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

LUNCHEON ADDRESS

at

THE INAUGURAL CONFERENCE ON BUSINESS, BANKING AND FINANCE

by

Ewart S. Williams,
Governor, Central Bank of Trinidad and Tobago

April 27, 2004

Let me first congratulate UWI, CMMB and the other sponsors on the occasion of their **Inaugural International Conference on Business, Banking and Finance**. It is an excellent idea and a much needed forum (I am sorry I didn't think about it first).

This morning we were treated to a (stirring) feature address by our Honourable Prime Minister, and this was followed by a number of excellent papers. After such an auspicious start and a most sumptuous meal, I hope that you are now disposed to listen sympathetically to my many problems.

In my remarks this afternoon, I would like to give a brief overview of the state of the financial system of Trinidad and Tobago

and to discuss what I consider to be the major challenges facing the sector. I would couch my remarks against the background of financial sector developments globally, and with particular reference to the U.S.

Technology and financial innovation are transforming banking. Automated Teller Machines (ATMs) are now not only a convenience but a mechanism for drastically lowering the cost of banking and in many ways, substituting for bank branches. The development of the international ATM network makes many bank functions, including foreign exchange transactions, even more convenient. Credit and debit cards and point-of-sale electronic transfer systems have increased the speed and efficiency of payments while reducing the need to hold bank deposits.

Added to this, the universalization of banking is increasingly blurring the boundaries between banks and non-banks.

As you know, bank crises were a standard fare of recessions in the 1980's and early 1990's. The global economy is currently emerging from a recession, but what's interesting this time is that by and large, financial systems in both developed and the developing economies seem to have survived the recent economic downturn, (which included sharp adjustments in asset prices and some corporate bankruptcies), without any major crises.

Admittedly, a major reason for the improved resilience of financial systems **in developing and emerging market countries** has been the general improvement in macro-economic management. **In the developed countries** where, in several cases financial imbalances have widened, the resilience has been due **to the structural changes in the financial systems** and **the quantum improvements in the capacity of financial institutions to manage risks.**

In the U.S., for example, banks are emerging from the recession with very **strong capital positions** (averaging 13 percent, significantly above regulatory standards), with **robust asset quality**, (non-performing loans averaging about 1.2 percent), and with financial markets pricing banking sector risks at very favourable levels. A similar situation is occurring in the Eurozone. Even the Japanese banking sector seems to be slowly returning to health.

What are the structural factors that have **contributed to the banking system resilience**?

Well, in the U.S., an important factor has **been the tremendous** consolidation in the banking industry following the lifting of banking restrictions in 1994. In the Eurozone, economic integration and the introduction of the Euro have had a similar effect.

Another structural factor in the U.S. has been the slowing down in demand for business loans as corporations shifted to bond financing. This increase in corporate bond issuance was, on the one hand, a means of substituting longer-term debt for short-term obligations and on the other, a reaction to the tightening in credit standards by banks in response to the deterioration in credit quality in the mid 1990's.

While these structural factors were important, it is widely agreed that **the improvement in risk management among financial sector firms is an even more significant factor contributing to the recent resilience of the US banking system**. This improvement has been effected in several ways.

These days, virtually all U.S. banks have devised tools for measuring risk exposures, established limits on individual positions

taken by risk managers, and have established clear investment guidelines.

In terms of their operations, banks began making more intensive use of available opportunities for the sharing of risks, in part through a great use of **loan syndication**. Through this mechanism, banks could maintain their relationship with their clients while spreading the risk among a wide range of investors.

The growing attractiveness of loan assets among institutional investors has spawned another risk management technique – the **increased use of secondary loan markets**. These loan markets also provide very useful secondary price information which allows commercial banks to manage their credit risk more effectively and to price new credit extensions more efficiently.

These two risk management techniques represent a marked shift by U.S. banks, away from the traditional "**lend and hold**" business practices toward a fee-oriented "**originate and distribute**" business model.

Data suggest that U.S. banks, particularly the larger ones, are also making greater use of **credit derivatives** to help manage bank portfolios. One form of derivative that has become popular is the **credit default swap** where the bank actually buys default protection for a small fee. These guarantees are then traded at market prices.

Deregulation, technology and financial innovation have also been transforming the financial sector in Trinidad and Tobago. For the most part, the impact of these influences has been to create a stronger and more dynamic sector. However, the new environment has also led to some systemic weaknesses such as excessive bank concentration, imbalances in the rate of development of the various

sub-sectors, and has still left some critical growth sectors inadequately serviced.

These shortcomings raise challenges which must be addressed to reduce the systemic vulnerability and to broaden the contribution that the financial system must make, if we are to achieve our medium-term economic goals.

I will like to turn to some of these issues after a brief overview of our financial sector.

A recent report by one of the international rating agencies characterised our financial system as **fairly advanced, with relatively sophisticated institutions, products and technologies**, highlighting Trinidad and Tobago's status as a regional economic power (and I might add, the regional financial centre).

The commercial banks dominate our financial system but we have a wide range of financial institutions, including many of those found in developed countries – merchant banks, mutual funds, a specialised mortgage institution and a couple institutions that are dedicated to the financing of small- and medium-term enterprises.

Most of our six commercial banks have become **universal banks**, offering banking products as well as pension and mutual fund management, trust services, leasing, brokerage and merchant banking services. Two of the banks have moved to organise their operations under holding companies. Most of the banks have close relationships with insurance companies and securities firms.

Comprehensive, consistent and timely data are only available for the banking system and these show that:

(i) **the banks are very well capitalised** with a capital adequacy ratio of over 20 percent, way above the statutory minimum required to cover credit risks and to provide a buffer for other market and operational risks;

(ii) **non-performing loans for the system as a whole averages about 3 percent** which, although higher than in the U.S. (where it is about 1 percent), is a marked decline from the double digit levels of the early 1990's;

(iii) **bank's profitability** is fairly healthy, by international standards, with an average return on assets of about 2.3 percent, compared with 1.4 percent for banks supervised by the FDIC. Loan income continues to contribute the major share of bank revenues but income from investments and service charges have been increasing in importance.

(iv) The data also indicate that a disproportionately large share of bank credit (close to 40 percent) is directed to the **consumer sector**. In contrast, **the energy sector** accounts for a very small part of domestic bank credit, because of its large financing requirements which are met by international funding. Some banks are currently targeting **smaller energy sector supply-firms** with more modest financing arrangements and with more limited access to foreign financing. Lending to **small businesses** is limited and is largely in the form of personal short-term loans at high interest rates, to compensate for a higher perceived risk.

(v) Our local banks have been expanding their delivery channels through the **introduction of ATMs**. It is

estimated that banks now own about 250 ATMs or about 1 ATM per 5,200 inhabitants; this compares with 1 ATM per 780 persons in the U.S. Technology investments have also enabled two local banks to offer **some telephone and internet banking**.

There used to be the notion that banking in Trinidad and Tobago was characterised by **weak competitive pressures** which allowed banks to maintain profitability levels through increasing margins, rather than by improving operating efficiency. If this was so several years ago, the current reality is **that competition in the banking system is intense** (especially in the consumer lending market).

Banks have been trying to adapt to the more competitive environment through:

- improving the quality of the services being offered to customers (stressing efficiency, convenience, and product options etc.);

- moving to riskier lending;

- extending their activities to new lines of business, (such as mutual funds, insurance etc); and by

- increasing fee-based income

Most importantly, the larger banks have begun to pursue **aggressive regional growth strategies**. The regional expansion provides the opportunity for increasing critical mass, and justifying the high cost of investment in cutting edge technology.

Like in the U.S., **our local banks have made great strides in improving their risk management**. The significant efforts in this area were a reaction to the sizeable loan losses during the debt crisis of the 1980's (when non-performing loans reached over 20 percent) and the tightening of international bank regulations that came with the Basel Accord in 1992.

Currently the typical risk management strategy employed by the banks makes use of:

(i) a series of **exposure limits** covering secured and unsecured lending to a single borrower or borrowing group and for related party lending and a capital charge on net foreign exchange exposure.

(ii) an interest pricing system based on **risk rating models** for corporate accounts and **credit scoring** for retail accounts. These models de-emphasise the weight of collateral and raise that of projected cash flows in credit decisions.

(iii) the increased use of **securitisation and instruments such as bankers acceptances**, to minimise large corporate exposures.

(iv) increasing the role of the **Board** and **the Credit Committee,** in approving and monitoring large exposures.

So far, I have pointed to the positive spill-offs from the changes in the financial environment. In the case of Trinidad and Tobago, these forces have also led to a **level of concentration** that in several aspects has increased the vulnerability of our financial system. A continuation of the trend could even lead to further downside risks.

While in the U.S., loans and securities held by commercial banks account for less than 20 percent of all US credit market debt, **in Trinidad and Tobago commercial banks account for about one-half of total financial sector assets. Further, two of the six banks account for sixty percent of bank assets,** underscoring the concentration in the financial system.

Part of the dominance of the commercial banks comes from the fact that **they own the largest non-bank financial intermediaries.** The other contributing factor is a bit more complicated and has to do with the **relatively under-developed state of the capital market**.

Even by developing country standards, our equity market is shallow and illiquid with limited corporate bond activity. The bond market has traditionally been dominated by local public sector issues though over the last few years; these have been supplemented by foreign currency issues made by regional governments.

I don't want to get into the reasons behind the stunted development of our capital market (as that is an interesting study, in its own right). Suffice it to say that we are encumbered by many of the factors that are common to most developing and several emerging market countries. The list includes **a weak governance framework, a fiscal system that favours debt over equity financing, a corporate structure dominated by small family-owned firms with an aversion for information disclosure and inadequate regulatory oversight**.

Personally, I do not accept the notion that our small size and dual economic structure are insurmountable obstacles to the development of our capital market. In fact, I am convinced that if we are to have a chance at achieving developed country status by 2020, if

we are to succeed in diversifying our economy and reducing our reliance on the energy sector, **we need to accelerate the development of our capital market as a source of long term capital**. We also need to develop new and more efficient mechanisms for **small business financing**.

There could be serious downside risks to bank concentration. Specifically, if taken too far it could lead to an abuse of a dominant market position and could raise moral hazard issues, including the "too big to fail" phenomenon.

The transformation of the financial sector has already had far-reaching implications for prudential and supervisory policy.

Firstly, financial innovation, the increased use of "off-balance sheet operations" and the blurring of financial boundaries between banks and non-banks have made traditional bank supervision techniques obsolete. There is now need for a whole new approach to financial sector supervision – **one that de-emphasises rigid rules and regulations but rather focuses on risk management**.

This approach recognises that financial engineering can be used by banks and other intermediaries to escape regulation; that within financial groups there is a tendency for risks to be shifted to the areas where regulation is weakest, and that because of the limited availability of regulatory resources, continuous surveillance is a formidable undertaking.

The approach, therefore, focuses on ensuring that the correct internal risk management systems are in place; that the regulator has the power to intervene early to suggest corrective action and to enforce sanctions. The approach also establishes clear **exit rules**.

The Central Bank is currently the regulatory authority for the banking system. Legislation is about to be passed to extend this authority to the insurance industry and pension funds; later, the plan is to bring the credit unions, which are now becoming major players in the financial system.

A second important challenge facing us is to undertake a **comprehensive reform of our financial sector legislation** (applicable to the commercial banks, the insurance companies, pension funds and the securities industry). The reform should recognise the changes that have taken place in the financial sector and provide the regulatory authorities with the necessary tools to manage systemic risks.

Unfortunately, regulatory frameworks are always playing catch-up to market and institutional changes and are normally delayed until forced into being by crisis.

Jamaica now has, arguably, the most up-to-date financial legislation in the region, mainly because legislative reform was a by-product of the financial crisis of 1996-1997.

Here at home, the critical amendments to the Central Bank and banking Acts as well as the establishment of the Deposit Insurance Corporation in the mid-1980's came out of crisis in the non-bank financial sector. In fact, the last significant amendment to our financial legislation (the FIA) was also prompted by the need to deal with Central Bank intervention of three state-owned banks.

I am hoping that we are ahead of the curve this time and that we accomplish comprehensive legislative reform to avoid a financial crisis.

At the present moment, the Government of Trinidad and Tobago is preparing a **White Paper** that will seek to guide the course of our financial system over the next few years. At the centre of our vision is the creation of a **Pan-Caribbean Financial Centre** that is **globally competitive**, **market driven** and **well diversified**. One pre-requisite for the emergence of this Centre will be the updated legislative infrastructure that I have just mentioned. The supporting architecture will need to include:

(i) a **modern payments system** that facilitates real-time settlements and reduces settlement risks;

(ii) a modern expanded **information technology environment** that enables the delivery of cost-effective financial services;

(iii) a **well-educated, skilled and flexible cadre of professionals** with advanced training in investments, regulation, finance and information technology; and

(iv) a network of **information vendors** that would help promote market discipline to support the enhanced supervisory framework.

Some of these initiatives are well underway; others would require planning and close collaboration between all the major stakeholders – the Government, the private sector and the regulatory authorities.

Ladies and Gentlemen, we have several challenges ahead of us but we can do it, if we try.