CENTRAL BANK OF
TRINIDAD & TOBAGO

Eric Williams Plaza, Independence Square, Port-of-Spain, Trinidad, West Indies
Postal Address: P.O. Box 1250
Telephone: (868) 625-4835; 4921; 5028; Fax (868) 627-4696; Telex: 22532; 22386
E-Mail Address: info@central-bank.org.tt
Website: www.central-bank.org.tt

"Regulating the Financial Sector"

Address at the

Arthur Lok Jack Graduate School of Business Ideas Forum

by

Ewart S. Williams
Governor, Central Bank of Trinidad and Tobago
27/10/05

<<<<<< >>>>>>

Why do we need to regulate the financial sector?

The literature cites two reasons viz : (i) to protect depositors and policy holders; and (ii) to avert a crisis (to avert systemic risks).

Firstly, bank regulation arises from the need to protect small depositors in a market characterised by **informational asymmetries and sharply differing incentives**. People put money in banks as a place to safely store their funds : they lack both the means and the incentives to monitor the risky behaviour of bank owners and managers : depositors are not privy to the detailed inside information about the riskiness of the banks' loans. Under these circumstances, **regulation and supervision of banks' activities become necessary to protect the interest of depositors.**

That's one reason : the second reason is that banks operate with a public safety net : in principle, they have access to Central Bank funds in an emergency, and they are covered by publicly-subsidised deposit insurance. Both these facilities permit banks to transfer some of the risk in their **asset portfolios from shareholders to taxpayers** .. this safety net could prompt banks to take more risks: thus they should be regulated.

In short therefore, the public relies on the Government and the Central Bank to assess the riskiness of financial institutions because we grant the licences for the institutions to operate; we set the rules for their operation, and therefore we must ensure that these institutions are properly managed.

Another important justification for regulation is the fact that financial crises carry a staggering cost to the Government (meaning taxpayer), and to the country as a whole, in terms of economic dislocation. These costs justify the efforts to strengthen domestic financial systems. **In terms of the positive payback** …. strong financial systems help foster prosperity because, after all, financial systems perform a task that is central to the proper functioning of the national economy.

The Central Bank is currently involved in an intensive process of **reforming financial sector legislation** and **upgrading our regulatory and supervisory practices**. We are playing **catch-up** because the evolution of the financial sector has outpaced our legislation and has made some of our supervisory practices outdated in the new environment.

This phenomenon – of lagging regulatory structures - is not unique to Trinidad and Tobago : it exists in most developing and emerging markets.

Developed countries tend to be proactive and anticipate the need for regulatory changes. In most of these countries, for instance there are legal provisions for a routine review of financial sector legislation every three years. **That is so in most developed systems**. In developing countries we wait for things to happen and then react.

Thus, it is not coincidental that Jamaica, is **arguably the most** advanced in the Caribbean, **in terms of financial sector legislation**, because the financial crisis of the late 1990's, which cost an estimated ten percent of GDP, prompted a strengthening of existing legislation.

Early Regulatory Changes

In Trinidad and Tobago there have been two occasions on which important changes were made to our banking sector legislation. **Firstly, in 1986**, in response to the failure of a number of finance houses there was an amendment to the Central Bank Act to provide for the establishment of the **Deposit Insurance Scheme** to protect small depositors. In 1993/1994 the Banking and the Non-Banking Acts were consolidated into the **Financial Institutions Act (the FIA)** and bank regulation was strengthened – for instance, by setting prudential limits on secured and unsecured lending, by specifying minimum capital adequacy in accordance with the Basle Capital Accord and by prescribing the international accounting treatment for loans and advances. These amendments came **in the context of the difficulties faced by three local commercial banks and their subsequent merger into the present First Citizens Bank**.

The current urgency to reform financial sector regulation is being undertaken against the background of a **revolution in information technology** and the **elimination of traditional barriers** between various compartments of the financial services industry and between national jurisdictions and the rapid expansion in the financial sector.

The Changing Financial Environment

Compared with the 1990's when financial liberalisation was introduced, **our financial system has grown enormously in complexity**, with increasing linkages between banks, insurance companies and other parts of the financial system. In some cases, these linkages have been formalised under the umbrella of **financial conglomerates**, with operations in different sectors of the financial here at home and across the Caribbean and in Latin America.

Along with the new configuration, the risk profile of the financial system has also undergone a profound change. For example, a sharp **upward pressure in asset prices** has inflated balance sheets (particularly of insurance companies and pension funds): in some credit unions, asset growth has been driven by investments in real estate development rather than from their core activities.

The risk in these portfolios has been exacerbated in the case of mixed conglomerates, by **significant intra group exposures**. The expansion into regional markets has also led to a **non-transparent increase in cross-border risk**.

And in the face of all of this, our financial laws remain outdated and in most cases do not provide regulatory agencies sufficient powers to deal with the complexity of the financial system.

The New Regulatory Agenda

There has already been the **integration of supervision of the banking, insurance and pension sectors within the Central Bank**. The Government has also announced that the **credit union sector** will be brought under the ambit of the Central Bank from a prudential supervisory perspective. (Other aspects of co-operative development will continue to be handled by the Government ministry).

Currently, supervision of **mutual funds** is shared between the Trinidad and Tobago Securities and Exchange Commission (TTSEC) and the Central Bank, with the Central Bank having responsibility for funds operated by banks. The intention is to bring the supervision of all mutual funds under the TTSEC.

Amendments to the FIA

An ambitious proposal for strengthening the legal and regulatory framework is under implementation. We are well advanced with the **amendments to the FIA**, which is the legislation governing the banks and other deposit-taking institutions. While the objective of the exercise is to upgrade our legislation in line with international best practices, we are taking pains to recognise the nuances to our specific circumstances. For that reason the Central Bank is working in close collaboration with the licensees themselves in the drafting of the legislation.

This is critical since we know that the importation of a regulatory framework, appropriate for developed systems, where we that lack some of the required institutions, would be counter-productive and provide supervisors with a false sense of security.

The amendments to the FIA currently being discussed will:

1. enable the Central Bank to conduct **consolidated supervision** by broadening its powers to inspect subsidiaries and offshore operations of licensees - This is important **in order to be able to effectively assess and address the risks to the regulated entities within a group, including risks of contagion**;

2. require the establishment of financial holding companies in order to protect the licensees from group risk, **by separating financial from non-financial entities in the conglomerate structures**;

3. allow for **sharing of information with other regulatory agencies**, locally and of other jurisdictions and law enforcement authorities - This ability to share reduces the duplication of supervisory effort (for example, between the Central Bank and the TTSEC) and **puts the Bank on the same level with other jurisdictions in the Caribbean who have signed information-sharing arrangements**.

4. There is an amendment requiring that **mergers and acquisitions, be first approved by the Central Bank**. This is needed so that the regulator can assess and address the risk profile of the resulting amalgamated company and the impact on the financial sector as a whole. **It is also important to protect the public from excessive concentration** in the financial sector.

5. We are expanding “the criteria” which is used when granting a permit to a controlling shareholder. Currently, the only criteria specified in the law is, “fit and proper” which is specifically defined. However, we think that other criteria should be taken into account such as one’s business history : banking knowledge : the business plan etc. Prior Central Bank approval will also be needed before a controlling shareholder is able to expand his shareholding.

6. We are proposing an amendment that would authorise the Central Bank to disclose information on a licensee when it is of the opinion that such disclosure would be in the best interests of depositors, policyholders, creditors, shareholders or the financial system. The Central Bank would also have the authorisation to publish information obtained from the institutions, in the interest of maintaining market discipline. and

7. Very importantly, the amendments will give the Central Bank the authority to impose civil money penalties as an immediate enforcement tool and **alternative to prosecuting through the Court system, for breaching certain sections under the Act**.

These are but some of the amendments.

Amendments to the Insurance Act

The current Insurance Act, dates back to 1980 and is ill-suited to the current position of the industry. It is unduly restrictive in certain aspects (for example in investment management), pays no recognition to

prudential risk management, and gives limited authority to the regulator to ensure that companies are operating in the interest of policy-holders.

The new legislation is likely to focus on:

(i) increasing capital requirements;

(ii) easing current restrictions on permissible investments;

(iii) adopting international standards for the valuation of assets;

(iv) insisting on more disclosure, including the annual publication of audited consolidated financial statements and other information on business activities and the risks to which the company are exposed.

The Credit Union Sector

Like the insurance industry, the **credit union sector** has undergone exponential growth over the last two decades. The expansion has, however, taken place in **the absence of an appropriate legislative framework**. The present legislation covering the **credit union movement** (the Co-operative Society Act) **dates back to 1971** and does not deal with prudential issues.

Arriving at an appropriate supervisory regime for the **credit union sector** will present some challenges since it is important to respect the uniqueness and the co-operative aspect of the movement. On the other hand, however, the case for stricter regulation of the credit union sector is compelling.

It is based on the amount of resources now being intermediated (now estimated at about $4 billion) and the business models of the larger credit unions, **which encompass more complex and riskier operations**. These factors require that greater attention be paid to risk-management by the unions themselves and that there be a formal supervisory framework for credit unions to protect members' savings and to help maintain the integrity of the financial system. [And remember that we are talking about an estimated 500,000 credit union members (about one-third of population) and largely lower and middle income people].

Pension Funds

We also have on our agenda, initiatives to enhance the supervision of **private pension funds**. Currently, most plans are over-funded **reflecting asset price increases in local stock and property markets**. Nonetheless, we have started addressing several issues in the sector, including late and non-filing of regulatory returns and valuation, inadequate separation among trustees, investment managers and fund administrators, inadequate disclosure to pension members and prudent investment management. We are also working closely with the Ministry of Finance on its Pension Reform initiative.

Money Laundering

Our Central Bank, as is the case with central banks all over the world, **is required to collaborate with the law enforcement agencies,** whose mandate is the combating of **money laundering and terrorist financing**.

In September 2004, the Central Bank issued a revised Guideline on anti-money laundering, updating the previous regulations issued in 1995. The new Guideline is consistent with the Forty Recommendations on Terrorist Financing developed by the Financial Action Task Force on Money Laundering (which is the internationally recognised regulator for these matters). The new Guideline expands on the definition of "**money laundering**" which now covers attempts to legitimise resources from any illicit activity, not only drug-trafficking. It also introduces enhanced customer due diligence procedures for higher risk customers, such as correspondence banking relationships, referrals and politically exposed persons. The Guideline requires that the institutions designate a compliance officer, train staff, retain transaction records and set up policies and procedures regarding knowing-your-customer.

Setting Standards and Market Conduct

I would like to note that the business of regulating the financial sector involves more than the regulators, like the Central Bank or the TTSEC. In fact, the regulators need to rely on other groups, such as the accounting associations, the external auditors and the actuaries. These are important self-regulatory organisations on whom the regulators depend for setting accounting, actuarial standards and external auditing standards. The Central Bank has recognised the role of these organisations through the establishment of a **Professional Advisory Committee**.

Another important partner in the regulatory process is **the public**. In the "economics" jargon, **market discipline** is critical for regulatory compliance. Unfortunately, in Trinidad and Tobago, we have not established the mechanisms for effective market discipline and this places excessive reliance on institutions' internal control practices and on the supervisory system.

The Central Bank is trying to foster greater market discipline by insisting that financial institutions make **greater disclosures** – for example, through the publication of quarterly balance sheets so that the public can judge the institutions' strength : through publication of their investment procedures so that investors can assess whether these are consistent with their risk tolerance levels. It is also important that institutions disclose their governance structures and openly discuss real or potential conflicts of interest.

Transitioning

Now that we are well along the way to upgrading our legislative frameworks, it has become clear that some institutions need time to adjust to the new regulatory requirements. Change is often very difficult and particularly when it comes in large discrete steps.

So we will need to provide for **transition periods to give institutions time to meet the new requirements**. Thus for example, institutions will need time to replace "connected" directors by "independent" directors; to **unwind related party exposures** which could be done only gradually and to ring-fence the financial entities from the non-financial entities in mixed conglomerates.

A particular challenge has arisen in the case of the insurance sector. This sector has had the minimum of regulation over the past twenty-five (25) years and while **many companies** took it upon themselves not only to meet the requirements of the outdated legislation, but to operate according to more up-to-date criteria, **a few exploited the regulatory vacuum** - so that they are not even in compliance with the provisions of the 1980 Insurance Act.

Market Conduct

One aspect of regulation that is often overlooked is that of **Market Conduct.** This rationale behind market conduct is that there is an imbalance of power between the institutions and their clients. In recognition of this imbalance, in mid-2003 the Central Bank established the Banking Services Ombudsman to adjudicate complaints between banks and small customers. Early this year the Ombudsman's office was intended to cover the insurance industry.

In the five months from May to September 2005, **the Financial Services Ombudsman (FSO) handled 190 complaints against insurance companies**. Of these, 47 complaints did not fall within the jurisdiction of the FSO, leaving a total of 144 complaints for consideration by the Office of the FSO (OFSO). Of the 28 companies under the scheme, 5 companies accounted for 95 out of the 144 or two-thirds of these complaints.

As we investigated these complaints **it is very clear that there are a few insurance companies that are having difficulties in** meeting legitimate claims.

We have started working closely with the management in these companies to address areas of weakness and non-compliance. Fixing the weaknesses depends in large part on the willingness of the managers and owners to cooperate and take corrective actions to make their companies safe and sound for their policyholders. **However, the regulator must be**

realistic and determine, at the appropriate time, the need to invoke the powers under the Act. The Regulator must maintain its focus on the main objectives which are:

1. to protect consumers;

2. to promote the existence of efficient, fair, safe and stable industry; and

3. to enhance public confidence in the industry.

And finally, while we in Trinidad and Tobago are trying to bring our regulatory practices in line with the **basic standard** or **what is called the Basel Core Principles**, international regulators are about to set a new and higher standard referred to as Basel II. This new standard is really intended to facilitate the **measurement and management of the risk exposures of large internationally-active banks**. However, developing countries like Trinidad and Tobago are concerned, (and rightly so), that international creditors and lending agencies will tend to assess the strength of their financial systems by their adherence to this more sophisticated standard. Accordingly, regional regulators are studying how the Basel II framework could be modified to suit our Caribbean environment.

But that's a discussion for another time. Thank you for the opportunity to share these thoughts.