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Limits on Investments in Foreign Currency Assets

Remarks by

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Governor

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Ladies and Gentlemen, good afternoon.

Thank you for inviting me here today to give you Bank of Jamaica's perspective on the topical issue of the limits on foreign currency denominated investments in Jamaica.

I would like to start by commending the Development Bank of Jamaica ("DBJ") on the role they have been playing in providing financing to small and medium-sized enterprises ("SMEs"). As we see by this initiative of the Jamaica Venture Capital Programme ("JVCP"), DBJ has thrown its support behind the development of a venture capital industry as an important strategic vehicle to fund the development of Jamaican businesses. Since DBJ launched this programme, I have noticed increased interest by local institutions to participate in this ecosystem.

Before commenting on the main issue that I have been invited here to speak about, I would like to offer a few words on the policy framework for ameliorating the constraints to SME financing in Jamaica.

Constraints to Financing SMEs

Access to finance by SMEs in Jamaica has been constrained in the recent past by a number of factors. Although deposit-taking institutions ("DTIs") have historically been the main financiers for SMEs, they are not well suited to drive such investments given their traditional low tolerance for these types of risks. Traditional financial institutions have little knowledge about these specialized businesses, particularly when they are start-ups, a problem we refer to as *information asymmetry*. DTIs have also complained about the lack of reliable financial statements for SMEs that makes it difficult for them to assess risks. Further, the dearth of adequate collateral and the illiquidity of equity investments do not blend well with the fact that DTIs are mostly funded by short-term liabilities. Industry watchers have also cited a lack of strategies, processes, lending methodologies and financial instruments by banks and other financial institutions to lend to this market segment. I have noted, however, that financial institutions have started to develop such methodologies and there are also active discussions elsewhere on initiatives to develop more appropriate financial instruments (such as leasing, factoring and partial credit guarantees). In all of this, the current regulatory framework mandates that DTIs must always follow relatively stringent prudential financing practices. Hence, DTIs tend to offer tightly secured credit to SMEs while applying a low loan-to-value ratio on collateral and relatively higher interest rates to this market segment compared to loans to larger, more mature firms.

Recent Efforts in Improving SME Access to Credit

In the context of this problem, the government has taken some steps to strengthen Jamaica's financial infrastructure. To address the information asymmetry problem, three credit bureau licenses have been issued since the credit reporting framework was established in 2010; two of them are currently operational. Information provided by these credit bureaus should contribute greatly to the risk management capabilities of all financial institutions, which will reinforce the growth of SME financing in Jamaica.

Beyond this, the government has been engaged in modernising the legal framework for secured transactions and has established the movable collateral registry. The Insolvency Act was also passed by Parliament in late 2014 and the associated regulations have been developed. Further improvements to the financial infrastructure framework are possible, I am sure, including in areas such as consumer protection.

Investment Limits on Foreign Currency-Denominated Assets

I will now turn to the issue of the participation of pension funds and insurance companies in additional foreign currency-denominated investments. This participation is currently constrained by section 22B of the Bank of Jamaica Act which places a macro-prudential overlay on the FSC's prudential regulations with regard to both quantitative and qualitative choices open to these institutional investors. Under this law, investments by these investors are subject to ministerial directions which currently limit them to a 5% cap on foreign currency-denominated assets as a percentage of total assets.*

This macro-prudential overlay exists in the context of the potential adverse impact of the foreign currency investment activities of these institutions – who are custodians of large pools of funds - on the stability of the domestic foreign exchange market and the country's foreign currency reserves. It is well known that rebuilding the reserves to adequate levels plays a vital role in restoring and retaining confidence in the economy and improving the country's credit rating.

On the other hand, Bank of Jamaica recognises that relaxing foreign currency restrictions is an essential step in reaping the economic benefits from financial diversification. As such, the government began the process of incrementally raising the cap on foreign currency investment for securities dealers and CIS at the beginning of 2014 and aims to remove it altogether by the end of 2016, unless negative shocks arise for the foreign exchange market and the NIR. Bank of Jamaica has taken the view, however, that relaxing the cap for pension funds and insurance companies is best served after undertaking a careful assessment of the issues involved in this relaxation and to proceed in moderate steps. We have therefore begun a process of consultation with the pension fund and insurance sectors with a view to better understanding the implications for the country's reserves of relaxing the cap for this segment of the industry.

Aside from raising the cap, debate is focused around the question what are the appropriate qualitative restrictions on the type of investments that may be undertaken. The relaxation of the cap for securities dealers and CIS expanded the permissible categories of foreign currency instruments to include, *inter alia,* some types of equity investments. For these types of investments, there is now a stipulation that shares of only foreign corporations that issue investment grade debt securities can be acquired by securities dealers and CIS who are in compliance with the reporting requirements of the new regime. While this restriction is intended to limit the potential for substantial portfolio losses, especially on large pools of foreign currency investments, the question is still not settled as to whether or not this is the best type of restriction to achieve the objective of limiting the potential for substantial portfolio losses while permitting prudent diversification.

This then leads me to raise the final issue of the potential role of pension funds and insurance companies in financing SMEs in Jamaica.

Opportunities for Private Equity in Financing SME Expansion

Unlike DTIs, institutional investors such as pension funds and life insurance companies issue long-term liabilities and therefore represent major pools of resources available to facilitate venture capital initiatives in Jamaica. Among the key advantages for SMEs of this source of equity financing is the fact that there is often no collateral required nor obligations for the entrepreneur to repay loan principal at maturity, which are standard elements in credit facilities. Also, private equity firms bring specialised knowledge and management expertise to the SMEs in which they invest. These advantages result in start-ups generally benefiting more from venture capital investment compared to traditional credit arrangements.

In closing, I would like to say that the transformative role that a viable venture capital ecosystem can play in financing high-risk but high-growth firms in Jamaica is an important motivation for efforts to refine the restrictions on private equity investments in a way that will not threaten financial stability. We therefore welcome the opportunity for dialogue with stakeholders in the venture capital industry on how best to achieve this.

Thank you.

* **Addendum:** The following text, which was inserted in error, has been deleted: "*except in relation to the acquisition of instruments issued by the government itself and instruments issued or guaranteed by US, UK and Canadian sovereigns*."