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A New Regulatory Framework in Jamaica: The Legislative Challenge

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Good morning, ladies and gentlemen. It is indeed a pleasure for me to have this opportunity to address the members and guests of the Insurance Association of the Caribbean at its annual conference.

In considering the topic that I was asked to speak on I decided to avoid, except in a very brief summary, discussion of the specific provisions in our new insurance legislation. It seemed to me that you would instead be more interested in hearing about the context of Jamaica's regulatory reforms and how we went about it. In doing so I have sought to provide you with some idea of the new regulatory body that was created and the new regulatory framework within which it has been situated.

First then, let me briefly describe for you the background to Jamaica's recent financial sector regulatory reforms. This background set a number of challenges

for regulators and for the industries that they regulate. These challenges have been addressed in Jamaica by a combination of legislative and institutional reforms which I propose to describe to you in summary form.

BACKGROUND

In the middle of the 1990's, Jamaica experienced failures in a significant percentage of the financial sector when the life insurance industry and most of the banking sector collapsed. Many factors have been blamed for the collapse and there has been much debate as to its principal causes. I do not propose to enter this debate, interesting as it might be. What became clear very quickly, however, were the limitations of the regulatory framework, both legislative and institutional.

In the period, life insurance companies reacted to the perceived needs of the market by launching products designed to take advantage of the prevailing high interest rates and the bullish stock market. They introduced interest sensitive policies and guaranteed the rate of return to policyholders who had the option to withdraw their principal and interest at any time. These life insurance companies, however, did not manage their investment portfolios to match these short-term liabilities. The premiums from these new investment type policies were invested in long-term assets like real estate and listed equities. When real asset returns declined and stock prices fell, the companies suffered, as they still had to meet the previously guaranteed interest rates. Arising from the fall in asset values and the subsequent decline in nominal interest rates the companies had to deal with overwhelming cash outflows as policyholders rushed to protect their investments. Unable to liquidate long-term assets on a timely basis to meet

these immediate demands for cash the companies resorted to borrowing and incurred interest costs which diminished capital ultimately to disastrous levels. Extensive related party transactions and relationships further compounded these problems and, coupled with governance weaknesses, meant that early remedial action by the companies themselves was either ineffective or non-existent.

The government stepped in and rescued the life insurance industry. In the process, a number of life insurance companies were forced to merge to ensure viability. As a result the number declined from eleven to seven and the merger process is still continuing. In contrast, the general insurance industry saw only one failure which was salvaged through government assistance.

Corrective Action

The problems described above led the government to examine the causes and to take appropriate actions to remedy the deficiencies that were identified. The response was centred on upgrading the regulatory framework, improving legislation and strengthening the institutional capacity to meet the new supervisory and regulatory challenges. The objectives of upgrading the regulatory framework and creating stronger institutional capacity were met in part by the creation of the Financial Services Commission (“FSC”).

Before the creation of the FSC, however, the government formed a now well-known company called the Financial Sector Adjustment Company (“FINSAC”) to intervene and rehabilitate the financial sector.

In the rehabilitation process, it was clear from the outset that success could not be achieved without an overhaul of the regulatory system. While the insurance statute then in force, the Insurance Act of 1971, was generally a good piece of legislation for its time, it proved to be completely inadequate for the modern environment. It suffered from many important shortcomings that were, perhaps naturally, exploited by the insurance industry. The Act lacked standards for solvency, investments and accounting. There were no substantial provisions relating to corporate governance, related party transactions and market conduct. There were no penalties for breaches of the Act and Regulations outside of cancellation of registration. In addition, the regulatory institution lacked adequate resources to monitor and supervise the rapidly growing industry. The insurance industry, in particular the life insurance sector, was therefore able to operate with inadequate capital and poor operational standards. While the behaviour of companies in the different Caribbean jurisdictions undoubtedly varies and, we trust, has not followed the excesses witnessed in Jamaica, nevertheless we suspect that similar deficiencies are to be found in the regulatory regimes of a number of the Caribbean territories.

For the protection of consumers and the maintenance of a strong industry it was determined that the old Act should be repealed and replaced by a new one that would effectively deal with the many areas of deficiency, including capital adequacy, financial reporting and penalties.

We therefore introduced a completely new Insurance Act accompanied by a significant set of regulations during the last year and a half or so. This Act is administered by the new regulatory body, the FSC, which was created at about the same time by the Financial Services Commission Act which itself contains

significant new regulatory provisions affecting all regulated sectors, including insurance.

THE LEGISLATIVE CHALLENGE

These reforms represent major changes to the way in which insurance companies carry out their business in Jamaica. What are the challenges faced in reaching this point? Are there challenges peculiar to legislative activity that merit comment?

In considering the question of legislative challenges in relation to financial sector regulatory reform, several other questions also call to be answered. Who is challenged by new legislation, or the lack thereof? Should the law be amended or completely rewritten? In several new areas (corporate governance or market conduct, for example) how far should you go in regulating and prescribing what persons and companies must do or must not do?

These challenges are compounded by other elements. International standards must be met in order for domestic industries to be regarded internationally as well-supervised. But how suitable are these standards, and how relevant are they in each case to our own circumstances? These questions also raise special challenges in the attempt to forge consensus with industry participants in order to improve compliance.

More generally, how do you even reach the point where legislation is recognised as being needed and the government makes a commitment to legislating? Ought you to give extensive powers to make regulations to the regulator and let it get

on with the job? Or do you wait for a crisis to happen like the one that enveloped Jamaica's financial sector? I suspect, sadly, that our experience is not uncommon when it comes to the genesis of regulatory reform. In Jamaica at least, whatever the reason, we have now a pretty solid consensus between the government and the regulated that good regulation is a good thing and not something to be avoided.

Despite this, for us the legislative challenge was, in the end, simple but enormous: to completely overhaul the regulatory regime for insurance while at the same time intervening and rehabilitating substantial parts of the industry. In setting out on the path of reform we concentrated on two complementary avenues: legislation (both primary and subsidiary) and institutional change.

Legislation

As previously mentioned, it was necessary to write a new Insurance Act and Regulations and to conceive and legislate into existence a new regulatory institution (the FSC).

The first point to be made about this challenge is that it takes many years of concentrated effort. The new Act and regulations and the FSC Act were several years in the making.

The precise nature of problems needed to be identified and broad solutions explored. Jamaica was guided by the IAIS Insurance Core Principles and its own direct experience with the failures in the financial sector. For better or worse, we

were provided with an object lesson in the significance of a number of the elements found in the Core Principles.

With the problems identified, some broad, or high level, policy decisions had to be made. Two amongst these were key.

First, the architecture of the overall regulatory framework and the place of insurance regulation within it had to be determined. The regulatory framework for financial services in Jamaica now consists of:

- two regulators: an integrated regulator of the insurance, securities and pensions sectors (the FSC) and a bank regulator (the Central Bank)
- a safety net currently with two compensation schemes: a deposit insurance agency and a stock exchange investor compensation fund
- a Regulatory Policy Council comprised of the two regulators, the deposit insurance agency and the Ministry of Finance.

The FSC Act provides for the FSC to make regulations regarding the establishment, maintenance and use of compensation funds for the benefit of persons using financial services regulated by the FSC, in other words, investor compensation schemes, policyholder protection schemes and pension benefit guarantee schemes.

Second, the policy thrust and focus of insurance regulation had to be determined. This involved a switch from an emphasis on intermediaries to an emphasis on insurer solvency and governance and the exclusive primacy of the interests of the policyholder. This latter point covers matters such as claims settlement

standards, the maintenance of complaints records to facilitate investigations by the FSC and anti-discrimination provisions amongst others. It also includes a statutory requirement that directors and senior officers of insurance companies must take into account the interests of policyholders.

A technical project was developed to produce detailed proposals for legislative change. There was extensive involvement of the insurance community and broad consultations with affected parties in the development of the technical proposals.

As the foregoing elements were completed or came substantially close to completion the government created a Task Force to pull together and implement all of the elements. This Task Force was composed of representatives of the governmental agencies relevant to the completion of the reform and was given dedicated staff in order to maintain an exclusive focus on Task Force objectives. The Task Force had to determine the best way in which to achieve implementation of the reforms and a number of policy issues had to be determined. Ultimately this led to the development and carrying through to final passage of the following pieces of legislation:

1. Financial Services Commission Act
2. Insurance Act
3. Securities (Amendment) Act
4. Unit Trusts (Amendment) Act
5. Bank of Jamaica (Amendment) Act

This work required the dedicated effort of senior technical/policy level resources both in the Task Force and in the government backed by a coalition of relevant governmental parties. A project like this, to succeed, must have the ability to enlist the dedicated and concentrated efforts of a wide range of persons working in separate agencies which normally might have disparate goals. It also requires the intensive involvement of the private sector via consultations and public participation in the parliamentary process.

To harness this type of effort requires that the project be firmly identified as a priority for attention from the very top. I suspect that in this lies perhaps the greatest challenge to regulatory reform. I am certain that we would still be struggling through the legislation today in Jamaica if it were not for the project being given this clear and consistent priority from the top.

Legislative Process

Jamaica subscribes to the system of government referred to as parliamentary democracy. The exact procedure of passing laws in Parliament is best left to your comparative politics course from your respective school days and I will not indulge myself and take up your time by going into it. Suffice it to say that this aspect of the process alone represents a significant challenge for which the prospective reformer must prepare.

One feature is worth highlighting, however, as valuable, constructive and, although time-consuming, to be recommended. At a particular point in our parliamentary process we submit complicated proposed new laws such as our financial sector reform bills to a special committee of Parliament called a Joint

Select Committee. Our legislature is of the bicameral variety, that is, one with two separate chambers. The Joint Select Committee is a committee the members of which are drawn from both chambers and which undertakes a detailed consideration of the bills before they are taken for debate and passage in the respective chambers. At this stage numerous changes can be and often are made. The sittings of this committee are not only open to the public but the public is invited to participate directly in the proceedings. In the case of the financial sector reform bills there was active and detailed participation by representatives of the insurance industry as well as their legal advisors. The debate was frequently vigorous and in the end led to significant changes being made with a number of provisions being removed altogether and others modified. The active but responsible participation of the insurance industry contributed significantly to the quality of the legislation that was finally passed and represented what we believe is a model for successful lawmaking. We strongly encourage others, in the case of the authorities, to open up their legislative process in this way and, in the case of the insurance industry, to take advantage of this opening by making a positive contribution instead of seeking to use this opening to pursue lobbying efforts aimed at undermining the policy intention of the proposed legislation. The result is not only better quality legislative provisions but also legislation which, because of the involvement and understanding of the industries being regulated, has better prospects of being effective.

Concurrent with the parliamentary legislative process was the process of drafting, reviewing and final preparation of the subsidiary legislation, or regulations, which would immediately follow the coming into effect of the new Insurance Act and without which many of the key provisions of the new Act could not be implemented. These regulations were extensive and, as is often the

case, exceeded the primary legislation in both length and complexity. For the practitioners in the industry the provisions in the regulations are as important as the provisions of the primary statute. However, the regulations are made by a completely different process that contains only the most perfunctory or formulaic parliamentary scrutiny. Regulations under the Insurance Act are made by the FSC itself but must be approved by the Minister of Finance and then tabled in the lower house of parliament for a period of 21 days after which they become law without debate or any need for a vote. While this facilitates greater flexibility for regulation making, allowing for faster and more responsive changes as needed, it is also much less democratic and exposes the regulated to the prospect, however remote, of sudden, arbitrary or capricious changes to important regulatory provisions. However, Jamaica has built a tradition of wide consultation into the process of financial regulatory decision-making and the FSC is committed to this. In the case of the Insurance Regulations there had been widespread consultation with the industry over a period of two years before the regulations were finalised and passed into law. The FSC continues to consult regularly with the industry on legislative provisions, most recently by issuing a discussion paper on interpretations of the investment regulations and by holding a seminar for insurance company board members and senior managers on the corporate governance and related party provisions of the new Insurance Act and accompanying regulations.

Before leaving the discussion on legislation it is difficult for me to not at least mention some of the areas of strengthening contained in the new Act and regulations.

- (i) market conduct standards - new prominence for the consumer;

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- (ii) sanctions and penalties – together with the FSC Act, introduces capacity for more graduated regulatory response to compliance failures and problem institutions;
 - (iii) investment regulations – one of the most significant weaknesses was poor investment management within the context of weak or non-existent internal controls. Broadly, poor risk management;
 - (iv) solvency standards and actuarial guidelines -
 - (a) provisions for technical reserves and standardisation
 - (b) solvency/MCCSR/MAT/DCAT;
 - (v) related party restrictions;
 - (vi) fitness and propriety;
 - (vii) corporate governance requirements; and
 - (viii) auditor and appointed actuary requirements.

The last three represent core elements in the risk management concept embodied in the regulatory reforms. First, the individuals who make decisions must be not only honest but also competent (fit and proper requirements). Second, the institutions must operate within a framework of corporate governance that adequately considers the risks to the enterprise and takes appropriate steps to manage these risks (ie, reduce, eliminate or hedge). This should cover risks that arise in the ordinary course of business as well as any other risks to which the institution is exposed. Third, the auditor and the appointed actuary represent professional insiders whose role, and ability to withstand untoward challenges to their professionalism, have been significantly strengthened in the Act.

Institutional Change

Once the Act and Regulations have been passed a second phase begins which is the implementation of the new regulatory provisions. In my experience this stage is the more critical stage. In a sense, it is better to have deficient legislation implemented well than excellent legislation poorly implemented. It is true that optimally one needs good legislation that is well implemented. However, at the risk of being considered a pessimist, I would suggest that the real world, for all but perhaps the extraordinarily lucky few, can be described as a series of sub-optimal experiences. I am aware that this flies in the face of a very respectable line of philosophical thinking that claims for the world that it is the best of all possible worlds. Anybody with practical experience of achievement in the real world of business, finance, politics or governance of any kind would, however, recognise the element of truth in what I am saying. The real challenge is to seek to achieve your desired goals using the usually sub-optimal combination of resources available to you at any given time. It is within this context that I claim the priority of institutional capability over legislative authority.

In any reform of a financial sector regulatory regime, therefore, considerable attention should be paid to the institutional framework and the institutional capacity that will be tasked with implementing the new regulatory regime. This imperative was recognised in our reforms and the single regulator for the non-deposit taking financial sector was conceived.

Since it was created in order to undertake the regulation and supervision of all financial services that do not involve the taking of deposits it may be properly described as an integrated financial services regulator. Furthermore, financial

services are defined in the FSC Act in such a way that the Minister of Finance can respond quickly to ensure proper regulation of new types of financial services. The Minister by making an order can speedily bring such financial services within the statutory regime.

The FSC is responsible for overseeing the registration, solvency and conduct of approximately 180 firms and over 1,400 individuals in the following categories:

- Securities Dealers
- Investment Advisors
- Securities Dealers' Representatives
- Investment Advisors' Representatives
- Mutual Funds
- Unit Trusts
- Jamaica Stock Exchange
- Jamaica Central Securities Depository
- Insurance Companies
- Insurance Brokers
- Insurance Agencies
- Insurance Managing General Agents
- Insurance Sales Representatives
- Insurance Loss Adjusters
- Insurance Consultants

While the exact numbers are difficult to estimate, the FSC will be responsible for the registration and oversight of over 800 private pension plans and an as yet unknown number of pensions administrators and investment managers.

The FSC was created as an autonomous entity with the full legal capacity to take all steps required to ensure regulatory compliance without reference to the Minister of Finance or anybody else.¹ The political directorate therefore has very limited involvement except at the level of general policy directions and at the law-making level. All other powers are in the hands of the regulatory institution.

It is clear that to properly carry out this mandate and to achieve its aims the regulator needs to ensure that it has

- the resources to carry out its supervisory duties effectively;
- the capacity to anticipate any changes to regulation or implementation that will be necessary in the face of new circumstances;
- the ability to be responsive to the public and other interested groups; and
- the recognition and stature such that it is sufficiently respected both within the government and by owners, directors, managers and professionals in the industries that it regulates.

In this regard the aims of the institution need to be crafted in a manner which makes them unambiguous and uncluttered in order to preserve a clear focus on the ultimate objective of the regulatory function.

The institution must also have the capacity to ensure that the legislation and regulations continue to be modified and upgraded in response to new needs or newly identified gaps in the existing provisions. This is of particular importance in a climate of evolving international concerns and standards.

¹ Certain actions are reserved for the courts or may only be taken under court supervision.

The third IAIS Core Principle (ICP3) requires that the regulator be “independent”. Independence can be variously described, but in my view true independence ultimately rests not on legal provisions that say so but on the quality of the institution and its reputation. The FSC was created as an institution empowered and expected to be self-funding. This is one of the places where independence begins. During this financial year (its second full financial year) the FSC is expecting to be self-funding. This means that our expenses will be met out of fees and charges levied on the industries that we supervise. This is, for Caribbean territories, fairly radical although the insurance industries in our countries are accustomed to special regimes of taxation and other duties and imposts (especially the life insurance sector). For the new regulatory body it is one of the necessary conditions for ensuring that it meets the full charge of its mandate.

In closing, I would like to point to two areas of challenge for us in the Caribbean’s future. First, we all face a challenge in continuing to upgrade our regulatory capability (both legislative and institutional) to meet the evolving international standards. In facing this challenge we need to find a way to gather together the time and resources of the regulators and industry stakeholders so that we can have a sufficient voice in the molding of those standards. Second, we face a challenge in developing the capability to share regulatory information on a consistent and sustained basis across borders. As you, the providers of insurance services, increasingly are reflecting cross-border alliances, acquisitions and partnerships, so must the regulatory framework in the Caribbean evolve so that it continues to provide the highest standards of safety for our residents while facilitating continuing improvement in the quality and extent of the services that you, the insurers and intermediaries, provide to them.

I am indeed glad to be able to refer to these issues in front of you because I have noted from your website that the IAC's major objectives include:

- To harmonise regulatory legislation and insurance laws.
- To be the effective lobby for the strengthening of Caribbean companies operating throughout the region.

Both suggest that the IAC and its members across the region will continue to be willing and active partners with regional regulators as we tackle these challenges in the future.

Thank you.

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