest that considerations should be given to limiting the share ownership of banks. Alternatively, consideration could also be given to establishing limits on the appointment of bank directors. The authors recommend that the composition of board of directors should be as follows. There should be between two or three staff directors; no more than half of the board should consist of connected/related persons; and no less than two non-executive directors should be part of any quorum. Further, at least two non-executive directors of commercial banks should possess relevant banking experience. Additionally, the maximum deposit taking capacity of new commercial banks should be lower than the extant statutory limit of 25 times deposit liabilities. Increases to this limit over time should only be made after an evaluation of variables such as the length of banking experience and the performance of these entities is conducted.

Conclusion

This paper clearly shows that the conditions required for the financial sector to generate economic growth (e.g., Wachtel, 2001a) did not exist in pre-1997 Jamaica. The dilution of managerial expertise in commercial banks; the lowering of the standards of banking practices; the use of non-banking investments and fixed assets as

part of commercial bank’s statutory capital; and the punitive interest rate regime all contributed to the near collapse of the financial sector in 1997. Ironically enough, a regulatory body presided over this inefficient environment. A pertinent question that must be now asked is *what are the prospects for the recurrence of another crisis*? The authors suggest that there are several critical issues that need to be urgently addressed. These include the need to ensure that policies are implemented, which do not adversely affect the liquidity of commercial banks; the re-examination of the capital requirements imposed on commercial banks by the Bank of Jamaica; the need to establish a clear and realistic time frame for the submission of the consolidated accounts of holding companies of commercial banks; and the continuous monitoring of the performance of shareholders of commercial banks. Indeed, the long-term viability and stability of the financial sector rest on policy makers in Jamaica resolving these critical issues.

Table 1: The local incorporation of foreign banks in Jamaica

Bank	Date when operations were commenced	Date of local incorporation
Barclays (now NCB)	1837	1971
Bank of Nova Scotia	1889	1966
Royal Bank of Canada (later sold and renamed Mutual Security Bank)	1911	1971
Canadian Imperial Bank of Commerce	1920	1975
Bank of London and Montreal	1959	1980

Table 2: The use of the liquid asset ratio and the cash reserve ratio as tools of monetary policy during the years, 1986 to 1995

Year	Liquid Assets Ratio	Cash Reserve Ratio
1 February 1986	Decreased from 48% to 44%	Was 20% from 8 July 1985
1 May 1986	Decrease to 38%	
26 March 1987	Decrease to 38%	
27 January 1988	Decrease to 30%	
24 February 1988	Decrease to 25%	
24 March 1988	Decrease to 20%	
1 April 1990	Increase to 25%	
1 May 1990	Increase to 27.5%	
1 November 1990	Increase to 32%	
10 January 1991	Increase to 33.5%	
1 April 1991	Decrease to 20%	
1 November 1991		Decrease to19%
23 December 1991	Set at a variable rate according to commercial banks	
1 May 1992		Increase to 21%
1 June 1992		Increase to 23%
1 July 1992	Increase to 50%	Increase to 25%
15 June 1995	Decrease to 47%	Remain at 25%

Source: Bank of Jamaica, Statistical Digest, June 1997.

Table 3: Inflation Rates in Jamaica, 1976 to 1998.
(percentage)

Year	Rate
1976	8.1
1977	14.1
1978	49.4
1979	19.8
1980	29.0
1981	4.6
1982	6.5
1983	16.7
1984	31.2
1985	23.4
1986	10.4
1987	8.4
1988	8.5
1989	17.2
1990	29.8
1991	80.2
1992	40.2
1993	30.1
1994	26.9
1995	25.5
1996	15.8
1997	9.2
1998	7.9

Source: Planning Institute of Jamaica, *Economic and Social Survey-Jamaica* (various issues).

Notes:
Base Year: 1975 to 1987 = January 1975
Base Year: 1988 to 1998 = January 1988

Table 4: A Profile of the Board of Directors of the locally owned commercial bank, National Commercial Bank during the years, 1992 to 1996

Member of the Board	Allegiance	1992	1993	1994	1995	1996
Mr. A	S	√ (C)	√	R	-	-
Mr. B	S	√	√	√	√	√
Mr. C	S	√	√	√	√	√
Mr. D	S	√	√	√	√	√
Mr. E	R	√	√	√	√	√
Mr. F	S	-	-	√	√	√
Mr. G	S	-	-	√	√	√
Mr. H	M	-	-	√ (C)	√ (C)	-
Mr. I	S	-		√	√	√
Mr. K	M	-		√	√	√
Mr. L 22/10/1996	M	-	-	√	R	√
Mr. M 22/10/1996	M	-	-	-	-	√
Mr. N	-	-	-	-	-	√

Source: Annual Report of National Commercial Bank (various issues)

Notes:
S = Staff
M= Major Shareholder Representative
R = Retired Staff Member
C = Chairman

Table 5: Exchange Rates in Jamaica, 1980 to 1998.
J$ = US$ 1

Year	Official	Free Market
1980	1.8	2.5
1981	1.8	2.6
1982	3.3	2.9
1983	3.3	3.6
1984	3.94	5.6
1985	5.56	6.5
1986	5.48	6.5
1987	5.49	6.5
1988	5.75	6.7
1989	7.18	8.3
1990	12.85	10.2
1991	23.01	23.0
1992	25.68	24.8
1993	25.68	33.0
1994	33.35	33.2
1995	35.54	39.6
1996	37.02	34.9
1997	35.58	36.3
1998	37.1	37.1

Sources: Bank of Jamaica, Statistical Digest; World Currency Yearbook

Table 6: Percentage of Non-performing Loans to Total Loans for Two Commercial Banks in Jamaica

Year	Bank of Nova Scotia	National Commercial Bank
1992	2.48	N.A.
1995	0.96	N.A.
1997	2.62	55.01
1998	4.70	17.55
2000	4.13	37.52

Source: Annual Reports of Bank of Nova Scotia and National Commercial Bank (various issues)

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[1] Several researchers argue that the relationship between financial sector development and economic growth is not the supply-leading relationship advanced by researchers such as McKinnon (1973) and Shaw (1973). Rather, the relationship is a demand-following one, where economic growth leads to financial sector development since economic growth creates a demand for financial services. Others such as Patrick (1966) argue that the direction of this relationship would change with economic growth. Financial sector development is necessary for economic growth to occur. However, as economic growth is achieved, the supply-leading relationship progressively becomes less important, while the demand-following one becomes dominant. Nonetheless, Wachtel (2003) asserts that the debate over the direction of this causality has been convincingly been resolved. The recent literature has clearly demonstrated that causality is from finance to growth.

[2] This discussion draws heavily from Wachtel (2001a).

[3] The authors argued that the critical shortage of trained staff experienced by the banking industry during the period, 1984 to 1992 was compounded by the significant migration of these skills in the latter part of the 1970s.

[4] An examination of some of the conglomerates operating in Jamaica during this time reveals the following conglomerates all owned and operated financial intermediaries. These include the following:

Company	Affiliated Financial Intermediaries
Grace Kennedy Group	George and Brandy
Corporate Group	Workers Savings and Loans Banks and Corporate Merchant Bank
UGI Group	International Trust and Merchant Bank
Pan Jam Group	Pan Caribbean Merchant Bank and Trafalgar Commercial Bank
ICWI Group	Life of Jamaica and Citizens Bank Limited
Mutual Group	NCB and Mutual Security Bank
Eagle Group	Eagle Commercial Bank and Eagle Merchant Bank
Billy Craig Group	Billy Craig Finance and Merchant Bank

[5] The higher levels of book profits resulted in increases in expenditure such as salaries, bonuses, and even taxes, all of which require immediate cash payments.

[6] Asset lending places a significant reliance on the inherent value of the asset for loan repayment, while cash flow lending relies on the cash generated from the project, for which the loan was granted, for loan repayment.

[7] Margin gatherer is a banking term, which essentially refers to taking deposits and making loans. The resulting margins from these activities belong to the bank. This is how the bank earns the main part of its revenue.

[8] It is noteworthy that the weighted average lending rates of commercial banks reached an all time high of 67 per cent per annum in April 1994. Conversely, during February 1994, the cost of three months deposits peaked at 57 percent for deposits and 51 percent for six months deposits. See Bank of Jamaica, Statistical Digest, June 1997.

[9] Interestingly enough, King (2002) notes that during this period, the government of Jamaica was faced with the conflicting objectives of financial liberalization and the maintenance of macroeconomic stability. The government indeed attempted to liberalize the financial sector as evidenced by its removal of deposit rate controls. During the period, 1991 to 1997, restrictions were removed on deposit rates (See King 2002, Table 3). However, at the same time, the government was preoccupied with maintaining macroeconomic stability by absorbing the excess liquidity arising from monetarised fiscal deficits. The effect of these two conflicting objectives resulted in there being little liberalization of the financial sector during this period.

[10] This point can be illustrated by the following model of the break-even position of commercial banks at March 1994. The data in this model is derived from statistics obtained in the Bank of Jamaica, Statistical Digest, June 1997.

Break-even Model for Commercial Banks
Loans/ Deposits

1994 March

Liquid Assets Ratio = 50%
Cash Reserve Ratio = 25%
Weighted Average Deposit Rate = 39.29%
Range of interest cost on deposits:
Low = 20%
High = 50%
Yield on Treasury Bills = 50.04%
Weighted Average Loan rate = 64.2%
Actual Liquidity = 53.5%

Per $1000 deposit:

	Scenario- Low	Scenario-Weighted Average	Scenario-High
Deposit Cost	$200	$ 392.9	$500
Earnings for Bank:			
Liquid Assets ($500): 1. Cash reserve ratio (25%) 2. Other liquid assets (treasury bills) (25%)	NIL $125.1	NIL $125.1	NIL $125.1
Earnings required for bank to break even	$74.9	$ 267.8	$ 374.9
Funds available for lending ($500 -$10) ($10 is held as cash in vault)	$490	$490	$490
Break even lending rate (Earnings required to break even divided by funds available for lending)	15.29%	54.65	76.5%
Net Interest margin or Spread (Breakeven lending rate – deposit cost rate)	-4.71	15.36	26.5

From the above, it is evident that at least one institution could have been offering rates as low as 20 percent while others were offering over 50 percent as they may have benefited from Central Government's demand deposits of J$ 3.03 billion.

[11] Prescribed liabilities are deposits from customers as well as loans from financial institutions that are accepted by a commercial bank.