

**CHANGES IN JAMAICA'S COMPETITIVE BANKING LANDSCAPE**  
**Are US\$ Loan Pricing adequately reflecting the inherent Credit & Currency Risks?**

**By Stacie Ann Wright, The Bank of Nova Scotia Jamaica Limited**

**Introduction**

The competitive landscape in Jamaica's banking sector has changed significantly since the 1990s. This change has been more profound in the market for foreign currency denominated loans to corporate and commercial clients. Due to heightened competition among commercial and merchant banks to maintain the size of their foreign currency loan portfolio, US\$ lending rates have sharply declined in 2003 and have only moderately increased since then, in spite of the general rise in interest rates worldwide. It is therefore no longer considered a remote occurrence to see rates in the local market being quoted marginally below the level of the USD Prime lending rate, currently at 8.25%.

**Background**

In 1996 the banking system comprised of 41 Commercial and Merchant banks (refer Table 1). In the mid 1990's the government intervened in five commercial banks in order to protect the sector from total collapse, as these institutions were experiencing severe liquidity problems. The financial sector crisis was caused by several factors that

included weak regulatory supervision, under capitalization of the industry and imprudent lending practices. Four of these commercial banks were merged, restructured and sold as a single entity while the larger commercial bank was restructured and sold by itself.

**Table 1**

	Commercial Banks			Merchant Banks		
	Number	Total Assets (J\$ Billion)	Total Assets (US\$ Billion)	Number	Total Assets (J\$ Billion)	Total Assets (US\$ Billion)
Dec-96	11	148.0	4.2	30	20.1	0.6
Dec-98	9	170.0	4.6	21	16.7	0.4
Dec-99	6	194.9	4.7	14	11.9	0.3
Dec-00	6	222.1	4.9	11	7.6	0.2
Dec-01	6	239.8	5.1	11	15.6	0.3
Dec-02	6	269.0	5.3	10	24.8	0.5
Dec-03	6	320.0	5.3	7	36.5	0.6
Dec-04	6	350.5	5.7	5	49.4	0.8
Dec-05	6	375.8	5.8	5	43.1	0.7
Apr-06	6	395.0	6.0	5	47.1	0.7

**Source - Bank of Jamaica**

Since the government's intervention and restructuring of the entire financial sector in the mid 1990's, the drive to build critical mass and grow the size of balance sheets of financial entities led to further mergers and acquisitions in the sector, pushing the numbers down to six (6) commercial banks and five (5) merchant banks.

This development coupled with increased investor confidence, has resulted in a heightened increase in the competitive landscape. This has reduced profit margins among commercial and

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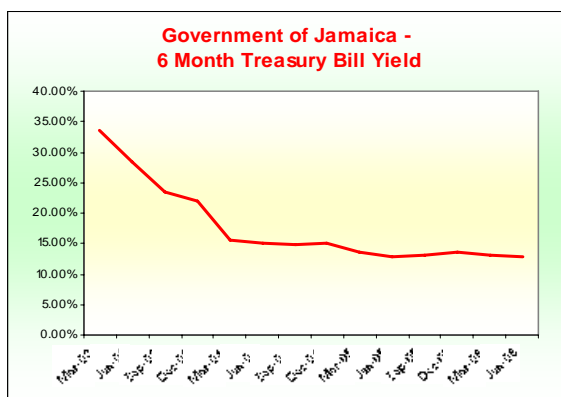
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merchant banks that, in addition to competing with themselves have also faced competition from the growing local Investment Dealers & Brokers, which offer similar products without the commensurate prudential reserve requirements.

In addition to the competitive forces, profit margins have also been impacted by the reduction of interest rates on Government of Jamaica risk-free debt as both the Bank of Jamaica and the Government have worked at reducing interest rates as part of their overall macroeconomic policy.

pronounced in the market for foreign currency denominated loans to corporate and commercial clients. US Dollar lending rates have sharply declined since 2003 and have only moderately increased subsequently, in spite of the general rise in interest rates worldwide.

Since 1999, demand for foreign currency denominated loans has outpaced the demand for domestic currency denominated loans. For instance, for the year ended December 2005, foreign currency loans increased by 16%, while the domestic currency denominated loans increased by only 13%.



**Table 2**

	Local Currency Loans (J\$ Millions)	Foreign Currency Loans (US\$ Thousands)	% of Foreign Currency Loans to Total Loans
Dec-99	26,276	252,117	28.4%
Dec-00	27,933	277,636	31.2%
Dec-01	32,979	338,746	32.7%
Dec-02	49,293	483,620	33.3%
Dec-03	61,782	616,436	37.7%
Dec-04	67,766	739,956	40.2%
Dec-05	76,898	857,738	41.9%
Apr-06	78,960	825,398	40.7%

**Source - Bank of Jamaica**

**Recent Trends in the Foreign Currency Credit Market**

The effects of the low interest rate policy and the heightened competitiveness of the banking sector is perhaps most

In addition, the overall proportion of total loans denominated in foreign currency moved from 28.4% in 1999 to 40.70% in April 2006. The weighted average USD lending rate for Commercial Credit fell sharply between 2002 and 2003 and

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increased moderately up to February 2006 in spite of the steady rise in interest rates worldwide (*refer to table 3*). To underscore the point, while the USD Prime increased by 225 bps between December 2004 and February 2006, the weighted average USD lending rate in Jamaica increased by only 43 bps.

**Table 3**

	Lending Rates (Commercial Credit)		
	Domestic Currency	Foreign Currency	USD Prime
Dec 2001	19.50%	12.11%	4.75%
Dec 2002	18.26%	12.08%	4.25%
Dec 2003	19.32%	8.79%	4.00%
Dec 2004	17.72%	9.13%	5.25%
Dec 2005	17.32%	9.50%	7.25%
Mar 2006	17.54%	9.69%	7.75%

**Source - Bank of Jamaica**

It is therefore no longer considered a remote occurrence to see rates being quoted in Jamaica at marginal levels below that of the USD Prime lending rate, currently at 8.25%.

**Reasons for the Demand**

The strong demand for foreign currency loans has been driven largely by the relative stability in the value of the Jamaican dollar when compared to the major currencies. The average annual depreciation against the United States

dollar between 2001 and 2005 was 5.2%. Therefore, Jamaican dollar earners are now more willing to assume the exchange rate risk, given that the landscape has become more predictable. This, coupled with the huge differential between Jamaican dollar lending rates and US\$ lending rates (*see table 3*), makes it more attractive for borrowers to source US\$ funding and assume the currency risk, as it is more economical.

The fast growing Tourism and e-services sectors have also been at the forefront of the demand for foreign currency credit as the Jamaican economy transitions from manufacturing to the provision of services.

**Sources of Liquidity**

With annual Foreign Direct Investments remaining fairly robust during the last five years (*refer to table 4*), & the Bank of Jamaica's position of maintaining high Net International Reserves, the level of foreign currency liquidity within the banking system has been good in recent years. Banks have therefore, demonstrated a strong inclination to convert this liquidity into loans, to generate an attractive stream of long-term income, as against traditional

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investments of deposits with overseas banks and Government of Jamaica USD global bonds, which offer lower yields or are relatively unavailable.

reasonable credit risk premium to account for the inherent risk in weaker credits.

**Table 4**

	<b>Net Foreign Direct Investments</b>	<b>Deposits in Commercial Banks</b>
	<b>USD Millions</b>	<b>USD Millions</b>
2000	381.8	3,454.92
2001	524.9	3,440.53
2002	404.9	3,672.87
2003	604.4	3,413.03
2004	549.3	3,717.05
2005	n/a	3,935.72

**Source - Bank of Jamaica**

Another major source of the build up of US\$ liquidity in the local market has been the stringent restrictions and requirements imposed by the U.S. Patriot Act on non-US citizens wishing to open deposit bank accounts in the USA. Jamaicans are finding it increasingly difficult to deposit funds directly in the USA, despite few local restrictions in this regard.

This underlines the extent to which competitive pressures have depressed US\$ lending rates, and has resulted in some levels of mis-pricing from a risk-return standpoint. Essentially, banks no longer have as much flexibility to add a

**Current Anomalies with Deposit Rates**

In spite of the general rise in interest rates worldwide, to prevent further margin compression local banks have not been able to offer depositors much higher rates, given their lack of flexibility in adjusting lending rates upward. This has resulted in a convergence of locally quoted foreign currency deposit rates with rates available overseas from AAA rated banks. For example, the rate on 1-month Certificates of Deposit with local commercial banks now averages between 4% and 5.25%. The corresponding rates with overseas banks (*AAA-rated*) now average between 5.05% to 5.15%.

However, given the rigidity in the flow of funds created by the US Patriot Act, it is unlikely that significant deposits will flow overseas to banks to realign the risk-return equation.

**Outlook**

Regarding the medium-term outlook, the proportion of foreign currency denominated loans could increase

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further, especially if the value of the local currency remains relatively stable against the major currencies.

Based on preliminary data from the Bank of Jamaica, foreign currency loans have continued to expand, making up approximately 41% of outstanding loans as at April 2006. For the same period, the weighted average lending rate increased only marginally to 9.88%.

Given that it is likely that the US Federal Reserve could increase rates at least once more for 2006 (*resulting in a commensurate increase in the Prime lending Rate*), the current phenomenon of sub-Prime rates may not be short-lived. With the banking sector growth projected to be fairly moderate over the medium-term, it is likely that competitive pressures could push lending rates marginally lower, resulting in further mis-pricings on a risk-return basis.

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