Ewart S Williams: Status of the financial services sector in Trinidad and Tobago and implications for national development

Address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, to the South Trinidad Chamber Energy Luncheon, Port-of-Spain, 6 April 2009.

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Thank you very much for inviting me to discuss a theme that is very topical (very much in the news) in the light of the international financial crisis which has engulfed the world since the fourth quarter of last year and especially since the emergence of the financial meltdown of CL Financial, the largest conglomerate in the Caribbean.

For me, the chance to discuss the state of the financial sector is particularly opportune, in the light of a survey quoted in a local newspaper which carried a headline "T&T Citizens have no trust in the financial sector". In a poll conducted between March 5 and 6, 72 percent of the 502 persons interviewed had no confidence in the financial sector.

In view of the recent developments – the crisis facing financial systems all over the world, our CL Financial/CLICO crisis, the international recession and the slowdown in the domestic economy, **people are justified in asking the questions**: is our financial system safe, as a repository for my savings; is the financial system operating in my interest; does the financial sector have a role in reversing this economic slowdown, or simply, should we have confidence in the financial sector?

Answering the last first, and **while confessing to partiality**, I categorically affirm that **you could and should have absolute confidence in our financial system**. While there are deficiencies, while there are things that need to be fixed, as financial systems go, **ours is strong, robust, resilient,** and with **some tweaking could and should make an even greater contribution to our national development**.

Although my topic refers to the financial system, my remarks will be heavily focused on the banks, non-banks and the insurance industry – those institutions that come under the regulatory control of the Central Bank. I will not comment on our capital markets which would need a lecture by itself.

To understand the current status of our financial system, one needs to have some context.

Our financial system was liberalized in the early 1990s, as part of a process of structural reform which included many other aspects such as: trade and tariff reform, privatization, tax reform, capital account, liberalization etc.

Financial liberalization, along with rapid economic growth, induced by the steady increase in oil and gas prices, set **in motion the evolution of a more sophisticated, more diversified and more complex financial sector** which brought with it many benefits. Not unexpectedly, it also brought a whole host of challenges, some of which are still to be resolved. Let me cite some of the more notable changes that have occurred in our financial system over the past twenty years:

- There has been **significant consolidation** among the banks, with the three largest banks now accounting for 70 per cent of total bank assets; similarly the three largest insurance companies accounting for three-quarters of the insurance industry. (The largest insurance company, CLICO accounts for close to 55 per cent of total insurance assets).
- Most banks have greatly expanded their product offerings, functioning as "**universal banks**", offering in addition to basic banking services, pension and mutual fund management, individual annuity plans, trust services, leasing, brokerage and merchant banking services. **In an effort to compete, insurance companies** have

been issuing deposit-like products and mutual funds. (CLICO has led the cross-over to bank-like products).

- To reduce costs and to compete effectively, some of the institutions adopted **conglomerate structures**. Here again, CL Financial led the way in terms of the breadth and complexity of its structure.
- A fourth significant change in the last few years is **the extent of regional penetration** by our banks and insurance companies, both through off-shore lending and insurance coverage as well as through shareholding and ownership. Of course, the extra-ordinary level of regional penetration brought increased risk and has created special problems in the CLICO case.
- And one last change I would like to mention: you would re-call that in the 1970s and 1980s, we embarked on the "**localization**" of the banking sector. Currently, reflecting the impact of what we could broadly call "**globalization**", **of the eight commercial banks operating in Trinidad and Tobago**, six are foreign-owned – a reversal of the localization trend.

Unfortunately, neither the legal nor the prudential framework kept pace with the rapid evolution of the financial sector.

For example, the first upgrade of the **Financial Institutions Act** since the early 1990s came in September 2006. This was followed by a comprehensive reform of the FIA, which was approved by Parliament in December 2008. The current Insurance Act dates back to **1966**, with an important amendment from **1980**. The next upgrade came a few weeks ago, in the context of the CLICO crisis.

The **other elements of our legislative framework** are similar, if not more antiquated. Our **Credit Union legislation** dates back to the Co-operative Societies Act of 1971, when credit unions were small, truly cooperative, societies handling paltry sums; legislation on **pensions** was embedded in the 1980 Insurance Act; and even now, there is no **legislation governing mutual funds**, just guidelines for institutions licensed under the FIA).

In 2004, the Government adopted a **White Paper on financial sector reform**, implementation of which is currently in progress. As noted, Parliament recently approved a new FIA, which is the centerpiece of our financial legislation. A new Securities Industry Act (SIA) is close to being presented to Parliament.

We are fairly advanced in the preparation of a new **Insurance Act** and new **credit union legislation** is not too far around the corner. After these we plan to concentrate on **new pensions legislation** next year. We will also need to turn our attention to legislation to address some unregulated intermediaries such as, the business of **bureaux de change** and **money transfer companies**, which are institutions of more recent vintage. We are also working on designing a regulatory regime for two "statutory corporations", **the HMB and the UTC**.

The Central Bank has been given an **expanded regulatory mandate** to include the insurance companies and pension funds and the credit unions. The Bank has been taking steps to adapt its regulatory methodologies to the requirements of these new institutions and has been upgrading its personnel to cope with the rapidly evolving financial environment – an environment that requires a new regulatory approach to deal with **conglomerate structures, consolidated supervision**, **cross-border holdings and ownership**, a whole new emphasis on governance and an assessment of institutions own risk management frameworks.

It will take time for any Regulator to get on top of all these new challenges; and **it is taking time for us in the Central Bank to do so**. But we are doing so fast.

Notwithstanding the legislative and regulatory challenges, I could state emphatically that, by all international indicators, we have a robust banking system.

- In aggregate, the banks' **capital ratios** are very high (18 per cent compared with a statutory minimum of 8 per cent)
- In aggregate, the level of **non-performing loans** is low; about 2 per cent, which would be the envy of banking systems in most developing countries and not too far from the level you find in most developed countries. Some would argue that the low level of nonperforming loans reflects, in part, the banks' ultra conservative lending policies, focusing on short-term consumer loans and avoiding more risky lending for business activity and more so for small business. Be that as it may ……
- Our profitability indicators are also impressive. In 2008, the profits after tax amounted to $2.2 billion **representing a return on equity of 20 percent**.

For many, the high level of profitability enjoyed by the banks, speaks to the proliferation of charges and commissions levied on most bank transactions, together with the spread between the rates on loans and advances and that paid to depositors. In Trinidad and Tobago this spread stands at about 8.2 percentage points, compared with 7 percentage points for the region as a whole. In advanced countries the figure is around 3 percentage points.

I should note that from time to time the Central Bank has engaged the commercial banks in discussions about these issues and while we understand some of their arguments, **I am not sure that we have a perfect meeting of minds**.

The banks note, for instance, that **bank charges** in Trinidad and Tobago are lower than those that obtain in the rest of the region and in developed countries.

They also point to the several factors that explain the sizable spread between deposit and lending rates. One factor is, without doubt, the level of reserve requirements. Currently, at 17 per cent, this level is determined by the Central Bank as part of its anti-inflation policy. The fact that these reserves are un-remunerated certainly acts as a tax on the banks which they try to re-coup by increasing the level of the spread.

However, even abstracting from the reserve requirement, the spread between deposit and lending rates can still be considered high. In theory, high spreads can represent the level of oligopolistic power (or the lack of competition) in the banking system as well as an indicator of the level of efficiency of banking operations. It is somewhat surprising that the increased use of technology has not yet resulted in **greater efficiency which could be passed on to the consumer**.

As an aside, complaints about high bank spreads are also an important issue in **Jamaica,** so much so that three years ago, the Jamaica Manufacturers Association filed a complaint with the country's Fair Trading Commission alleging collusion in rate setting. The FTC cleared the institutions saying that it found no evidence to substantiate the charge. Let me state that, in my view competition is alive and well in our banking system and I see absolutely no evidence of interest rate collusion.

Let me make one other comment about our banking system, having to do with its lending patterns.

The data show that **credit to business firms accounts** for just under one-half of bank credit, followed by **consumer credit**, about one-third, and **real estate mortgage loans**, about 20 per cent of the total. The level of consumer credit is fairly high by developing country standards. In Latin America, for instance consumer credit stands at under 20 percent of total bank credit.

For most of 2007 and 2008 consumer credit was growing at a significantly faster rate than business credit, the **impact of which can be seen by the number of cars on the roads**. For the last few months, reflecting the steady rise in interest rates and some concerns about the economic slowdown, the rate of expansion of consumer credit has slowed drastically.

The data on bank credit to businesses need to be interpreted with caution. In developed countries large firms raise much of their funding from capital markets. In Trinidad and Tobago, like in most developing countries, the largest firms finance their investment through bank borrowing. **It is the small and medium-sized firms** that find difficulty in obtaining bank financing. The reasons for this are well-known and have to do with their lack of acceptable collateral, the perceived riskiness and the high cost of servicing such loans.

So, granted that the banking system is currently robust, **what's the risk it faces if the economic slowdown in Trinidad and Tobago and in the region is prolonged**?

If the slowdown is prolonged and is accompanied by a significant increase in unemployment, **one would expect that non-performing loans will rise**. However, the current level of about 2 per cent provides significant room, before non-performing loans reach critical levels. Moreover, the **level of regulatory capital** of **18 per cent** provides an adequate buffer to meet any difficulties.

In the US, **the decline in real estate prices** contributed greatly to the difficulties in the banking system. In Trinidad and Tobago, our banking system has maintained high mortgage approval standards, in part by restricting loan to value ratio between 75-80 percent (no sub-prime mortgages here) and has contained its exposure to falling real estate prices by limiting the share of these loans in its portfolio to 20 percent.

What about our insurance companies…. What is the health of our insurance sector? The honest answer is **uneven.** Excluding CLICO for the time being, for reasons I will discuss later, **many insurance companies need to strengthen their risk management and governance policies**. Let me explain a bit:

- The existing legislation requires insurance companies carrying on long term insurance business to have **share capital of a mere $3 million, which if strictly observed, robs them of the needed buffer to meet adverse circumstances**. For general companies, share capital of only $1 million is required. This has not changed since 1980.
- The statutory fund, which is meant to protect policy-holders, **is only effective if it was funded on an on-going basis**. Prior to last month, strictly speaking, the law only required companies to meet its statutory fund requirements for one-month, after the end of their fiscal year.
- In the case of **non-life companies** there are far too many complaints **regarding the timeliness and adequacy of claims settlement**.
- The truth of the matter is that the insurance industry has not been subject to formal regulation for a long time and as such, **has not internalized a regulatory culture**. Consequently there are challenges in getting some companies to meet normal regulatory requirements such as:
  - **Filing statutory returns** within the stipulated time frame.
  - **Complying with recommendations** resulting from on-site examinations.
  - **Topping up their statutory fund** within the required time frame.
  - Complying with their own internal audit recommendations.

Fortunately things are improving and the introduction of new legislation would contribute to enhancing regulatory compliance.

Before I end, let me briefly address the **CIB/CLICO issue**.

If the financial sector was in such good shape how does one explain the CLICO affair? My simple answer is that CLICO/CIB was an aberration.

As you know CLICO and CIB were subsidiaries of the **conglomerate CL Financial Group**, which covered some 60 subsidiaries in the financial sector, in energy, real estate manufacturing and distribution. The financial institutions in the Group, if you include the commercial bank, has assets of equivalent to about 37 per cent of GDP. On paper, CL Financial has assets of over $100 billion.

In a financial system which, could be described as well-capitalised and generally conservative, **Clico/CIB were isolated cases of an overly aggressive and risky business model**. This model was characterized by:

- **excessive related-party transactions** which carry significant contagion risks. This high level of concentration is **not specifically prohibited by the present legislation;**
- **an aggressive high interest rate resource mobilization strategy** to finance **equally high risk investments**, much of which were in illiquid assets (including real estate both in Trinidad and Tobago and abroad); and
- a very **high leveraging of the Group's assets**.

In this model, the flow of deposits and policyholders' funds, through rollovers and new business, **masked the limited profitability of many of CL Financial's investments**. Then came the recent international crisis, methanol prices (a major source of dividends) declined; real estate values plummeted and in a climate of uncertainty, **the rate of roll-overs and new deposits slowed markedly**. This led to liquidity and perhaps solvency problems, the real impact of which is now being assessed.

I would want to suggest that the CLICO/CIB crisis represents a case of "**systemic failure**" from which we all can take invaluable lessons.

Clearly we need to upgrade our legislation as a matter of urgency. It is hoped that the recent international financial crisis as well as the recent stresses in both the credit union and the insurance industry would convince industry participants of the need for modern legislation to cope with a modern financial sector.

Two, **directors and management** need to take seriously their fiduciary obligation to protect depositors'/policyholders' funds. Independent directors have a special obligation to provide checks and balances and **play a "whistle-blowing role"**, if necessary.

Three, **external auditors** must also recognize their fiduciary responsibilities and must be held accountable. The self-regulatory bodies must set and enforce the highest auditing standards. **That's the legacy** of Enron and World com.

Four, as **Regulator we need to continue to upgrade our skills and quickly achieve the level of competence** in the insurance and credit union regulations as we have achieved in bank regulation. Of course, we have been in bank regulation for close to fifty years whilst we have only recently been doing insurance.

The CLICO/CIB crisis is a major setback for the financial sector in the region. We have been able to contain the contagion but the challenge of strengthening market confidence and ensuring that the cost to taxpayers remains minimal in the medium term is ongoing.

The CLICO/CIB collapse should be a lesson that serves to strengthen our financial system for the next several years.