Ewart Williams: The Central Bank and preparations for integrated supervision

Address by Mr Ewart Williams, Governor of the Central Bank of Trinidad and Tobago, at a Breakfast Seminar hosted by the Association of Trinidad and Tobago Insurance Companies and the Trinidad and Tobago Insurance Institute, Port of Spain, 8 July 2003.

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Let me first thank the Executive of the Association of Trinidad and Tobago Insurance Companies (ATTIC), the Trinidad and Tobago Insurance Institute (TTII), as well as the entire membership for the invitation to address you at this Breakfast Meeting. I would hope that this is the start of a process of dialogue and consultation between the Central Bank, earmarked to become the regulator, and all the stakeholders in the industry.

This “integrated supervision project” which essentially focuses on bringing the insurance companies and pension funds under the supervisory authority of the Central Bank is in principle part of a larger strategy geared towards reinforcing safety and soundness while at the same time preparing our financial system to play a pivotal role in the future development of the economy. This broader financial sector strategy involves, inter alia, improving the regulatory framework governing mutual funds and credit unions, strengthening the Securities and Exchange Commission and building an efficient capital market that would mobilize and channel savings into long term investment.

The planning for the Integrated Supervision Project started several years ago and was supported by a team of Canadian Consultants (Lawrie Savage and Associates) who worked closely with the Central Bank, the Ministry of Finance and major stakeholders in the Insurance Industry.

But all this is by way of background. What I would like to do this morning is:

(i) Take some time to explain the rationale behind the impending shift of supervisory authority for the insurance industry from the Office of the Supervisor of Insurance (OSI) to the Central Bank;

(ii) Tell you what we have been doing in preparation for this shift; and

(iii) Clarify what you can expect from us.

You should know that very many countries, both developed and developing, have moved to integrate their specialised regulatory agencies into a single entity. In a few cases the single entity has been outside the Central Bank; the best known of these cases is the United Kingdom which has a Financial Services Authority (FSA) which regulates all financial institutions. The FSA is however separate and apart from the Bank of England. There is a variant of this model, for instance in Canada and Australia, where the supervision of the banking and insurance sector is done by one regulatory agency outside the Central Bank, but where there are other regulatory agencies for other financial sub-sectors. In Jamaica, the Central Bank continues to regulate and supervise the commercial banks and non-banks, but the rest of the financial system is supervised by a separate entity, the Financial Services Commission (FSC).

Our Government has indicated that bringing the insurance industry and pension funds within the regulatory ambit of the Central Bank is a first phase and that over the longer term consideration is to be given to a Super Regulatory Agency which will supervise all financial services (credit unions, the securities industry etc.).

What is the rationale for a single regulatory entity?

(i) The increasing complexity of the financial services industry, as evidenced by the emergence of financial conglomerates, requires a strong institution to supervise the conglomerate as a whole, rather than a series of agencies supervising parts of the complex.

(ii) Many products and services offered to consumers by the insurance industry (or the securities industry, for that matter) are becoming difficult to distinguish from those offered by deposit taking institutions. Accordingly, integrated supervision avoids the different regulatory treatment of similar products: it eliminates gaps in consumer protection and reduces the scope for regulatory arbitrage.

(iii) Trinidad and Tobago, like most other developing countries is unfortunately short on human capital. The creation of a single agency avoids the problem of spreading our limited human resources too thinly among different specialized agencies.

In addition to these reasons, the Central Bank sees integrated supervision as a way of facilitating the task of maintaining the soundness of the financial system. Recent examples worldwide have shown that weaknesses or breakdowns in the financial system, occurring at various points in the chain can lead to widespread economic crisis. We don't have to look too far: we have as ample evidence the case of Jamaica, where the collapse of the financial system in the mid 1990's is estimated to have cost taxpayers some 10% of GDP.

In discussing some of the factors leading up to the financial crisis in Jamaica, the Chairman of FINSAC (the government agency charged with resolving the crisis) pointed to the country's indigenous financial sector entrepreneurs whom he thought were, (and I quote):

- too eager to get rich;
- too bullish in risking other people's money;
- too eager to start at the top;
- too competitive with one another in demonstrating the trappings of success, reflected in the rush to form larger and more complex groups; and
- too prone to bend prudential norms and regulations.

The FINSAC head also blamed the crisis on Jamaica's failure to adequately regulate and supervise the financial sector. He noted, in particular, that the Office of the Superintendent of Insurance, was not adequately staffed and as a department within the Ministry of Finance did not appear to have the stature needed to deal "at eye level" with the moguls of the insurance industry.

This was the Jamaican situation in the 1990s. It may not be our present circumstance, but let's be frank, we have our own skeletons and we should learn from the Jamaican experience and seek to put our house in order.

In the context of the integrated supervision project conducted by the Lawrie Savage group, diagnostic studies on several insurance companies were conducted. The data obtained from these studies, as well as information from the Office of the Supervisor of Insurance, suggest that while several companies operate in conformity with the statutory requirements, there are too many cases, similar to the Jamaican example, where the prudential norms and regulatory requirements are flouted.

The evidence suggests that there are far too many cases of chronic statutory fund deficits, late filing of returns, inadequate reinsurance and other areas of non-compliance. The diagnostic studies also indicate that the investment strategy of some companies requires stricter regulatory attention, in part because of **limited portfolio diversification** and **related party transactions**.

The latest Insurance Industry Report makes reference to the need for companies to upgrade corporate governance and risk management structures. It also identifies market conduct in the industry as another matter of concern. In this regard, there are clearly too many instances of inadequate and delayed settlement of legitimate claims of policyholders as well as questionable, if not, unfair and deceptive marketing practices. The capacity of intermediaries to competently fulfill their role is also an issue that reportedly comes up with some frequency. Specifically, there is a perception that the training of intermediaries does not always keep pace with the evolution of products offered by some companies.

These are but some of the issues that call for stronger regulation and more focused supervision.

And so, what are we doing?

As you know, Cabinet has approved that the supervision of insurance companies and pension funds be integrated with that of banking institutions under the authority of the existing Bank Inspection Department of the Central Bank. The legislation to effect this transfer is currently being finalized and is expected to be presented to Parliament by the end of July or early August. In the meantime preparations for the transfer are proceeding apace.

Internal re-organisation

- A new structure in the Bank Inspection Department has been adopted to deal with these expanded supervisory responsibilities.
- **The staff of our Bank Inspection Department has been increased, through the recruitment of new graduates with finance and accounting qualifications. This cadre of recruits has undergone intensive training in insurance supervision.** {Incidentally, experience has shown that people who have worked in the insurance industry make the best insurance supervisors and regulators, so be on notice that we are in the market for suitable insurance staff.}
- We intend to supplement our domestic resources with senior-level technical assistance from the Office of the Superintendent of Financial Institutions, Canada. Insurance supervision is a highly technical and involved business and the Canadians are recognized to have developed a high level of expertise in this area.

We are in the process of incorporating some of the staff of the Office of the Supervisor of Insurance of the Ministry of Finance into the Bank Inspection Department of the Central Bank.

A major focus of the Central Bank will be preparing for the updating of the Insurance Act (1980)

Because of rapid financial sector innovation, the Central Bank is in the process of introducing amendments to the **Financial Institutions Act (FIA)** to strengthen the Bank's ability to effectively regulate and supervise the deposit taking institutions - for example, to deal with the new realities of increased cross-border lending; to conduct consolidated supervision of financial conglomerates; and generally, to strengthen the hand of the regulator to ensure compliance.

It is exactly the same thing that we need to do with the insurance industry. The current insurance legislation (the Insurance Act 1980) was framed at a time when insurance companies operated in an entirely different environment. Proposals put forward to amend this legislation during the 1990's, to keep pace with industry changes, were not enacted for various reasons. **In our view, there is now urgent need for new insurance legislation, to deal with the reality of the current day industry** and to give the Central Bank, as regulator, the required level of authority and empowerment to act effectively to strengthen and ensure the safety and soundness of the insurance sector. The new legislation should also bring the supervisory framework in Trinidad and Tobago into closer compliance with international insurance core principles, in the context of a local environment.

A first draft of new insurance legislation was prepared last year by the Canadian consultants, (Lawrie Savage and Associates) with local legal support. There is much disagreement as to the amount of industry input in the draft and there is also disagreement about the opportunity that was provided for local stakeholders' comment. My understanding is that the local industry has several issues with the draft and that a Working Committee of ATTIC is in the process of articulating these concerns and making recommendations.

I gave this commitment to the Executive of ATTIC, when we met at the Central Bank a couple of months ago and I am repeating the commitment again - **that the Central Bank would work closely with the industry, through ATTIC, to formulate legislation that is appropriate to the local environment, that is feasible to implement, but also and very importantly, that is in line with international best practices.** We cannot be marching towards developed country status and acquiesce into outdated financial sector legislation befitting the 1980's. We are ready to begin to work with ATTIC on this new legislation, as soon as the working group is ready with its comments. I'm sure that, as reasonable people, we will arrive at the best insurance legislation for Trinidad and Tobago.

In terms of the need to adopt international best practices, we feel strongly that the new legislation should cover a number of critical areas including:

- adequate minimum capital requirements
- modern standards of corporate governance
- restrictions on related party transactions
- new standards of market conduct
- corporate transactions (mergers, transfers of business, etc.)

- financial reporting and records
- enhanced powers for the Supervisor
- clear exit rules

Let me turn to the kinds of changes that could be expected under the new supervisory regime

When the transfer of supervisory authority is effected, supervision will continue to be on the basis of the existing Insurance Act. However, we envisage several significant changes in our operational approach.

Firstly, **on-site examinations and continuous monitoring** would supplement the current of off-site reporting and “hands-off” supervision. It is important to note that under the current legislation the OSI had the authority to do on-site supervision, but no inspections have ever taken place, partly because of resource constraints. The Central Bank staff has the experience with on-site supervision of the commercial banks for several years, and training has been provided to the new staff that has been recruited to work in insurance supervision. **We intend to make supervisory insurance training an on-going activity.**

Secondly, while supervision will continue to involve the monitoring of legal compliance and critical performance ratios, as we currently do with the commercial banks, we intend to incorporate the risk-based approach into our operational policies and procedures vis-à-vis the insurance industry. I am certain that many insurance companies have already incorporated risk management techniques in their operations and are very familiar with the approach.

In summary, as regulator, our approach will be to identify areas of higher risk in each institution’s operations and to work with the management to reduce these risks to acceptable levels. The risk-based supervisory approach is recognized to be ideal for identifying problems at an early stage rather than attempting to fix them after they have developed. This approach will place focus on **corporate governance** requiring the Board of Directors and Senior Management to take full responsibility that their corporations operate in accordance with sound business and financial practices.

I would like to emphasise that with the risk-based approach our supervisory teams will need to have access to senior management to discuss business strategy and future plans. That’s what we currently do with the banks and that’s what we would expect to do with the insurance companies.

Procedures and policy manuals to allow for risk-based supervision and regulatory compliance are being finalized. The Central Bank is also developing new prudential and solvency requirements for the insurance industry that conform to best practice. We plan to engage the industry in consultations on these matters.

We propose to commence these on-site visits soon after assuming our responsibilities and after we have conducted a number of outreach sessions so that the industry is prepared for the process. Obviously, with some thirty (30) insurance companies we would need to start with a small carefully selected sample. As we currently do with the commercial banks, the findings of each on-site examination will be documented in a formal report which will be discussed with the management of the institution before we finalize and submit to the Minister of Finance. The report will also include recommendations for correcting the deficiencies identified, within specified timeframes.

In closing, let me re-affirm that we at the Central Bank are looking forward to the challenge that the transfer of supervisory responsibility will surely bring. We are committed to working with the insurance industry in an atmosphere of understanding and mutual respect, to have integrated supervision implemented in an effective manner that benefits the industry and the economy as a whole. Our mission is the same as yours: **we want an industry that adequately satisfies the expectations of policy holders: that instills confidence and respect: that contributes to the strengthening of savings and investment, in the interest of long term economic viability.**

Let me assure you that the objective of the Central Bank as regulator is not to stand in the way of structural changes in the industry. Insurance companies - like all other firms in the financial sector - need to respond constructively to changing conditions; this could mean more mergers, more product innovation and the taking on of new risks.

Well-managed institutions in strong financial condition should have great freedom. The Central Bank will give weak companies time to manage themselves back to financial health and will also develop appropriate exit strategies for those which can no longer be viable.

I invite the stakeholders in the industry - ATTIC, TTII, the Brokers Association - to work with the Central Bank to meet these objectives. **It's in all our interest to have strong and effective regulation that meets international standards.** Stakeholders can and should bring peer pressure to bear on companies that do not play by the rules or flaunt best practices, since a few non-compliant operations can present industry-wide risks or even threaten the stability of the financial system.

Thanks again for inviting me.