Ewart S Williams: Implications of the current financial crisis for Trinidad and Tobago

Address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at a TTMA Seminar "Crisis in global financial markets: implications for Trinidad and Tobago", Port-of-Spain, 26 September 2008.

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Thanks for the invitation. The sub-prime crisis first grabbed the headlines sometime around August 2007. Who would have thought that after one year of high-priced casualties, not only is the end not in sight, the ongoing spillovers now threaten to destroy the workings of the international financial system as we know it. We are now seeing, among the industrialized countries a level of financial panic the likes of which we have not seen in our life time.

President Bush, in making the case for the US$700 billion rescue package warned that "the entire US economy was now in danger": he cautioned that the current crisis could wipe out banks, empty retirement nest-eggs, send home-values into a free-fall and create millions of new jobless. Warren Buffet called the crisis "a financial Pearl Harbor".

The speakers before me have given their take on how the crisis will affect various sectors of our economy. I will try to avoid too much overlap by focusing on the impact of the crisis on the **country's external reserves** and on our financial system as a whole. In the latter context, I would also like to suggest some lessons for financial sector regulation. I would end with a few brief comments on the macro-economic risks to the economy as a whole.

Last week, at least two commentators wondered why specific details on the impact of crisis on the country's reserves were not forthcoming, surmising that the Government or the Central Bank had something to hide. With the indulgence of my host, I would like to address this issue in some detail.

Let me say up front that, as far as the official reserves are concerned, we have not suffered any capital losses as a result of the financial turmoil on Wall Street. And this is so because we have stuck to our mandate which requires the Central Bank to adhere to conservative reserve management principles and to have in place as many risk mitigants as feasible.

Let me explain our reserve management system:

Very often central banks are criticized for being too conservative in investing the country's reserves and not maximizing their income potential. It's an unfortunate criticism since the conventional wisdom is that generating returns is not the primary purpose for holding central bank reserves. For all central banks, capital value preservation is paramount. **Simply put, reserves should be invested at low risk.**

Of course, reserves represent the country's savings and thus the return objective should not be entirely neglected. Typically for central banks, the return objective is secondary to liquidity and safety.

And this has been our approach to managing the country's reserves.

As you know, official reserves have increased significantly since 2000, in line with the increase in international energy prices. Currently, official reserves stand at US$ 8.5 billion compared with US$1.4 billion at the beginning of the decade. This represents a six-fold increase.

To handle our increasing wealth, a few years ago the Bank introduced a structured foreign reserve management strategy, allocating these resources between three tranches; one to meet working capital needs; another tranche, as a second line reserve; with the residual allocated to an investment tranche.

The Bank engages six foreign money managers (including the World Bank) to manage portions of the reserves according to international benchmarks. External managers handle 32 percent of our total official reserves, while 68% is managed by the Central Bank. Lehman Brothers was one of the external managers.

Consistent with international best practice the Bank utilizes an independent custodian to safe-keep the foreign assets. This custodian arrangement ensures that our assets are not co-mingled with the resources of the external manager. This proved to be extremely important since it meant that in the case of Lehman Bros our resources were not involved in Lehman's insolvency.

Our strategy also provides for investment guidelines designed to reduce the risk to which the portfolio is exposed.

- One such guideline specifies a minimum rating for the banks in which the deposits are lodged.
- A second guideline puts a ceiling on the amounts that can be deposited into each bank.

As at the end of August 2008, just before the latest episodes of global financial stress

- some 58 per cent of central bank reserves was invested in money market instruments;
- 26 per cent was invested in US government and other GF government bonds;
- 6 per cent was invested in agency bonds (Fannie Mae and Freddie Mac); and
- the remainder was held in asset-back securities and other money market instruments.

This structure helped in insulating the official reserves from any loss.

All our **deposits** are in commercial banks which have not been affected by the recent crisis. You would note that, so far, **the turmoil has been largely in the investment banks**: Bear Stearns, Lehman Bros, and Merrill Lynch; with some ripples in Goldman Sachs and Morgan Stanley.

Our US bond holdings have benefitted from the increase in prices consequent on the flight to quality, which has been the main reaction to the market meltdown.

Our limited exposure to Fannie Mae and Freddie Mac bonds (some 6 per cent of our total reserves) **could have resulted in some losses**. However, the US Government take-over of these institutions has reduced, if not eliminated, the risk of this exposure.

Lehman Bros, as one of our external managers managed about 6 per cent of the total portfolio. The bulk of these resources was invested in treasury securities of G7 countries, and as such faced very low risk. A very small amount (US$85 million) was invested in a mutual fund sponsored directly by Lehman Bros. We were able to liquidate this asset at no loss.

The bulk of our asset-backed securities were issued by Merrill Lynch. The take-over of this institution by the Bank of America eliminates or reduces the risk attached to this asset.

But ladies and gentlemen, if we had any doubts, the current turmoil in international financial markets should remind us that **no institution is totally immune from possible contagion**, regardless of what the rating agencies may say.

As you may know, not too long before Bear Stearns was declared insolvent it was rated BBB; Lehman Bros was rated (A+) and Merrill Lynch (A+): they were all considered investment grade. Before selecting Lehman Bros as an external manager, we went through a rigorous selection process that not only included examination of past performance of funds managed and Lehman's ability to deliver superior returns, we also conducted a thorough examination of Lehman's financials.

But as happened many years ago, with the dot-com crash, investor sentiment can change very quickly and sharp declines in stock prices can quickly erode the capital of even the strongest banks, producing the dire consequences that have attended three of the world's five largest investment banks.

Since Lehman's and Merrill Lynch's difficulties, the Bank has carefully reexamined the financial status of all our counterparties as well as our investment managers to **ensure that none of these are on any watch-list**. We have also taken the decision to introduce two new elements to our investment strategy. First, until financial markets have been stabilized, maturing deposits will be rolled over but for shorter periods and **second**, we will aim for further diversification among banks (within our approved guidelines), even at the risk of lower returns.

I would just make this brief comment on the HSF. As you know, the plan is **to invest HSF resources more aggressively** with a focus on returns, subject to an acceptable level of risk. A few months ago the HSF Board approved a Strategic Asset Allocation which called for HSF funds to be invested in money market instruments, US government bonds of a maturity of 1-5 years, and US, and global equities. Under the HSF Act, the Central Bank is to act as the Fund Manager with the understanding that the management of the equity portfolio will be outsourced.

Over the past few months, the Bank has been involved in the selection process for the external managers. The HSF Board agreed that pending the selection of the external managers and the implementation of the Strategic Asset Allocation, the HSF resources should be invested like the central bank reserves.

Consistent with this guideline the resources are invested in short term deposits (95 per cent) and US treasuries (5 per cent). The deposit holdings are subject to the same prudential guidelines. Consequently, these reserves have suffered no loss and are at no undue risk.

Impact on the financial system

Having surveyed most of our domestic financial institutions we can say, **with a great deal of certainty**, that the immediate impact of the crisis has been minimal. Some institutions had direct exposure to Lehman Bros, Merrill Lynch and AIG but in all instances the exposure was minimal, in relation to total assets.

From our analysis there is no immediate risk facing our banking system which happens to be well capitalized (with a capital/assets ratio of about 18 per cent), with a very low level of non-performing loans and basking in excess liquidity.

Unlike the banks in large emerging markets the lending operations of our banks are based on local deposits rather than on borrowing from foreign banks. All of our local banks have foreign short-term revolving credit lines. However, given the ample availability of foreign exchange from the central bank and in the domestic market, these lines are quickly amortized when used. The credit crunch is unlikely to affect the availability of these lines though there could be some increase in cost.

The insurance companies in Trinidad and Tobago also, for the most part, match their domestic liabilities with an investment portfolio heavily concentrated in domestic assets. Some companies have external exposure but to a very limited extent.

But ladies and gentlemen, if the Wall Street crisis should remind us of anything, it is that we can't be complacent. Rather, the crisis should spur **all our institutions to take a close look at their risk management systems** and it should make us realize that it is in all our interest to have robust regulatory systems.

We are hoping to have a **new FIA** in place before the end of the year and we expect to have a **new Insurance Act** and perhaps **new Credit Union legislation** by the middle of next year. While this is progress, ladies and gentlemen, there is a view that even the proposed new legislation will not be as robust as it should be and still short of international best practice.

I can't help making the observation that because we have not had a systemic disruption in our financial system for several years, **many of our institutions prefer to cling to the status-quo and fight change even when they recognize the risks involved in not upgrading the existing systems**.

How else could one explain:

- The tendency for so many institutions not to have audited accounts, six months after the end of their fiscal year;
- The opposition to the separation of an institution's financial and non-financial activities to avoid contagion; or
- The reluctance on the part of some institutions to readily support steps to reduce related party transactions, or strengthen internal audit, or corporate governance practices.

In the Bank's view, the current turmoil in the US market should serve as a catalyst for boards of directors and senior management of all companies, whether they are banks, insurers or credit unions, to look closely at their risk profile and determine if their level of capital and liquidity are appropriate to their individual circumstances. Also these tough times, having unbiased and objective advice and thinking is crucial and the **existence of independent directors on companies'** boards would facilitate this.

Unfortunately, not all companies see these requirements as being essential to mitigating un-necessary risks.

And finally, ladies and gentlemen, in terms of the macro-economics, **what can we expect going forward?**

I really wish we had a crystal ball to predict how the global economy will evolve in the short term. Unfortunately, we don't and in such a situation, prudence is the best policy; a policy of preparing for the worst and putting systems in place to meet any downside. In a way, that's what risk management is all about.

And what are the downside risks?

Well, even if order is quickly restored to the US financial system, with the approval of the $700 billion package, the consensus is that the global economy is scheduled to undergo a pronounced slowdown (some are using the R word…recession).

If this occurs, the reduction could prompt a fall in international oil and energy prices. Under these circumstances, something will have to give; either a reduction in expenditure or a reduction in savings through the HSF, which strictly speaking, is permitted under the HSF Act. Either option has unpalatable consequences.

Trinidad and Tobago is in a better position to withstand a global slowdown than our CARICOM neighbors, who have already begun to experience declines in tourist arrivals and in migrants' remittances. If this goes beyond a certain level, our manufacturing sector which contributes US$1 billion in exports, but provides substantial employment, could be affected.

These are just two examples.

There is no doubt that compared to the 1980s, we are in a better position now to withstand a global down-turn. But borrowing from the current lexicon, we have by no means **de-coupled** and a global slowdown could present a new set of challenges and at least slow our advance to our 20/20 vision.

But ladies and gentlemen, "God is a Trini" and these risks may not materialize. Even if we are inclined to take this view, we should see in the current global financial crisis, an opportunity to further strengthen our economic fundamentals most notable by reducing inflation, increasing productivity and accelerating the diversification of our non-energy sector. That is the surest way of ensuring self-sustaining growth and improvements in the quality of life for our population.