Marion Williams: The global financial crisis – can we withstand the shock

Address by Dr Marion Williams, Governor of the Central Bank of Barbados, at the Luncheon Meeting of the Barbados Chamber of Commerce, Needhams Point, St Michael, 25 February 2009.

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Mr. Magnus Whitehead CEO of the Barbados Chamber of Commerce and Master of Ceremonies, Mr. Andy Armstrong Senior Vice President, Mr. Roger Blackman Council Member, Mr. Oliver Jordan President of the Barbados Bankers Association, ladies and gentlemen.

This address comes at a most important time. Often in times like these in the interest of financial stability one tries to avoid controversy. However, regulators have an obligation to inform. It is important that we strike the right balance. I trust that at the end of this presentation I would have informed, would have inspired confidence in our financial system and would also have avoided controversy.

As you are aware, the genesis of the current crisis was shaped in the US by complex financing structures – structures which are generally not found in emerging countries such as ours so our region would largely have avoided a direct impact. It is true that it started as a crisis in the financial sector, particularly in the US, and then Europe, but it is no longer just a financial crisis. Indeed, though the financial sector in the developed world is in crisis the world is in a global economic recession. Indeed in some cases the financial sector in emerging markets has not been as seriously affected but almost all developing countries' economies are at best suffering a downturn.

Emerging countries have been hit on a number of fronts as a result of the global economic downturn. Firstly, through trade reduction, secondly, through liquidity tightness in some domestic financial markets and lower capital inflows, and thirdly, through a reduction or a slowdown in remittances from overseas. For these reasons, it will be a difficult 2009 for most developing countries. Having been until recently impacted by the twin food and fuel shocks, most emerging markets now have to face this additional financial and fiscal shock which may carry severe consequences, especially for those economies with weaker macroeconomic fundamentals.

Fortunately for Barbados it entered this period with relatively strong macroeconomic fundamentals. It had had 7 years of positive growth, its fiscal deficit was manageable and though its debt ratio was relatively high, its external debt ratio was quite low. It had also recorded annual surpluses on its balance of payments and its financial system was sound.

The continued global financial uncertainty can however deprive or slow the access of developing countries to funding for high priority development objectives including heath, education and infrastructure – in our case primarily tourism-related activities and can aggravate a likely economic downturn.

Central banks and governments across the globe have been forced to take unprecedented measures to preserve stability, in an attempt to cushion the impact of the financial crisis on their economies. They have been forced to broaden the pool of eligible collateral in order to provide liquidity. The speed and magnitude of monetary policy easing during the past six months or so, including recapitalisations and government guarantees has been unprecedented.

The ripple effects have adversely influenced the economic condition of the new industrialising export economies – as we have seen in China and the Far East – as global demand shrinks. How badly the less aggressive exporters will be affected – like those in the Caribbean – is not yet clear, but as prices fall those countries whose exports were barely competitive will have difficulty in retaining their market share. Those with special market niches will likely stand a better chance of maintaining volumes.

The brightest spot is likely to be a very low inflation rate, although there is concern in North America of possible deflation.

While the efforts of policy makers in the major economies will no doubt in time "heal" their economies, in the short to medium term, their responses are likely to impact on us in Barbados and the developing world generally. The severity of the impact is largely uncertain.

One can hypothesise about the impact on the regional offshore or financial services sector of the blanket guarantees to bank depositors and creditors by some of the governments in the developed world. These guarantees tend not to extend beyond national borders and may have consequences for the eagerness of investors to go offshore. In addition, much wealth has been lost in the financial meltdown and the international financial sector will need to market itself very aggressively in order to maintain the growth it has experienced over the past five years in the area of wealth management. Indeed recent events in Antigua should prompt us to more aggressively try to distinguish ourselves from the pack and try to avoid being linked by geography. Though the US economy has been weakening, the repatriation of funds to the US has been evident in the strengthening of the US dollar in the past three months versus most of the major currencies, with the exception of the Japanese yen. Of note, this is also likely to negatively impact capital markets in emerging economies, as foreign investors from Europe and North America, retreat.

Much has been said about the impact of the global recession on the Barbadian economy, especially on sectors such as tourism and construction. At the Central Bank, we have recognised the need to keep the real economy going and accordingly have reduced interest rates rapidly over the past six months, so that the reduction being passed through translates to lower bank lending rates. This should serve to ease the financing conditions for companies and households.

I have spoken elsewhere about labour market flexibility as a key method for mitigating the effects of the downturn. Today however, I will speak primarily about how our financial system is positioned to withstand these global pressures.

Today, policy makers all over the globe are assessing whether – and to what extent – certain features of the financial system encouraged market excesses and the build up of large financial imbalances. Many are also considering what changes should be made to the financial system and to the regulatory and supervisory framework.

First I will start with capital adequacy and tell you where Barbados stands. Adequate capital provides the institution with a buffer to support it in bad times. It allows the bank to make losses without going insolvent and to effect writedowns and to suffer reductions in asset values without facing the prospect of its assets falling below its liabilities.

Capital adequacy

The capital adequacy framework based on Basel II emphasises greater sensitivity to risk, because it links required capital to the perceived riskiness of assets.

In the US, information available suggests that tier 1 capital of most large US banks is 7.5% of assets, and for European banks 3.3%. In Barbados a comparable ratio is about 11.5% well above the statutory threshold – somewhat higher than even the Canadian banks which are at 9%.

In normal times adequacy of capital can sustain an institution in a bad patch. However, we have observed such dramatic declines in the market value of assets that 8% – the Basel guideline for combined tier 1 and tier 2 – is no longer adequate, since market values can move swiftly and by large percentages, as has happened in recent times.

Reserve requirements

While many central banks in developed economies have virtually abandoned reserve requirements, commercial banks in Barbados are still required by the Central Bank to hold reserve requirements. This can act as a source of support should banks experience liquidity problems. The Central Bank discourages banks from falling below their required liquidity levels but if they are in difficulties and are willing to meet the costs, it is accessible. A second tier, called securities requirements, is also in place in Barbados. Central banks across the developed world do not require this tier of reserves – not even in Canada – though some central banks in the developing world still retain it. However, for years developing countries including Barbados, were pressured by the IMF to remove it. In these circumstances if banks in the US and UK and Europe had such reserves, they would have had a fall-back position – ability to sell off these securities or have the central bank lower the requirement so providing them with liquidity. Commercial banks in Barbados therefore have three tiers of support; cash reserve requirements, securities requirements and capital requirements.

Corporate governance

Part of the process of vigilance also includes the need to continuously look at the strengthening of corporate governance standards. Corporate governance over the past few years has been in the forefront of public opinion. In some markets, policymakers are rapidly taking steps to ensure that governing boards understand the nature and complexity of the risk a corporation is assuming.

Review of accounting rules

There have been stringent calls to review the accounting rules applied to financial transactions, in particular the mark to market rules. Indeed, the current accounting rules have been highlighted as having contributed to financial market volatility in the US and Europe. When markets are erratic as they are in the US, marking-to-market does not provide accurate or useful information, especially from a medium or longer-term perspective. International regulators are currently reviewing those rules.

Moreover, the current impairment rules have not allowed banks to have forward-looking provisions so that they could build up provisions in good times, and draw them down when the cycle turns, and defaults surface. We should therefore reflect on how we can dampen or correct the pro-cyclical impact of fair-value accounting and provisioning regimes, without compromising the delivery of accurate and useful information or a “true and fair value” to investors.

The mortgage market

Barbadians are not a high risk-taking people and our banks have tended to be risk averse. For this reason, even 100% mortgages have been slow in coming to Barbados. Indeed some banks do not agree with it even now, because they believe that the borrower must have some stake in the borrowing or else if things get difficult early in the life of the loan or market values tumble, he can walk away with impunity. In addition, while banks in Barbados offer variable rate mortgages they have not got involved in step-up mortgages. Indeed our variable rate mortgages are always related to future market rates, not to a pre-determined schedule of step-ups in interest rates. The notion of having an enticement rate to lure borrowers in, which steps up sharply two to three years later irrespective of where market rates are at the time, has not been a part of our financial landscape. In our situation higher default rates tend to occur mostly if the job market gets difficult and borrowers cannot service their loans, or, as was becoming the case late last year when high rates of inflation eroded real incomes.

Fortunately, that should be corrected in 2009 as low global demand will lead to lower inflation rates.

In recent times however, the lure of the credit card has become a potential problem. Borrowers must be more prudent in accepting the offer of an increasing number of credit cards. In this regard, the Central Bank has initiated a financial education programme which will include guidance on money management and personal financial planning. This programme was launched last year and will continue in 2009, and will draw on presenters inside and outside the Bank. For the moment, however, although there has been an increase in delinquency as noted in the increase in commercial bank provisioning last year, it is within manageable proportions.

Securitization

The policy of originate and securitize taken to its extreme in the case of the US market is also a development that does not exist here. There is limited securitization here in Barbados. In fact there is not sufficient securitization. Entities which were supposed to be securitizing, that is, issuing commercial paper and money market instruments were issuing certificates that looked very much like deposits. Perhaps this is related to the Barbadian desire to avoid taking risks, but it shifts the risks on to the institution. In the case of commercial paper, it can be traded and could trade at above or below its value, so that the institution does not bear all the risk. This allows the lender to take his money out at any time – at a price. In the case of deposits the institution has an obligation to return the value of the deposit plus interest at the due date, unless some prior arrangement has been agreed as to early removal. To this extent in the Barbados situation with its tendency to deposit-taking, systems are less liquid.

However securitization has its merits. It leads to a more liquid market where money moves more quickly. In times where liquidity is needed rapidly, thinly securitized markets have their downsides, though they tend to be more safe and less volatile. In such cases the strength of the balance sheet is more important than changes in the market value of deposit institutions. All the balance sheets of financial institutions that I have seen show solvent institutions so though this is not the only relevant factor, we start with an advantage.

Risk management

Risk-taking is a necessary element in conducting business, and effective risk management systems, together with good governance strong regulation and supervision all serve to mitigate risk exposure. Supervisors instil market discipline by employing strong licensing criteria that ensure the fitness and propriety of directors and executive officers. We should not use the opportunity of these hiccups to remove ourselves from risk-taking. We need to take well considered risk. It is part of the growth process. Enforceable guidelines (e.g. corporate governance, operational risk management and capital adequacy) and regulations must be supported by effective ongoing monitoring of risk exposures and monitoring for compliance with legal requirements. Sometimes legislation is necessary to ensure that supervisors have the needed powers of enforcement to intervene at various stages where infractions may be detected so as to avoid escalation of the problem. Both the Central Bank of Barbados and the Supervisor of Insurance possess legal powers to conduct inspections of their licensees. In some cases the strength of the oversight in the non-bank sector needs to be enhanced as was mentioned in the last Financial Sector Assessment programme report.

Capital controls

In the Barbados situation, capital controls have served us well. They serve to control and monitor cross-border financial transactions. Further, entities that are licensed under the Financial Institutions Act, Cap 324 are additionally subject to credit exposure restrictions relative to capital – that is levels on lending to a single person or group. Where these are below acceptable levels, licensees are given specified time periods to have them corrected. This is a key credit risk control and is monitored on a quarterly basis using prudential returns submitted by all Central Bank licensees. Institutions are not always perfect, breaches can be corrected and the earlier the better, but it must be done in an orderly fashion. A disorderly correction is to be avoided.

Consolidated supervision

Consolidated supervision of financial groups necessitates collaboration at different levels. Memoranda of Understanding among all domestic regulatory agencies are key in facilitating information exchange and collaboration. There is such an agreement among all domestic regulators in Barbados. Regulatory Policy Councils have also emerging in jurisdictions with multiple regulatory agencies (Jamaica – 2000, The Bahamas – 2001, Trinidad and Tobago – 2005) as another forum for collaboration. These are however evolving. The Central Bank of Barbados hosts a similar forum with domestic regulators, on which cross-sectoral representatives from the board of national oversight bodies such as the Anti-Money Laundering Authority are included. This serves as an opportunity to share concerns on common issues or issues which affect some or all regulators. It is important also to note the ongoing work at harmonization regulatory and supervisory standards by such bodies as the Caribbean Group of Banking Supervisors, a group which is over 20 years old, works collaboratively with banking supervisors in the region. In addition, there is the Offshore Group of Banking Supervisors, Association of Supervisors of Banks of the Americas which have wider representation within Latin America and the Caribbean Financial Action Task Force which is focused on anti-money laundering. Barbados is a member of all of these bodies and benefits from shared views. However there is clearly a need for greater intra regional collaboration, particularly with respect to crisis management.

Slipping between the cracks – regulatory arbitrage investment houses

Regulatory and supervisory regimes differ across the region and models reflect shared responsibility between central banks or monetary authorities, and government departments. Consolidation of regimes has been a gradual process and Barbados is presently considering a revised model that will see the establishment of a Financial Services Commission. For example, insurance companies are supervised by the Central Bank of Trinidad and Tobago. This is not so in Barbados and Jamaica. Credit unions are also supervised by the Central Bank of Trinidad and Tobago and in Jamaica, by the Bank of Jamaica. This is not the case in Barbados. Despite the variance across the region, regulatory arbitrage has been minimized as all sectoral supervisors benchmark against international banking, securities, insurance and credit union standards and principles. (Regulatory arbitrage refers to a situation where regulations differ across jurisdictions and persons pick where they are going to do business to take advantage of these differences.)

Although a standardized CARICOM Financial Services Bill has been drafted, with facilitating financial services and investment Agreements, which collectively will provide a more harmonized legislative framework it has not yet been finalised. It (a) establishes consistent legal and regulatory requirements for financial groups; and (b) engenders compliance with prudential norms (including capital adequacy and large exposure limits), and ensures evaluation and control of risk on a group-wide basis. In that environment the rules and guidelines involved would be the same even though the responsibility for oversight may be different. The pace of implementation has been challenged recently by ongoing efforts of individual jurisdictions to reform their own national frameworks. For example Trinidad has just passed a new FIA and this would have been pre-occupying their attention.) Global and regional crises do not wait however until we are ready. Recent new developments necessitate an acceleration of the pace of such work and ongoing events now spur us to re-evaluate mechanisms to prepare regional approaches to responding to such problems.

Regional and national responses

As we in the region collectively grapple with the current financial crisis, originating in the Trinidad market we will continue to strengthen our own regulatory and supervisory frameworks at the national level. What we must not assume, is that because it happened in Trinidad it must happen here. Within recent times, several regional jurisdictions have had Financial Sector Assessment Program reviews performed by the IMF, or AML/CFT mutual evaluations by the Caribbean Financial Action Task Force. In the Barbados case, banking has traditionally received good ratings and findings were uneven as it relates to regulation in other sectors.

The need for increased co-operation

Given the levels of financial integration globally, and notably, the growing systemic relevance of cross-border corporate groups, regulators are aware that they must look to enhance their cross-border relations particularly with respect to crisis management. At the last meeting of the Caribbean regional Central Bank Governors a decision was taken that the Caribbean Group of Bank Supervisors (CGBS) should develop a management protocol to deal with events like the one currently being experienced. The CGBS provided an outline of what such a protocol should include, but it remains a work in process and has been overtaken by events. The plan is to be submitted to Governors for their approval in May 2009.

One of the key lessons of the global crisis stems from the fact that in an increasingly market-based and interconnected financial system, disturbances are likely to affect fundamental market mechanisms, such as the distribution of liquidity. This has cross-border implications. An adequate appreciation of these dynamics requires a systemic perspective for the analysis of financial stability which normally lies with the central banks, but clearly requires close interaction between central banks and other regulatory agencies. Over the past few weeks as the Barbados Council of Regulators met twice within the last 3 months – most recently last week – to discuss areas of mutual concern and to discuss approaches to providing mutual support and to put preventative measures in place over the short to medium term.

The use of macroprudential indicators

Macro prudential indicators have become more important in the current environment. Rather than concentrating only on the health and performance of individual financial institutions, macroprudential supervision uses a coordinated approach. This is necessary because financial institutions can influence asset prices, which can significantly affect the health of the economy as a whole. Greater emphasis on macroprudential supervision should produce "early warning" indicators, and macro-stress testing would serve to verify the resilience of the system. Already, regional governors through the Caribbean Centre for Money and Finance, are proposing this approach and seeking to fund it.

Stress testing is also being developed largely because the extent to which market values and liquidity structures in other countries affect us is growing, more so because our economies are intertwined.

Cooperation from all market participants in this regard can assist in countering the potential procyclicality of regulatory requirements and help us to identify early excessive leverage, risk concentration and the liquidity mismatch.

Effective cross-border monitoring will require procedures that would ensure that measures aimed at containing risks and vulnerabilities are identified and implemented. For example, in some situations in other jurisdictions it has been useful to have exchanges of currency deposits among central banks.

The appropriate balance of responsibility between home and host supervisors is another area that is being addressed. The Icelandic bank failures in particular taught us that when there is a problem, rescue procedures and fiscal support are national. It is for this reason that many regulators are requiring that operations be set up by way of subsidiaries. This way their capital requirements are under the authority of the host supervisor.

Regulation of liquidity

New approaches to the management and regulation of liquidity are just as necessary. Indeed the regulation of liquidity has been recognised as being at least as important as capital adequacy. Financial intermediaries can be faced with liquidity risk. However, the lack of a defined international standard has reflected the extreme complexity of the liquidity risk, and generally applicable quantitative ratios are difficult to identify. Effective ways for assessing and limiting the liquidity risks are however important and regulators have already begun to examine the possibility of introducing specific ways of measuring and monitoring liquidity risks.

Regulation by economic substance

My next point relates to the regulation of near-banks. Some jurisdictions have already commenced to regulate the financial institutions on the principle that if it looks and behaves like a bank, then it must be a bank. The Central Bank has recently extended reserve requirements and securities requirements to finance companies, (deposit-taking Part III companies), a decision taken before the regional problems arose, but which has turned out to be timely.

Crisis management

Providing emergency liquidity funding can be a challenge in a regional setting. Experience has shown that host countries may need to maintain the capacity to protect the domestic financial system on a stand-alone basis, but must do so within a framework of close coordination with the home regulator while giving as much regional support as possible. The bailouts in Europe are evidence of this. They concentrated on national bailouts but there was a coordinated approach.

Summary

Barbados' banking system was adjudged the third best regulated in the Western Hemisphere by the World Economic Forum. Barbados' onshore sector was adjudged by the IMF to be resilient to most market shocks. Notwithstanding the strength of the regulatory framework, it is however possible for a distressed situation to emerge. There is therefore the need to continue to strengthen financial regulation and to enhance regulatory resources in some areas and to be proactive.

Financial sector indicators reflect that all domestic entities are adequately capitalized and liquidity in the system is adequate. The recent crises affecting the region make it prudent to constantly reassess our systems and controls to ensure that they remain robust in the current dynamic financial environment (as cross-border transfer risk may arise where there are weaknesses in group-wide consolidated supervision). We propose to pay heightened attention to conglomerate supervision in the banking sector, and to improve the level of collaboration between regulatory agencies, both at the national and regional levels, while ensuring that supervisory processes are flexible and proactive. Despite our past achievements there is further room for improvement as it relates to conglomerate supervision.

Conclusion

I have devoted most of my presentation to the financial sector and the banking sector in particular for which the Central Bank has responsibility because it is critical to confidence in the system and can be easily undermined. It is my view that while the financial sector is not perfect it is well run. International organisations confirm this, even when specific areas of weakness have been highlighted. However, unless we create a confidence problem, it is the global economic recession that is likely to affect us most. We must ensure that our financial system is safe and well run by being proactive and by taking corrective measures where necessary but simultaneously we must prepare ourselves for the impact of the global economic recession.