

**Seminar for Judges of the
Court of Appeal and the Supreme Court**

Venue:

**Braco Village Hotel
Trelawny**

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Topic:

**Central Bank - Supervision of Statutory Compliance by
Commercial Bank - to Oblviate Mismanagement and Failure**

Presenter:

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The Role of the Central Bank in Achieving Statutory Compliance by Banks to Obviate Mismanagement and Failure

What this paper seeks to do in a concise manner is to deal with the following points:

1. What is the role of financial institutions, intermediaries ("banks")?
2. What are the essential ingredients of the financial sector and what is the controlling legislation in each case?
3. Why is supervision necessary and how is it effected?
4. What are the principal matters (both wide and limited sense) with which banks are required to comply? To what extent are they based on statute, or on some other source?
5. How is enforcement effected, and to what extent are criminal penalties involved? In this context we will wish to note certain problems of a very special nature that arise when you seek to apply criminal penalties to banks and bank officers.
6. What is the role of the judiciary in all of this?

1. The Role of Banks

Banks play an absolutely pivotal role in the mobilization and allocation of financial resources, since they constitute the repository of the nation's savings. Added to this is the function of allocating credit in the economy, subject, of course, to the power of the Bank of Jamaica and the Government to manipulate credit through monetary policy. Finally, banks manage the payments system, principally through the use of chequing accounts and, of course, now credit cards. The Government and the Bank of Jamaica, accordingly, have a vested interest in seeing that instability in the banking system is kept to a minimum, that the transfer of financial resources of savers to investors is achieved so that growth in the economy can take place.

2. Structure of the Financial Sector

(See attached sheet)

The principal players are commercial banks, the so-called near banks, building societies, credit unions (which keep growing), then more recently, life insurance companies exercising a questionable role through what has to be reviewed as loopholes in the law, the securities industry through the stock exchange and more recently, commercial paper, unit trusts (the source of some controversy in tax

matters), and finally the newest and very dynamic players - the "funds managers" who are primarily money-market brokers.

Added to the above are some typically Jamaican exploiters of loopholes, who take advantage of the fact that legislation does not keep pace with commercial practices in the financial sector, despite periodical and often frequent warnings by the supervisors. I'll just mention briefly some of these loopholes.

A. You had the sudden emergence of a rash of building societies, most of which had no intention of operating as building societies. They were able to avoid prudential supervision and withholding tax, and made a killing until the Government put the brakes on. Very few of them were able to obtain licences.

B. You had a billion dollar market in commercial paper for a decade without any regulation of the borrowers.

C. You had I & P societies set up and run as banks without any adherence whatever to the original purposes of such societies.

D. You had persons operating "loan companies" effectively by taking deposits from gullible members of the public, and ultimately causing grave losses to the public.

E. Last, but not least, you had irresponsible life insurance companies operating as banks and suffering massive losses, which

have been explained away by the euphemism of the 20th century a "mismatch of assets and liabilities"!!

3. The Justification and Nature of Supervision

For hundreds of years, ever since banks began to fail, countries saw the need for regulation and the process was usually started with regulatory legislation. Naturally, it soon became clear that some supervision was essential to monitor performance, and emerged as a factor in all countries.

Unfortunately, hiccups developed in the late 70s and early 80s, as the United States of America, in conjunction with the International Monetary Fund (IMF), World Bank, Inter-American Development Bank (IADB) etc., sought to thrust notions of de-regulation on an unsuspecting world. Such de-regulation normally led to loan facilities, a legal form of blackmail that continues to be practised by the United States in respect of money-laundering.

The irony is that the first massive fall-out from de-regulation occurred in the United States itself, and the policy reversal began. Unfortunately, with its extensive resources the United States is more capable of recovering from such disasters than most others, and small countries like Jamaica continue to suffer from the fallacy that a

market economy requires heavy liberalization of your financial sector - it just don't go so.

How is this supervision effected? The starting point is that of returns which must be made to the supervisory authority ranging from a daily basis to quarterly returns on a variety of operations. This is complemented by an annual (sometimes twice yearly) on-site inspection in which the returns are compared to the records in the bank's books, methods are looked at, compliance with other statutory provisions is examined, and a host of matters including the level of attendance of directors at Board meetings and the relative qualifications of officers.

These are supplemented by contact and consultation with the external auditors of the institution, examination of the books of subsidiaries and holding companies. Ratings are given to the institution and the final extensive Report forwarded to the Minister and also to the Directors. Post inspection meetings are held both with the institution and its Directors.

One section of the Report will allow the Supervisor to note any areas of loopholes, difficulty of verification of figures, difficulty in obtaining answers or records, and to make recommendations, through legislation or otherwise, for curing the problem.

4. Principal Areas for Compliance

1. Capital Adequacy
2. Liquidity
3. Purchase of Fixed Assets
4. Fit & Proper management
5. Changes in Control by Shareholders
6. Insider Transactions
7. Proper loan management & provisioning
8. Involvement in trade & other activities of risk
9. Concentration of risk - lending too much to a single customer or group
10. Control of conglomerates - consolidation of balance sheets, etc.
11. Disclosure of all relevant information.

All of the above are dealt with in the relevant statutes and give rise to the sanctions to be dealt with in Part 5. There has been recently, however, a move towards developing and establishing Guidelines for Implementation of Prudent Practices and Institutional Self-Governance by the banks. The Bank of Jamaica develops a set of principles of conduct in relation to certain matters, discusses them with the institutions and an agreed set of measures/principles are arrived at.

These are still regarded as voluntary. However the institutions understand that failure to apply them may lead to their being considered, in conjunction with other faults, as generally operating in a manner that will attract the sanctions.

For the time being the areas falling into this category include Capital Management, Internal Controls, Liquidity Management, Credit Risk Management, Interest rate Risk Management, Foreign Exchange Risk Management, Management of the bank's Securities, Appraisal of Real estate for taking of Security, and Management of the Conglomerate Risk.

5. Enforcement

The 1992 Banking Act placed in the hands of the Minister, in most (but effectively all) cases on the recommendation of the Bank of Jamaica, a variety of strong and effective measures, designed

- a. to try to rescue a bank that is in trouble;
- b. to terminate and bring to the relevant conclusion the operation of a bank that is deemed beyond rescue;
- c. to punish the bank itself, or officers thereof, either by fine or imprisonment or both, for deliberate breaches of the Act.

The exercise of the Minister of these powers is triggered by the occurrence of one or more situations which either have to do with a state of the bank being in trouble (such as a breach of its capital base, its assets being less than its liabilities etc.), or the bank or an officer carrying out specific practices (e.g. giving false information to the supervisors, refusing to produce books, breaching provisions of the Act and generally engaging in imprudent practices). The list is wide.

There is a kind of "ladder" of enforcement growing in height where the first steps fail or there is no co-operation from the bank. The Minister may start by giving directions in writing that certain things should be done or not done. He may follow this up with a formal Cease and Desist Order. He may then assume temporary management of the bank, he may suspend or revoke its license, or he may apply to the Court for liquidation of the bank or for its reconstruction, both of which follow procedures in the Companies Act (as well as the Banking Act).

Finally, the recent Act of 1998 allows the Minister to take control of the shares and assets of the bank in order to safeguard the interests of depositors. There are ancillary provisions for payment of compensation to shareholders.

As indicated previously there are a considerable number of offences set out in the Act but to date no prosecutions have been instigated.

6. The Role of the Judiciary

This is threefold.

A. Where the Minister issues a Cease and Desist Order, the bank affected may apply to the Supreme Court after a prescribed period, to have it set aside. In respect of temporary management the Minister must apply to the Court for confirmation of the temporary management after a prescribed period and various appeals lie to the Court of Appeal, likewise in respect of the Suspension or Revocation of license. Application for Winding-Up or Reconstruction lies to the Court under the Companies Act.

B. Criminal matters will be prosecuted in some cases in the Magistrate's Court but may also be dealt with in Circuit Court on Indictment;

C. It is always open to a bank or officer thereof to challenge action taken by the Bank of Jamaica or the Minister, in the Courts particularly where a discretion has been exercised or where there may be room for different interpretations of facts. This is not likely to occur

often as the action will usually have been taken as a last resort and there would be reasonable data to support the action.

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