THE IMF AGREEMENT, COMPLIANCE PRACTICES AND THE JAMAICAN SECURITIES INDUSTRY

Prepared Remarks

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Good afternoon.

Let me start by saying thanks to the Financial Services Commission ("FSC") for the invitation to speak to you on some aspects of Jamaica's economic blueprint that will affect the financial sector.

Ladies and gentlemen, Jamaica is about to present its Letter of Intent and the associated Memorandum of Economic and Financial Policies ("MEFP") to the IMF Board for approval. The agreement on Jamaica's policies and programmes reached between the IMF Staff and the Jamaican authorities on 15 February completed the negotiations towards a four-year Extended Fund Facility ("EFF"). I am anticipating that the IMF board will support Jamaica's programme of comprehensive policy reforms based on the strength of its design as well as the progress made in implementing the prior actions. These prior actions, as we are now well aware, include the successful execution of the national debt exchange ("NDX"). As this is my first public commentary since the completion of the NDX, I want to thank all the stakeholders who participated in the exchange, some of whom are here today, for their contribution towards the achievement of debt sustainability.

With implementation well underway, even ahead of formal approval, it may be useful to highlight some of the implications of the medium-term economic programme for the Jamaican securities industry. A complementary and relevant topic is the original theme for this luncheon, that is, the importance of compliance programmes for financial stability.

The Macroeconomic Programme and Implications for the Securities Industry

The most important objectives of Jamaica's reform programme are a reduction in the indebtedness of the public sector and an acceleration in the rate of growth in the real income of Jamaicans. These two objectives are inter-related because the size of Government's debt service limits the public investments needed to create the environment for sustainable growth. Simultaneously, higher GDP growth rates make the task of reducing the government's indebtedness easier.

The debt reduction objective requires a strenuous and sustained fiscal effort. Indeed, the commitment to the IMF requires that the central government lift its primary balance (the difference between its revenues and its non-debt expenditures) to 7.5% of GDP over the four-year period of the programme and for several years beyond. As you know, this effort includes, amongst other measures, wage restraint in the public sector and a significant tax package.

What are the implications of these policy initiatives for the securities industry? The elongation of the maturity structure of government's debt as well as the lower deficits that flow from the sustained programme of fiscal consolidation imply the need for the securities industry to either change its business model or enhance its capitalisation or, preferably, both. Lengthening the maturity structure of government debt increases the risks associated with a business model that funds long-dated assets with shorter-term liabilities. Regulators worry that the inherent risks in these models, that is, concentration risk, interest rate risk and liquidity risk, may not be matched by sufficient capital to weather the more extreme adverse scenarios that experience teaches us may indeed evolve.

In addition to higher risks, there will be a substantial reduction in Government's debt issues (both new and rollovers) over the life of the programme. Therefore, for those entities whose business model relies on earning a margin by funding government securities with repos, there will be a need to find new sources of business as the supply of government debt slows. The industry will have to diversity its portfolio into non-GOJ assets. From our perspective, we would like these assets to be domestic, but recognise that they could also involve some high grade foreign currency assets.

What will the regulators do?

Our work programme to facilitate this transition includes on-going efforts at strengthening the regulatory and oversight framework for the industry and fostering conditions that will encourage the industry to pursue an alternative business model. Bank of Jamaica has issued to the industry a consultation paper on the Omnibus Banking Law. The timeline for feedback is now 28 March 2013 and I am encouraging you to give us your feedback if you have not already done so. In addition, the government, under its work programme of tax reform, will be considering the removal of double taxation for mutual funds. We are preparing to provide a plan later this year that will over time raise and, in due course, remove the cap on investments in foreign securities which will pave the way for the industry to further diversify the currency composition of its portfolio. Over time, liquidity and other prudential standards for securities dealers that engage in retail repos will be strengthened.

Ladies and gentlemen, the government's growth agenda under the programme, in the context of continued single-digit inflation, will also facilitate the development of the securities industry. Jamaica has much potential for growth in logistics, agriculture and agro-processing and ICT. GDP growth is projected to rise above its historical long run average in the medium term as the benefits from the reform programme materialise. A recovery in investment is expected to be supported by foreign investors, including through Public Private Partnerships.

The structural reforms being undertaken by the Government are expected to result in improvements in productivity and the business environment. To improve the business climate, the government, among other things, intends to increase access to credit through a secured transactions framework. We are also expecting the coming fiscal year to see credit bureau operations enhancing the credit environment to the benefit of borrowers and lenders alike.

A significant fillip to growth should also come from the reduction of crowding out pressures from the fiscal accounts, leaving more resources for private sector investment and paving the way for long term interest rates to fall. This process is already underway. The projected near-term weakness in economic activity coupled with the outlook for sustained strong fiscal adjustment and the impact of the successful NDX created the conditions that allowed Bank of Jamaica to lower its signal rate by 50 basis points two weeks ago. Treasury Bill yields subsequently fell at the regular monthly auction by between 109 basis points and 182 basis points. The central bank is now watching for timely and commensurate reductions in lending rates by the major providers of credit.

Greater buoyancy in economic activity will also bring with it the demand for more innovation in corporate financing. Firms should seize the opportunity to obtain lower cost financing by issuing corporate paper. The securities industry must now facilitate the strong and vibrant market for corporate paper that will make this opportunity a reality for more of our productive enterprises.

The Importance of Compliance for Financial System Stability

I will now turn to the other issues that I had been asked to comment on in this forum: the importance of compliance.

The recent global financial crisis is stark reminder, if one was needed, that regulators cannot see or understand everything that transpires within the entities that they supervise. Additionally, they will never have enough resources to ensure that all the weaknesses that are identified are fully addressed. It is for this reason that, for the purpose of ensuring financial stability, regulations and compliance must be complementary and should even be symbiotic.

To highlight my point I will recall a number of recent examples of the failure of compliance systems. Last December HSBC Holdings paid significant fines (US$1.9 billion) for failure to implement adequate anti-money laundering (AML) systems in some of its Mexican operations. Consequent on that lapse in HSBC's AML protocols, South and Central American drug cartels were allegedly able to introduce illicitly obtained funds into the formal banking sector. Similarly, UBS incurred fines (US$1.5 billion/£940 million) for its involvement in the manipulation of LIBOR rates. This followed Barclays pay out of more than US$450 million for the same reason.

The identification of these failures naturally imposes significant cost on the individual financial institution. However, owing to the interconnectedness of modern markets, the economic and reputational damage done by compliance failures of this nature is not always neatly resolved within the subject institutions. They can, in some instances, result in significant externalities, including costs for the state when it is required to provide restitution, either as lender of last resort or through deposit insurance mechanisms.

While Jamaican regulators and the financial industry have had a history of amicable relations, we are acutely aware of this reality, given our own problems in the financial sector in the mid to late 1990s. The society, the public at large, is paying for the state's interventions during that period even now. For this added reason we must marry sound and responsive regulatory guidance with effective, proactive compliance within our institutions.

What Are the BOJ Expectations for Industry Compliance Programmes?

This sets the stage for me to outline BOJ's expectations for the industry's compliance programmes. As a start, when we as regulators inspect institutions, we are looking for well-planned and executed compliance programmes which can adequately identify, measure, monitor and mitigate compliance risks across business lines. Beyond that, the structure of each entity's compliance function should be commensurate with its profile, risk posture and scope of activities.

Perhaps the most critical, albeit intangible, element of a good compliance programme is the culture within an organisation. The Basel Committee on Banking Supervision (BCBS) has underscored that compliance starts at the top and highlighted the role that the board and senior management must play in establishing and maintaining a corporate culture that emphasizes high standards of honesty and integrity. Bank of Jamaica's Standards of Best Practice for Effective Corporate Governance similarly outline that senior managers are obligated to lead by example, emphasise standards of honesty and integrity and hold themselves and all employees to high standards of conduct, observing not only the letter but the spirit of laws, rules and standards.

Ladies and gentleman, significant opportunities lie ahead for the Jamaican economy both during this transitional period and into the foreseeable future as the government deleverages risk through the upfront actions under the economic programme. Undoubtedly, success will depend on how well the government executes the programme of reforms, but it will also depend on the fleet footedness of agents within the financial sector in changing and adapting their business model. Importantly as well, sound compliance practices in the industry, fostered and supported by the appropriate ethos at the top of organisations, will place Jamaica securely on the road to strong sustained growth in the future, free from the fitful stops and starts that, I hope, will come to reside only as a vague part of our collective memories.

Thank you.