Emsley D Tromp: International and local challenges for financial institutions in the Netherlands Antilles

Speech by Dr Emsley D Tromp, President of the Bank of the Netherlands Antilles, at the official opening of the new headquarters of Orco Bank, Willemstad, 10 April 2010.

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Good evening, ladies and gentlemen.

It is a pleasure for me to join you today on the occasion of the official opening of Orco Bank's new headquarters. I would like to start by congratulating the shareholders, management, and personnel on this milestone in Orco's Bank history. With the purchase of this historical building, you have contributed to the conservation of Curaçao's cultural heritage. In addition, with this investment you have demonstrated your confidence in the Antillean economy in general, and the Curaçao economy in particular. Given Orco Bank's performance and its prudent management, I am more than confident that in the future, your decision will prove to have been the right one.

Ladies and gentlemen, these are without doubt challenging times for financial institutions. Both internationally and locally, developments are taking place that affect the way financial institutions do business. Today, I would like to address some of these developments. I will first discuss recent international economic developments and their impact on the financial sector. Second, I will deal with the challenges our financial institutions are facing in the context of the constitutional changes within the Kingdom.

When discussing international economic developments, we cannot ignore the international financial crisis that resulted in a worldwide recession last year. Financial innovation and closer links between financial institutions transformed a liquidity crisis in the relatively small U.S. subprime mortgage market into a major solvency issue in other financial markets in the United States and abroad. Subsequently, the financial crisis rapidly spilled over into the real sector.

In an effort to prevent a collapse of the global financial system, authorities, particularly in industrial countries, took unprecedented measures aimed at supporting demand and reducing uncertainty and systemic risk in financial markets. These measures included the expansion of retail deposit insurance schemes and the provision of guarantees for bank liabilities other than deposits. In addition, banks received billions in capital injections and guarantees for their assets in return for government ownership stakes. Central banks also provided generous liquidity support and cut interest rates. However, these efforts could not prevent a deep worldwide recession.

As we all know, few if any economies have not been affected by the crisis. Output contracted in most of the advanced economies, including the United States and the Euro area. In addition, economic activities slowed in the emerging markets and developing economies. As a consequence, many economies experienced a significant increase in unemployment. Fortunately, global economic growth has rebounded recently, and financial conditions have improved. However, the pace of recovery is expected to be slow as uncertainties remain in the financial markets, and public intervention will gradually have to be withdrawn. According to the International Monetary Fund's most recent World Economic Outlook, global growth is forecasted to near 4 percent in 2010, following a contraction of 0.8 percent in 2009.

Although the sources of the crisis were extremely complex and numerous, a fundamental cause was that many financial firms simply did not appreciate the risks they were taking. Financial regulation was not equipped to detect the risk concentration and flawed incentives behind the financial innovations. Regulators, in fact, were not aware of the underlying risks of the financial innovations and the interconnectedness between activities and institutions. As a result, financial institutions and other investors took risky decisions beyond the regulatory net.

For that reason, economists and policymakers worldwide generally agree that the weaknesses that led to the recent financial crisis must be addressed. Financial regulation and supervision need to be strengthened to prevent a similar crisis in the future. This will require a number of steps. First, regulation should be broadened and include all activities that pose economy-wide risks. Second, financial regulation will have to focus on strengthening financial institutions' management of liquidity and risk. Third, conflicts of interest should be reduced by making bonuses more consistent with long-term success rather than short-term profits. And fourth, the transparency of the financial system should be improved. In the area of financial supervision, the focus should be to detect developments in the financial sector that might lead to a systemic crisis. Not only banks, but all financial institutions should be subject to strong and comprehensive supervision on a consolidated or firm wide basis.

An important lesson of the recent financial crisis is the need for international cooperation and policy coordination. As financial markets have become increasingly integrated and financial centers interconnected, no country can escape the effects of a financial crisis no matter where it occurs. As a consequence, financial sector reform cannot stop at the national borders. The recent experience in dealing with the crisis has shown us that international policy coordination actually can be very effective.

Ladies and gentlemen, the effects of the international financial crisis on the financial sector in the Netherlands Antilles were relatively contained. Of course, our financial institutions were affected by the global collapse of the debt and equities markets and the sharp reduction of interest rates. However, conservative investment strategies combined with relatively high risk-aversion limited our financial institutions' exposure to troubled assets. In addition, the financial sector supervision provided by the central bank has prevented major problems from the financial crisis. Nevertheless, we should be aware that the general tendency towards stronger financial supervision and regulation and increased international cooperation and policy coordination will have implications for our financial sector supervision. The supervisory and regulatory standards are set by international institutions such as the BIS and the IMF. If we do not follow these rules, we will run the risk of being blacklisted, thereby undermining confidence in our financial sector and investment climate. Hence, the notion of determining one's own supervisory policies is an illusion. In small economies like ours that are very vulnerable to shocks, international cooperation and policy coordination in financial sector regulation and supervision is indispensable for international recognition and to make us more resilient towards possible crises in the future.

Cooperation and policy coordination in the areas of financial sector supervision and regulation are also crucial on the Kingdom level. To address our financial sector's vulnerabilities, I envision a financial supervisory structure in which every country within the Kingdom will have its own supervisory institution, complemented by a standard-setting body at the Kingdom level or Committee of Kingdom Supervisors. As I advocated recently on the occasion of the ***"Kingdom seminar on Financial Sector Supervision"***, this body should consist of the presidents of the respective central banks and should be in charge of preparing legislation in line with international best practices, the timely implementation of rules and regulations, and monitoring compliance. Such a structure will guarantee compliance with international supervisory standards. In addition, this structure will create a level playing field with uniform rules within the Kingdom and promote credibility and transparency. The existing cooperative agreements between the central banks of the Netherlands, Aruba, and the Netherlands Antilles can serve as a basis for the development of a firm supervisory architecture and the achievement of sound financial institutions and financial stability in the new countries of the Kingdom.

Ladies and gentlemen, I would like to turn now to recent developments in our own economy. In 2009, our economy also was affected by the adverse international economic developments. Domestic demand weakened, due to lower private investment and consumption, although it was offset in part by increased public consumption and investments. Inflationary pressures eased in 2009, largely because of lower energy prices.

An analysis by sector reveals that the tourism industry was most affected by the global economic downturn. We estimate that the foreign exchange revenues from the industry dropped by 5.5 percent in 2009.

In most other sectors of the economy, activities weakened in 2009 compared to 2008. For example, in the construction sector, activities slowed down because several major tourism and transportation-related projects reached their final stages. In addition, activities in the wholesale and retail sector weakened reflecting lower domestic demand, a decline in the number of stay-over tourists, and lower re-exports by the free-zone companies in Curaçao.

Our economy did not contract in 2009, contrary to the experience of most countries in the region. Real economic growth in the Netherlands Antilles, however, is estimated to have decelerated from 1.8 percent in 2008 to 1.0 percent in 2009.

The main reasons why our economy is an exception in the region is the implementation of the debt relief program and the Social Economic Initiative. The inflow of debt relief funds from the Netherlands prevented a worsening of the current account of our balance of payments in 2009. In addition, it contributed to a cash surplus at the general government level and, hence, a decline in public sector debt. Thanks to the debt relief program, our debt-to-GDP ratio declined from 82 percent in 2008 to 72 percent in 2009.

Ladies and gentlemen, the Netherlands Antilles economy is expected to grow by 1.6 percent in 2010 as a result of an improvement in both domestic and external demand. The growth of domestic demand is accounted for primarily by public sector consumption and investment. Expectations are that wages and salaries expenses will increase moderately, despite the dismantling of the Netherlands Antilles, as no efficiency effects are expected in the short term. As a result of the culmination of the dismantling process in 2010, consultancy fees for setting up the necessary institutions to support the entities in their new constitutional status are projected to rise, causing spending on goods and services to remain elevated. Meanwhile, public investment is expected to peak as most projects of the Social Economic Initiative Program will be implemented in 2010. The current account of our balance of payments is projected to worsen as imports of goods and services will offset higher exports. However, the worsening of the current account will be partly offset by the net inflows of current transfers related to the implementation of the debt relief program.

The price climate is expected to remain favorable in 2010. Inflation is projected to rise modestly from 2 percent in 2009 to 2.3 percent in 2010, a result of higher commodity prices, reflecting the pickup of global economic activity.

Ladies and gentlemen, the constitutional changes within the Kingdom and the related implementation of the debt relief program and Social Economic Initiatives have played a crucial role in our recent economic performance and will continue to affect our performance in 2010. However, these developments also have implications for the financial sector.

The debt relief program started in January 2009 for the central government and in April 2009 for the island government after each entity met the qualifying requirements. These requirements included, among other things, balanced budgets and the strengthening of financial management. The Board of Financial Supervision, or College Financieel Toezicht (CFT), was established to temporarily supervise the finances of the government entities. As you may know, the terms of the debt relief program provide that the Dutch government will pay 70 percent of interest costs and 100 percent of maturing principal until approximately 70% of the outstanding debt at the end of 2005 has been settled.

The inflow of debt relief funds from the Netherlands adds to the existing excess liquidity in the domestic money market. This excess liquidity was due to the uncertainties regarding the international securities markets, which caused financial institutions and other investors to hold more funds locally. These developments put domestic interest rates under increased pressure, and these rates had already declined in line with international developments. As a consequence, local financial institutions are obtaining lower interest income, which forces them to reduce deposit rates, tap other sources of income, and improve cost efficiency to remain profitable.

Financial institutions in the Netherlands Antilles have always considered government securities as a main local investment instrument, given their low risk and attractive return. This view, however, has hampered progress in the further development of our capital market. Because of the debt relief, the availability of government securities is diminishing rapidly. In addition, new issues of government securities will be limited under the prevailing budget rules. Consequently, alternative investment opportunities are needed to keep our capital market attractive for investors.

One possible alternative is the issuance of bonds by public enterprises. However, these issues will be successful only if good corporate governance of public companies is observed. In this context, it is crucial that tariffs are determined based on sound business principles and rules set by a regulatory board. Strong internal controls, full disclosure, and independent boards of directors and supervisory directors also are important preconditions for effective governance of public enterprises. Under these circumstances, investors will be confident of receiving a fair return on investment. The Dutch Caribbean Stock Exchange is, in this context, also a welcome development as it could foster more investment alternatives in our capital market.

Ladies and gentlemen, as we are reaching the final stages of the dismantling process of the Netherlands Antilles, we also are closing a chapter in the history of central banking in the Netherlands Antilles. In a few months, the Netherlands Antilles will cease to exist. As a consequence, the central bank of the Netherlands Antilles as we currently know it also will disappear. The current system has served our nation well for over 180 years. It essential therefore that the current framers of the new central bank be guided by our past experience. If we are to have one central bank, it ought to be reflected also in the governance structure. Any attempt to make the new central bank function as one institution for two completely autonomous entities will be unproductive and will result in mutually inconsistent policy objectives. Therefore, I would like to share my views with you on the institution that should replace it in the new constitutional setting.

Currently, the most important objectives of our central bank are to maintain the external stability of the Netherlands Antillean guilder and to promote a sound and efficient financial system in the Netherlands Antilles. These objectives translate into the following functions: (1) the issuance of banknotes and the circulation of coins; (2) the supervision of financial institutions to guarantee depositors' and other creditors' funds; (3) the management of the foreign exchange reserves; (4) the promotion of a reliable and efficient payments system; and (5) banker of the government. Of course, the new countries of St. Maarten and Curaçao also need an institution in charge of executing these functions.

In the new constitutional arrangement, St. Maarten and Curaçao will establish a monetary union with a common central bank and a common currency. The preservation of economies of scale, the continuation of the good reputation and credibility of the current central bank, and a larger common economic area are the main considerations for having a common central bank. However, a common institution also poses great challenges for the countries involved. I think the high degree of policy coordination required to ensure a balanced and effective monetary policy is one of the greatest challenges because it means that already some of the newly won policy autonomy has to be forfeited. Also, the introduction of uniform legislation for monetary and financial sector supervision in both countries is a complex task lying ahead of us.

Ladies and gentlemen, the process of creating a new central bank and designing effective governance arrangements for this new institution is a complex one, especially given the involvement of two new autonomous countries. In addition, the environment in which central banks operate changes continuously, and the role and governance of a central bank will continue to evolve. Effective governance of the new central bank can be guaranteed only if certain preconditions are met. I would like to discuss these preconditions with you in more detail.

First, the new countries will have to continue adopting similar legislation, rules, and regulations related to monetary and financial sector supervision. Also, reconciliation of fiscal policies is recommended, but for the time being, this will be guaranteed by the common budget rules monitored by the CFT.

Second, the central bank should have a high degree of autonomy from the governments to guarantee that its monetary and supervisory policy decisions are made without political interference. Moreover, professional and technical expertise of monetary and financial matters is centralized in the central bank. Therefore, the relationship between the government and the central bank, and the roles and responsibilities of both entities should be clearly specified in legislation.

Third, the appointment procedures of the central bank's board of directors should be clearly specified in the Bank's statute. Needless to say, the board of directors of a central bank should meet certain requirements, including professional and personal qualifications. Furthermore, the members of the board of directors should abstain from activities that would create conflicts of interest regarding their role as central bankers. When stipulating the requirements for the board of directors, we also should take into consideration the reality of our labor market. Hence, we should avoid limitations on, for example, age or nationality that could become barriers for the appointment of experienced professionals. Ultimately, what the central bank needs is professionally and personally qualified persons who can manage the institution effectively. Once appointed, the directors of the central bank should direct their efforts towards the realization of the institution's objectives. Therefore, it is crucial that these individuals are provided with the required autonomy to execute their office effectively.

And finally, an independent and expert supervisory board should be appointed. The supervisory board plays a crucial role in ensuring the effective administration of the Bank. Central banks have supervisory boards to approve the institution's operational budget, review and approve the annual accounts, and oversee the audit process. In addition, the supervisory board promotes the use of structured planning and management frameworks. Because the supervisory board is part of the governance structure of an independent central bank, it also should have a high degree of autonomy in executing its functions. Similar to the board of directors, the members of the supervisory board should be selected on the basis of their personal and professional qualifications. Their age or nationality should not play a role.

Ladies and gentlemen, our financial institutions are currently facing many challenges. Developments are taking place on both the international and the local levels that will impact the way you operate in the near future. However, these challenges provide both the financial institutions and authorities with unique opportunities to strengthen our financial sector and the functioning of our financial market, which will contribute to building strong and prosperous new countries.

Once again, I would like to wish the shareholders, management, and personnel of Orco Bank all the best in their new office.

Thank you.