

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

JAMAICA

FINANCIAL SYSTEM REFORM SUPPORT PROGRAM

(JA-L1058)

PROJECT PROFILE

The project team consisting of prepared this document: Joan Prats, IFD/CMF, Team Leader; Navita Anganu, CMF/CJA, Alternate Team Leader; Agustina Calatayud, Gloria Lugo and Alison Arauz, IFD/CMF; Claudia Stevenson, IFD/CTI; Betina Hennig, LEG/SGO; Graham Burns, FMP/CBL; Juan Pedro Schmid and Brodrick Watson, CCB/CJA.

Under the Access to Information Policy, this document is subject to Public Disclosure.

PROJECT PROFILE

JAMAICA

I. BASIC DATA

Project Name:	Financial System Reform Support Program		
Project Number:	JA-L1058		
Project Team:	Joan Prats (IFD/CMF), Team Leader; Navita Anganu (CMF/CJA), Alternate Team Leader; Agustina Calatayud, Gloria Lugo and Alison Arauz (IFD/CMF); Claudia Stevenson (IFD/CTI); Betina Hennig (LEG/SGO); Graham Burns (FMP/CBL); Juan Pedro Schmid and Brodrick Watson (CCB/CJA).		
Borrower:	Jamaica		
Executing Agency:	Ministry of Finance and Planning		
Financial Plan:	IDB (OC):	US\$	100,000,000
	Total:	US\$	100,000,000
	Policies triggered:	N/A	
Safeguards:	Classification:	C	

II. GENERAL JUSTIFICATION AND OBJECTIVES

A. Background and problem

- 2.1 **Macroeconomic context.** In the last 30 years, Jamaica's real GDP has increased at an average of 1% per annum. Natural disasters and financial shocks coupled with insufficient fiscal restraint, resulted in persistent public deficits financed through significant public sector borrowing. Since entering an IMF Extended Fund Facility in 2013, Jamaica's economic situation has been recovering, with a projected increase in GDP of 1.5% for FY 2015/16. The stabilization has been backed up by a series of policy reforms,¹ including enhancing competitiveness, fiscal modernization, public finance and financial sector reforms. Markets and credit rating agencies have endorsed the economic program implemented in Jamaica (see IMF 10th Review under the Extended Fund Facility, 2015). Despite the implemented reforms, economic growth in Jamaica remains low. Fostering sustained economic growth is hence, a major priority for Jamaica in order to improve its developmental outcomes. This operation will contribute 7.3 percent to the overall FY2015/16 financing need (excluding the US\$1.5 billion exceptional financing for the Petrocaribe debt buyback).

¹ The Inter-American Development Bank supported a variety of these reforms through different programs, including the "Competitiveness Enhancement Program" II and III (JA-L1010 and JA-L1014, respectively), the "Fiscal Consolidation Program" I and II (JA-L1032 and JA-L1034), and the "Fiscal Structural Program for Economic Growth" (JA-L1038).

- 2.2 Importance of the financial system for growth.** The financial system has a critical role in promoting economic growth.² An efficient financial system enables, among others, (i) channeling resources to the most productive agents and projects in an economy; (ii) mitigating the impact of volatility and macroeconomic shocks; (iii) smoothing consumption of households and firms across time, thus overcoming liquidity restrictions; (iv) transforming maturities by redirecting short-term savings to long-term investment. In Jamaica, the limited development of the financial sector, together with the high level of sovereign debt issuance, has restricted the evolution of economic growth. Credit to the private sector as a percentage to GDP is a mere 30% in Jamaica, the lowest in comparator countries.³ Likewise, more than 40% of Jamaican firms identify access to finance as a major constraint compared to the average 31% in Latin America and the Caribbean countries (LAC). In order to improve the contribution of the financial sector to long term growth and in agreement with the recommendations from International Organizations⁴ and its overall growth and competitiveness reform agenda, the authorities have embarked on an ambitious financial reform agenda, to address weaknesses in the following three main areas: (i) strengthening financial stability; (ii) improving financial inclusion; and (iii) improving the financial and business legal framework.
- 2.3 Financial stability.** A strong regulatory environment of the financial sector is key to achieving financial deepening and stability of the financial system.⁵ The financial sector in Jamaica has been resilient with adequate profitability, capitalization, provisioning, and a relatively comfortable liquidity position, despite the short-term liquidity pressures. Nevertheless, according to recent analyses,⁶ Jamaica has the need to enact reforms in both the banking and capital markets sectors in order to continue reinforcing the stability of its financial system. In this regard, steps have been taken to upgrade and harmonize the regulatory framework of Deposit Taking Institutions (DTI),⁷ increase the supervisory autonomy of the Bank of Jamaica (BOJ) and enhance the prudential regulation of the securities markets.⁸ In particular, reforms have addressed important regulatory gaps in the financial sector through: (i) the introduction of clear and harmonized prudential and operational requirements for deposit taking

² Beck, T., Levine, R. and Loayza, N. (2000), "Finance and the sources of growth", *Journal of Financial Economics* 58 (12), 261-300.

³ Inter-American Development Bank (IDB), *Sector Framework Document on Support to SMEs, and Financial Access/Supervision*, GN-2768, 2014.

⁴ World Bank, *Financial Sector Assessment*, 2015. International Monetary Fund (IMF).

⁵ Norris, D. et al., *Reforms and Distance to Frontier*, IMF Discussion Note, 2013.

⁶ World Bank, *Financial Sector Assessment*, 2015. IMF, 9th Review under the EFF, 2015.

⁷ Deposit Taking Institutions (DTIs) account for 40 percent of financial sector assets and are supervised by BoJ. DTIs consist of six commercial banks, three building societies, and two merchant banks. Commercial banks represent 76 percent of DTIs' assets, building societies 22 percent, and merchant banks less than 2 percent. Concentration is high, with two banks holding over 75 percent of assets and deposits of the banking sector.

⁸ The Financial Services Commission (FSC) has the regulatory and supervisory authority over the securities, pension and insurance sectors. Especially important in the short term is to regulate the Retail Repo activities of Securities Dealers (SD). SDs, with total assets of about 40 percent of GDP, finance long-term government bonds with short-term, retail investments ("retail repos"). Regulation of this model is being strengthened to mitigate and minimize the attendant interest rate, liquidity, and concentration risks, which traditionally characterized the product. These risks were not matched by either capital or liquidity buffers (IMF, Article IV, 2014). In order to mitigate these risks, the FSC has engaged in a series of reforms to ensure prudential regulation and to provide better protection for investors.

institutions in a single core banking regulatory framework in order to avoid potential regulatory arbitrages; and (ii) strengthening the autonomy of financial regulatory and inspection authorities and clearly defining the authority responsible for financial stability; Additional reforms being undertaken include: (i) development of a clear financial crisis management plan and a financial institutions resolution framework; (ii) improving prudential regulation of the securities, insurance and pension sectors; and (iii) increasing compliance in the financial system.⁹ All of the aforementioned lines of reform are also included in the IMF structural benchmarks for 2015 – 2017.

- 2.4 **Financial inclusion.** Although in Jamaica more than 70% of adults have a formal account, only 8% of adults have a loan from a formal financial institution. The lack of access to credit is especially prevalent among low income households and micro, small and medium enterprises (MSMEs). Only 26% of MSMEs report having a bank loan or line of credit, compared to the average 38% for LAC countries. In addition, penetration of traditional distribution channels (e.g. branches, ATMs) is low, especially in rural areas. With 27 ATMs and 6 commercial bank branches per 100,000 adults in Jamaica, penetration is well behind countries like Bahamas, Belize, and Trinidad and Tobago.¹⁰ There are no specific instruments for agriculture finance and MSMEs finance, and alternatives to credit products are limited. At the same time, borrowing costs to Jamaican firms remain the highest, at 18% and are twice as high for MSMEs.¹¹ This high interest rate is due to the high informational asymmetries and a low degree of competition in the financial sector.¹² In order to deal with the aforementioned challenges, it is key to develop an integrative policy framework to promote financial inclusion for households and MSMEs. A lack of a national strategy limits the capabilities of the authorities to develop a coherent and integrated action plan towards improving financial inclusion in Jamaica. Therefore, in order to foster financial inclusion, the country is pursuing: (i) development of a National Financial Inclusion Strategy agreed among the major policy stakeholders (government, major regulatory agencies, development banks and the private sector) in order to establish a coordinated medium term policy action plan, defining goals, timing and responsibilities; (ii) enhancement of the consumer protection regulation and supervision in order to increase competition and promote transparency, efficiency and accountability; and (iii) enhancing access to financial services by those sectors particularly lagging behind (such as individuals, MSMEs and the rural and agricultural sector) by developing action plans targeted to address specific regulatory and institutional constraints.
- 2.5 **Financial and business legal framework.** The proper functioning of financial markets requires a regulatory framework capable of assuring effective and efficient enforcement of financial contracts, in order to among other things, reduce borrowing costs. In contrast, inefficiencies in these areas raise financial costs and limit access to finance. In Jamaica, the value of collateral needed for a

⁹ The sequencing and specifics of each of these reforms is important and will be explained in detail in the Proposal for Operation Development (POD) and reflected in the program's Policy Matrix.

¹⁰ World Bank, World Development Indicators, 2014.

¹¹ Tennant, D., op. cit.

¹² The Herfindhal Index in Jamaica, a proxy for competition, stands at 0.43 in 2010, well below its regional peers and the LAC average (0.74). The informal economy in Jamaica, a proxy of informational asymmetries, is around 35-40%.

loan, as a percentage of the loan, is on average 204%, going as high as 240% for medium size loans.¹³ In addition, in 2015 the country ranked 107/189 in the Enforcing Contracts indicator of the Doing Business. Financing productive development also requires sound regulatory frameworks and policy instruments in order to undertake productive investment projects with particular characteristics, such as those projects utilizing Public Private Partnerships (PPP) financing and innovation financing. Jamaica lacks an innovation financing program and needs to upgrade its PPP legislation, in order to streamline project design and execution. Finally, in order to facilitate the demand for financing, business productive initiatives should not be delayed by burdensome procedures that restrict economic activity. In this regard, although Jamaica has jumped 27 positions in the Doing Business Report in 2015, and an additional 7 points in 2016 ranking at the top in the Caribbean, additional actions are still needed to address other bottlenecks to enable private sector-led growth, as the distance to the frontier was calculated as 64 in 2016. Therefore, in order to enhance its financial and business legal framework to increase access to finance, Jamaica needs to implement reforms in the following areas:¹⁴ (i) long-term financing framework and procedures; (ii) contract enforcement mechanisms and creditors legal rights; and (iii) simplification of business registries and construction permits. These areas of reform were already supported by the “Competitiveness Enhancement Program” II and III (JA-L1010 and JA-L1014, respectively) and this program will continue the efforts in order to reinforce their effective implementation.

B. Alignment with the development objectives in the Country Strategy

- 2.6 This program is aligned with the third pillar of the Country Strategy for Jamaica, (Financial Sector and Business Climate) (GN-2694-2) (2012-2014) and with the new Strategy (2015-2020) (in preparation). In addition, it is aligned with the priorities set by the Government of Jamaica in its “National Strategic Plan Vision 2030” and its “Growth Agenda Policy Paper FY 2015/16”. The program is consistent with the IDB lending priority “Lending to small and vulnerable countries” and “Lending for poverty reduction and equity enhancement” of the “Ninth General Capital Increase” (AB-2764) (GCI-9), through the promotion of reforms to improve financial stability, financial inclusion and enhanced business climate. In addition, it will contribute to the regional development goal “Institutions for Growth and Social Welfare” of the GCI-9.

III. TECHNICAL ISSUES AND SECTOR KNOWLEDGE

- 3.1 **Program objectives.** The objective of the program is to enhance the contribution of the financial sector to economic growth by: (i) improving financial stability; (ii) increasing financial inclusion; and (iii) improving the financial and business legal framework.
- 3.2 The program will be structured as a policy-based loan under the programmatic modality (PBP), consisting of two individual and sequenced loan operations, in agreement with the Policy-Based Loans Guidelines (CS-3633-1). The PBP is

¹³ Ibidem.

¹⁴ See for example Tennant, D., op. cit.; and Global Information Technology Report, 2015.

considered the most appropriate, as it is an effective mechanism to support complex reforms that require sequenced actions for implementation.

- 3.3 The proposed program will be developed through the following components:
- 3.4 **Component I: Macroeconomic Stability.**
- 3.5 **Component II: Improving macro-financial regulation and supervision.** This component will develop policies directed to: (i) strengthening the financial system regulation and supervision by harmonizing prudential standards for DTIs, reinforcing the independency and mandate of institutions in charge of supervising the financial system, increasing compliance and improving the financial system risk management scheme; and (ii) strengthening the prudential regulation and supervision of securities, pension funds and insurance markets.
- 3.6 **Component III: Enhancing financial inclusion for firms and households.** This component will include the development of a National Financial Inclusion Strategy and measures to increase the usage of new financial instruments, as well as the adoption of reforms to strengthen consumer protection, to facilitate access to finance by the unserved and underserved as well as MSME and rural and agricultural clients.
- 3.7 **Component IV: Improving the financial and business legal framework.** This component will include policy measures to improve: (i) the legal framework for long-term financing by enhancing the availability of credible and accessible information on SMEs, providing information and simplifying processes for public-private partnerships (PPP), and facilitating the development of new financial instruments for sectors where information asymmetries limit access to finance (e.g. innovation and entrepreneurship); (ii) the legal rights of creditors to guarantee effective and efficient enforcement of financial contracts; and (iii) the simplification of business processes in order to increase the availability of productive firms and productive projects that the financial sector can support.

IV. ENVIRONMENTAL SAFEGUARDS AND FIDUCIARY SCREENING

- 4.1 In accordance with the directive B.13 of the Environmental and Safeguards Compliance Policy of the Bank (GN-2208-20 and OP 703 manually), this program does not require classification. Additionally, policy changes made in the framework of this operation will not have direct or significant effects on the environment or natural resources of the country.
- 4.2 Based on the “Safeguards Policy Filter Report and the Screening Form” this operation is classified as “C.”

V. OTHER ISSUES

- 5.1 **Coordination among multilateral organizations.** This program builds upon the technical assistance (TA) provided by the IDB, the International Monetary Fund (IMF) and the World Bank. The IMF is providing TA in order to improve the financial crisis regulatory framework and has provided TA to enhance prudential regulation in the securities and the banking sectors (Component II of this program). The World Bank is providing TA for the National Financial Inclusion Strategy contemplated in Component III of this program. The IDB will proceed to process a Technical Cooperation proposal in order to improve supervision

capacities of the Financial Services Commission (FSC), as well as to support certain actions contemplated in the other Components of this program. The IDB will coordinate its TC actions with the other multilateral organizations.

- 5.2 **Coordination mechanism.** The executing agency will be the Ministry of Finance and Planning, which will designate a program coordination unit (PCU) responsible for coordinating the agencies involved in execution. The PCU, together with the relevant authorities (BOJ, FSC, DBJ, MIIC, JAMPRO and PIOJ), will carry out periodic monitoring of the reforms envisaged in the Policy Matrix, with a view to preparing a semiannual report on progress towards the fulfillment of program conditions and submission of this report to the Bank.
- 5.3 **Risks.** The main risks that were identified are the following: (i) deterioration in global economic conditions could reduce the impact and speed of the proposed reforms; (ii) the proposed reforms will not show good results in the long run, if continuity is not given in a following sequence of reforms, that deepen progress in financial inclusion and financing of productive development; and (iii) the lack of coordination between public agencies responsible for the implementation of reforms, economic and social agents.

VI. RESOURCES AND TIMETABLE

- 6.1 The preparation of the program will require administrative sources for US\$53,000. The distribution of the Proposal for Operation Development (POD) to the Quality and Risk Review (QRR) is scheduled for January 15th, 2016 and for consideration of the Loan Proposal (LP) by the Bank's Board of Executive Directors is scheduled for March 15th, 2016.

CONFIDENTIAL

¹ The information contained in this Annex is confidential and will not be disclosed. This is in accordance with the "Deliberative Information" exception referred to in paragraph 4.1 (g) of the Access to Information Policy (GN-1831-28) at the Inter-American Development Bank.

SAFEGUARD POLICY FILTER REPORT

PROJECT DETAILS	
IDB Sector	FINANCIAL MARKETS-BANKING MARKET DEVELOPMENT
Type of Operation	Other Lending or Financing Instrument
Additional Operation Details	
Investment Checklist	Generic Checklist
Team Leader	Prats Cabrera, Joan Oriol (JOANP@iadb.org)
Project Title	Improving access to credit and competitiveness for growth
Project Number	JA-L1058
Safeguard Screening Assessor(s)	Arauz Herrera, Alison (alisona@IADB.ORG)
Assessment Date	2015-11-19

SAFEGUARD POLICY FILTER RESULTS		
Type of Operation	Loan Operation	
Safeguard Policy Items Identified (Yes)	Type of operation for which disaster risk is most likely to be low .	(B.01) Disaster Risk Management Policy– OP-704
	The Bank will make available to the public the relevant Project documents.	(B.01) Access to Information Policy– OP-102
	The operation is in compliance with environmental, specific women's rights, gender, and indigenous laws and regulations of the country where the operation is being implemented (including national obligations established under ratified Multilateral Environmental Agreements).	(B.02)
	The operation (including associated facilities) is screened and classified according to their potential environmental impacts.	(B.03)
	The Bank will monitor the executing agency/borrower's compliance with all safeguard requirements stipulated in the loan agreement and project operating or credit regulations.	(B.07)
	Suitable safeguard provisions for procurement of goods and services in Bank financed projects may be incorporated into project-specific loan agreements, operating	(B.17)

	regulations and bidding documents, as appropriate, to ensure environmentally responsible procurement.	
Potential Safeguard Policy Items(?)	No potential issues identified	
Recommended Action:	Operation has triggered 1 or more Policy Directives; please refer to appropriate Directive(s). Complete Project Classification Tool. Submit Safeguard Policy Filter Report, PP (or equivalent) and Safeguard Screening Form to ESR.	
Additional Comments:		

ASSESSOR DETAILS

Name of person who completed screening:	Arauz Herrera, Alison (alisona@IADB.ORG)
Title:	
Date:	2015-11-19

COMMENTS

No Comments

SAFEGUARD SCREENING FORM

PROJECT DETAILS	
IDB Sector	FINANCIAL MARKETS-BANKING MARKET DEVELOPMENT
Type of Operation	Other Lending or Financing Instrument
Additional Operation Details	
Country	JAMAICA
Project Status	
Investment Checklist	Generic Checklist
Team Leader	Prats Cabrera, Joan Oriol (JOANP@iadb.org)
Project Title	Improving access to credit and competitiveness for growth
Project Number	JA-L1058
Safeguard Screening	Arauz Herrera, Alison (alisona@IADB.ORG)

Assessor(s)	
Assessment Date	2015-11-19

PROJECT CLASSIFICATION SUMMARY		
Project Category: C	Override Rating:	Override Justification:
		Comments:
Conditions/ Recommendations	<ul style="list-style-type: none"> • No environmental assessment studies or consultations are required for Category "C" operations. • Some Category "C" operations may require specific safeguard or monitoring requirements (Policy Directive B.3).Where relevant, these operations will establish safeguard, or monitoring requirements to address environmental and other risks (social, disaster, cultural, health and safety etc.). • The Project Team must send the PP (or equivalent) containing the Environmental and Social Strategy (the requirements for an ESS are described in the Environment Policy Guideline: Directive B.3) as well as the Safeguard Policy Filter and Safeguard Screening Form Reports. 	

SUMMARY OF IMPACTS/RISKS AND POTENTIAL SOLUTIONS	
Identified Impacts/Risks	Potential Solutions

DISASTER RISK SUMMARY	
Disaster Risk Category: Low	
Disaster/ Recommendations	<ul style="list-style-type: none"> • No specific disaster risk management measures are required.

ASSESSOR DETAILS	
Name of person who completed screening:	Arauz Herrera, Alison (alisona@IADB.ORG)
Title:	
Date:	2015-11-19

COMMENTS
No Comments

ENVIRONMENTAL AND SOCIAL SAFEGUARD STRATEGY

1. The program aims to improve the contribution from the financial system to Jamaica's economic growth through: (i) improving financial regulation and supervision; (ii) developing regulation and instruments to promote financial inclusion of households and businesses; and (iii) strengthening the regulations, institutions and EP dedicated to providing services and key long-term investments.
2. The program is being proposed under the programmatic modality, with two separate and sequential operations, following the guidelines of the Programmatic Reform Loan Policy (GN-2200-13 and CS-3633) to facilitate the policy dialogue between the country and the Bank; and to provide the time-frame needed to implement the reforms. The second operation will deepen in aspects initiated on the first operation.
3. Therefore, and in accordance with the directive B.13 of the Environmental and Safeguards Compliance Policy of the Bank (GN-2208-20 and OP 703 manually), this program does not require classification. Additionally, policy changes made in the framework of this operation will not have direct or significant effects on the environment or natural resources of the country.

INDEX OF COMPLETED AND PROPOSED SECTOR WORK

TOPIC	DESCRIPTION	DATE	REFERENCES AND LINKS
Jamaica's economic reform and growth	A watershed for Jamaica's economic reform and growth, The Gleaner, November 18, 2015	November 2015	http://jamaica-gleaner.com/article/business/20151118/watershed-jamaicas-economic-reform-and-growth

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