Jwala Rambarran: Strengthening the national financial safety net – a new agenda for the Deposit Insurance Corporation of Trinidad and Tobago

Remarks by Mr Jwala Rambarran, Governor of the Central Bank of Trinidad and Tobago and Chairman of the Deposit Insurance Corporation of Trinidad and Tobago, at the 25th anniversary celebrations of the Deposit Insurance Corporation of Trinidad and Tobago, Port of Spain, 5 November 2012.

*   *   *

Ladies and Gentlemen, On behalf of its Board of Management and Staff, I extend a sincere welcome to the 25th Anniversary celebrations of the Deposit Insurance Corporation (DIC). Anniversaries have a special significance for society. Children love to celebrate their birthday each year, and society often honours great people with a holiday on their birthday, even long after they have departed into the history books. Wedding anniversaries are also significant shared milestones. Ladies and Gentlemen, the DIC's "silver" anniversary celebration comes at a time when the financial safety net has once again become a topic of prominent discussions, both at global and national levels. Indeed, I find it almost uncanny how the conditions impacting recent disruptions in Trinidad and Tobago's financial safety net, almost mirror the circumstances surrounding the origins of the DIC some 25 years ago.

Regulatory failure

Back then, you may recall that the Trinidad and Tobago economy was painfully adjusting to the end of its second energy boom. The sharp contraction of economic activity, declining incomes and job losses partly contributed to the failure of many non-bank financial institutions in the mid-1980s. But the more causative factors for the non-bank crisis seemed to be absence of regulation, weak managerial competence, poor or non-existence credit risk management and concentrated lending.

As Charles De Silva opined in his October 1990 article on "The Law and the Central Bank: Issues and Implications for Banking Supervision in Trinidad and Tobago", that was presented at the 22nd Annual Conference of the then Regional Programme of Monetary Studies, "*The non-bank crisis in Trinidad and Tobago immediately called into question the capacity and competence of the regulatory authority. But although there were limitations in regulatory capacity, the major and more decisive weaknesses were readily seen to be the inadequacies of the legislation itself*."

Unfortunately, the collapse of several finance companies and trust and mortgage finance companies was not averted. It is difficult, however, to know how long it took the officials at the Ministry of Finance and the Central Bank to recognise the impending danger of the sheer size and rapid growth of non-bank activity in the economy. A heavy public outcry over the tardiness and reactive response on the part of the Ministry of Finance and the Central Bank to protect their deposits, eventually led to the formation of the DIC in September 1986, more than 5 years after the Financial Institutions (Non-Banking) Act took effect in mid-1981, and more than 7 years after the Non-Banking Act was passed and assented to in 1979 but never proclaimed due to a still unexplained failure to publish the necessary regulations.

The cost of the late arrival of deposit insurance to Trinidad and Tobago was not only reflected in the heavy financial support to problem institutions, but in the erosion of public trust and confidence in the regulatory authorities. The fledgling DIC immediately became responsible for managing the deposit insurance payout of four insolvent institutions. By May 1993, the Corporation would oversee the closure of four more failed institutions. Nonetheless, the DIC managed to successfully discharge its mandate and to contribute to depositor confidence in the safety of their funds held in member financial institutions.

Impact of global crisis on national safety nets

Ladies and Gentlemen, as we fast forward to the present, our experience of the current global financial crisis points to some limitations of existing national safety nets for safeguarding financial stability. Deposit insurance, a key element of the national safety net, has proved to be inadequate at alleviating financial distress in many countries.

You may recall that when the crisis erupted at Northern Rock in the United Kingdom, the U.K. authorities were eventually forced to introduce a comprehensive guarantee for depositors and creditors to calm the markets and general public. Authorities in Ireland were also compelled to institute blanket guarantee schemes for virtually all bank liabilities, amid fears that the entire Irish banking sector was about to fail.

Moreover, the collapse of Lehman Brothers highlighted the importance and urgency of establishing a legal framework for dealing effectively with resolution of cross-border financial entities. At its summit in Pittsburgh in October 2009, the G-20 leaders called for the development of "*resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future*."

Last year, the G-20 leaders endorsed an international standard – the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions – that lays down what resolution regimes need to look like in different jurisdictions around the world without severe systemic disruption and without exposing tax payers to loss. The United States has put a resolution regime in place largely through the Dodd-Frank Act. Europe is supposed to be on the verge of doing so. Asia is expected to follow a similar FSB regime.

Here at home, the collapse of CL Financial and the failure of CLICO and Clico Investment Bank (CIB) demonstrated that such an effective resolution framework was conspicuously missing, and is still missing. It also compelled the government to provide guarantees to CLICO's liabilities, and the DIC to liquidate CIB's good but also, in some cases, poor quality assets, in what is now turning out to be the most complex liquidation exercise in the Caribbean.

As you can appreciate, these rescue actions are costly and run the risk of encouraging further moral hazard, that is, financial institutions might be tempted to take on even more risks in the future because they expect to be bailed out if their actions misfire.

Best practices for deposit insurance systems

Ladies and Gentlemen, in their quest to build safer financial systems, many countries are rethinking the design of their deposit insurance systems. They are assisted, in this respect, by the International Monetary Fund (IMF) which has compiled a list of international best practices for deposit insurance systems around the world.

On the basis of its research, the IMF recommends the following best practices for a deposit insurance system:

1. Be explicitly defined in law and regulation with a mandate and measurable objectives clearly understood by member institutions and the general public;
2. Be mandatory for financial institutions and accountable but free from unreasonable political interference;
3. Maintain good relations with other agencies in the safety net, especially the Central Bank which is the lender of last resort;
4. Allow supervisors a set of prompt corrective actions, resolve failed financial institutions promptly, and provide low coverage and pay out or transfer resources quickly; and

5. Have timely access to accurate information on the condition of its members to overcome the problem of asymmetric information when a financial institution knows its conditions better than anyone else, charge adequate risk-adjusted premia, invest its fund prudently, and have government backing to avoid insolvency when unexpected failures occur.

New DIC initiatives

Ladies and Gentlemen, the DIC can be neither tardy nor reactive in strengthening its part of the national financial safety net. In this regard, the Board of Management of the DIC has formulated a strategic plan to make the Corporation's operational framework more consistent with international best practices. Some of the major elements of the DIC's strategic plan that are contemplated are as follows:

- Enact legislative amendments to close several gaps in DIC's enabling legislation as well as to harmonise it with the Companies Act and the FIA 2008;
- Begin the move towards an integrated deposit insurance system by expanding protection to cover depositors/shareholders of credit unions and policyholders (life) of insurance companies;
- Explore the feasibility of moving from a pure pay box model, in which the DIC comes in at the backend of the financial crisis, to that of a risk minimiser model, in which the DIC is in a situation where red flags are raised and prompt corrective actions can be taken against member financial institutions;
- Prepare the DIC to become compliant with the Core Principles for Effective Deposit Insurance Systems by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers. This would include an evaluation of the DIC as part of an IMF Financial Stability Assessment Programme, known as FSAP; and
- Establish a Memorandum of Understanding between the Central Bank and DIC to facilitate information sharing on member institutions and adequate alerts for a possible pay-out in the event of a pending failure/closure.

Conclusion

In closing, Ladies and Gentlemen, I must caution you that, in the face of fundamental macroeconomic policy errors or significant contagion from abroad, even a good system of deposit insurance cannot guarantee financial stability.

We must remember that a well-designed deposit insurance system is, at best, just one component of a sound financial safety net. Deposit insurance must be part of a carefully planned financial safety net, which establishes an incentive-compatible structure that encourages good corporate governance, constructive market discipline, and effective prudential regulation and supervision.

The objective is, of course, to get to a position where taxpayer monies are never used to provide solvency support to a failing financial institution, no matter how large or complex. For their part, the DIC's Board of Management and Staff are committed to crafting a pro-active and efficient deposit insurance system to ensure continued coverage for all those who fall under its protective umbrella for another 25 years.

I thank you.