DeLisle Worrell: Making the financial system more secure

Address by Dr DeLisle Worrell, Governor of the Central Bank of Barbados, at a joint luncheon meeting of the Barbados International Business Association (BIBA) and domestic bankers, Hastings, 2 February 2010.

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The dramatic collapse of Lehman Brothers in September 2008 may well have completed the process of rethinking the management of financial systems, and of reinventing central banks. It used to be that central banks were mainly concerned with monetary policy, and only peripherally with matters of financial regulation. Indeed, there was sentiment in favour of removing responsibility for financial regulation from the ambit of central banking altogether, and some argued that for the monetary policy maker to be financial regulator as well, was a conflict of interest. That view of the world began to come unstuck in the 1990s, with the onset of a series of international financial crises with far reaching implications, and the mandate for monitoring the health of the financial system was placed squarely on the shoulders of the central bank. Financial stability is now firmly on the agenda of central banks everywhere, and the bank's mandate of necessity encompasses all financial institutions which have the potential to destabilise the system as a whole, whether or not they are actually under the central bank's legal purview. In this address I will explain what we mean by financial stability, why financial stability is important, and how we seek to attain financial stability.

The quest for financial stability

Interest in financial stability was rekindled by a series of financial (and exchange rate) crises which began with the Mexican crisis of 1994, followed by crises in Russia, Brazil, the Far East, and Turkey, to name the best known examples. In response, the scope of financial sector oversight, which had previously focused on the prudential health of individual institutions, was broadened to encompass the financial system as a whole. The aim was to avert the possibility of new financial crises emerging, to develop early warnings of possible financial difficulties, and to minimise the cost and ramifications of such financial failures as did occur, so as to prevent them snowballing in ways that would lead to widespread failure. That aim was reflected in the intensification of research on financial risk management, the widespread adoption of indicators of financial soundness, the universal obsession with the much misunderstood stress tests, the publication of financial stability reports, the revision of international guidelines for financial oversight and the institution by the IMF of a programme for assessing and reporting on the financial systems of all its member countries on a periodic basis. It is by no means reassuring that, in spite of this intensive effort over more than a decade, a crisis of unimagined proportions should have emerged, affecting the financial systems of all major countries, even those which were thought to be most skillfully managed and regulated, according to the new methodologies and guidelines.

One important element in the quest for financial stability was the development of tests of the soundness of the financial stem. Over the last decade, the financial community has adopted a commonly used suite of *financial soundness indicators* for commercial banks, with a lesser known set of indicators for insurance companies. The health of the financial system is judged by comparing each indicator against a rule-of-thumb benchmark, most of which are codified in an international agreement. For example, the international benchmark for the capital adequacy of commercial banks agreed under the original accords signed at the Bank for International Settlements in Basel, Switzerland, is that banks should maintain minimum capital equal to 8 percent of assets. (The assets are weighted according to the risk they are thought to carry.) Other indicators include the ratio of impaired assets to total assets, the ratio of liquid to total assets, the return on assets or equity, and the institution's exposure to foreign exchange, interest rate or capital market variation.

The indicators help to assess the current health of the financial system, but they offer limited insight into possible future challenges. Early warning systems (EWSs) have been developed in an effort to provide this insight. The logic of these systems is that, by examining the behaviour of financial indicators just before previous crises and financial failures, we may detect a pattern which could warn of future crises. The EWSs therefore attempt to forecast financial system performance based on a combination of indicators, taking into account past experience. A complementary approach is to forecast financial performance indicators, such as profitability and liquidity, as a supplementary outcome from the forecasts of general economic performance.

Stress tests may be the most widely recognised tool recently developed for the analysis of the fragility of financial systems, and they are just as widely misunderstood. What we ought to test for, is how far the financial institution or system is from its limit. For example, we may conduct a test to determine what level of loan delinquency would serve to render a financial institution bankrupt. Would its capital be totally eroded if 10 percent of its loan portfolio were to become a total loss to the bank? Or would it still be solvent if the loss were 20 percent, or 30 percent? What the stress test cannot tell you, is what the loss is likely to be. This is the misapprehension which is reflected in most commentary you will see on stress tests. The tests which the Federal Reserve conducted a year ago offered no reassurance, because even before the test results were made public, the actual extent of loss had exceeded the assumptions of the most severe test. Properly used, however, stress tests are helpful in identifying the areas of financial activity where the institutions under scrutiny are most at risk, and they can help in signalling when policy intervention may be needed to address these areas of vulnerability.

The quest for financial stability led to an intensive world wide review of systems for the oversight of banks and other financial institutions. The previous guidelines for the supervision of banks, developed through collaborative efforts of banking supervisors under the auspices of the Bank for International Settlements (known as the Basel Accords for Banking Supervision; the BIS is headquartered in Basel), were revisited, and new guidelines proposed, incorporating more sophisticated risk management techniques and procedures. The new guidelines provided explicitly for the use of financial market institutions such as credit rating systems to be used in assessing risk. After incorporating comments from a global review process, the revised framework for global banking supervision was promulgated as a new accord on international banking supervision principles, known popularly as Basel II. Unfortunately, just as the movement to upgrade banking supervision to Basel II standards started to gather momentum, the world financial markets collapsed into the mother of all recent financial crises. What will remain of Basel II in the wake of the financial crisis is as yet unclear. Some commentators, including our own Avinash Persaud, have argued that some underlying principles of the Basel accord are fundamentally flawed, a view which I happen to share. The Caribbean Centre for Money and Finance, where I worked prior to taking up my present post, will this year publish views of Professor Persaud and others on the flaws in the global regulatory approach that need to be addressed, going forward.

The importance of financial stability

It has been widely observed that financial crises are almost always accompanied by exchange rate crises, resulting in large devaluations of the domestic currency. In open economies that is not a coincidence: the failure of important financial institutions too often leads to a loss of confidence in the domestic currency and a flight of capital, which depresses the value of the currency. This was the experience of Indonesia, Russia, Brazil, Mexico and many others. As everyone knows, the fixed Barbados dollar peg is the bedrock of our economic stability. Financial stability therefore becomes central to the Barbados Central Bank’s concerns, because the stability of the financial sector, along with the credibility of fiscal policy, are the things that reassure the holders of financial assets that their Barbadian dollar investments are perfectly safe from devaluation.

The concern for financial stability encompasses insurance companies, credit unions, mutual funds and all other financial institutions, not just commercial banks. The stability of the entire system is the business of the Central Bank, even though the Central Bank has regulatory responsibility only for commercial and international banks. All central banks now have a financial stability mandate, even those which, like the Bank of England, have no regulatory responsibility at all. All UK financial institutions are supervised by the Financial Services Authority of that country, but it is the Bank of England that conducts financial stability analysis and publishes the financial stability report periodically. There is no contradiction in this arrangement. Financial regulation has to do with the licensing and health of individual financial institutions, while financial stability speaks to the health of the financial system as a whole. Regulators maintain oversight of prudential indicators, do inspections of financial institutions, make informed judgements and issue instructions for remedial action; the central bank, in its financial stability role, considers economic as well as prudential indicators, takes account of economic forecasts at home and abroad, and analyses the implications of relationships among financial institutions, in order to make judgements and policy recommendations where necessary, for the financial system as a whole, or for segments of it. The Central Banks' overall concern for financial stability is therefore wholly compatible with the existing arrangements for the regulation of non-bank financial institutions in Barbados, as well as with the proposed Financial Services Regulatory Commission for non-banks.

The framework for financial stability in Barbados

There have been two published reports on financial stability in Barbados, both prepared by the IMF, with input from the Central Bank of Barbados, in 2004 and 2009. They both found the financial system to be sound, and the risks to which it was exposed manageable. In addition, there is an academic assessment of the Barbadian financial system published by myself and three colleagues at the Central Bank, which contains much of the analytical work on which the IMF's judgements were based. That work continues at the Central Bank, and the Bank will itself begin to publish reports on financial stability from time to time, starting in December this year. Our financial stability assessments will take account of risks to which the system is exposed arising from domestic activity of financial institutions; risks that might arise from the activities on the institutions' head offices, associates and subsidiaries; risks due to activity conducted abroad by domestic institutions; and risks that might be indirect, through the impact of economic shocks on the customers of financial institutions. The Central Bank's financial stability reports will be prepared in close collaboration with other financial regulators, because the reports will need to cover risk exposures of insurance companies, pension fund managers, credit unions, and other financial institutions, as well as commercial and international banks.

Close collaboration between domestic financial regulators is already a fact of life for the Central Bank, the Supervisor of Insurance, the Registrar of Cooperatives and the Securities Exchange Commission, and these arrangements will be reviewed and upgraded. This cooperation was on display in the government's response to the January 2009 CL Financial crisis. As you are aware, the Bank and the Supervisor of Insurance are working together towards the orderly resolution of the domestic business of Clico Holdings and its subsidiaries. The CL Financial crisis is an example of reputational risk exposure, which can be especially difficult to anticipate. Even though there was no material change in the operations of Clico Holdings Barbados, the intervention of the Central Bank of Trinidad and Tobago in CL Financial in Trinidad necessitated corresponding action in Barbados. Reputational risk may be the principal exposure of banks in the international sector.

Credit unions are an essential element in the competitive structure of financial services in Barbados, and they therefore fall under the financial stability net. Problems in the credit union sector would hit the small saver especially hard, and would reduce credit availability for many household amenities and housing improvements which make a vital contribution to the standard of living of the ordinary Barbadian. Older Barbadians will know of the traumatic effect of the failure of the “Simmonds Penny Bank” in the 1950s, an event which stymied the growth of indigenous financial institutions for a generation. (Popular wisdom has it that the Bank was solvent, but its assets were mostly invested in real estate, and there was no one to provide cash against the real estate assets.)

Challenges and responses in strengthening financial stability

The first challenge the Central Bank and other financial regulators face is to broaden the range of financial soundness indicators currently collected, and to bring them up to date and disseminate them in a timely fashion, as we do for other economic and financial statistics. We plan to make all our statistics available online in electronic format in order to increase their timeliness, and financial soundness indicators will be included in this initiative.

A second challenge is to upgrade financial stability analysis at the Central Bank and the other financial regulators, and to assist financial institutions in upgrading their own prudential analysis and management of risk. This involves research to make analytical tools more robust, the development of appropriate indicators for non-banks, the refinement of analysis of contagion effects and indirect risks to financial stability, and training of staff. In addition, the Bank and other local financial regulators will need to monitor revisions in the Basel framework of banking supervision, and the evolution of international guidelines for insurance companies, credit unions, collective security institutions and other non-banks. Through our participation in regional organisations of regulators, the Barbados Central Bank and the other domestic financial regulators may collectively contribute a Caribbean and small country perspective to the discussion and opinions on the directions of reform of guidelines for financial regulation.

A third major challenge is to strengthen the collaboration among domestic financial supervisors, and to establish a framework among regional financial supervisors for ongoing surveillance of the regional financial system. In a recent paper, Julia Jhinkoo of the CCMF and I documented the extent of regional integration in the financial sector. As is evident from even casual observation, the degree of financial integration is considerable. Financial stability analysis must reflect this regionalisation of financial institutions, and going forward, financial stability monitoring must be a joint effort of all financial regulators, conducting regular scrutiny of the region as a whole, as well as the individual national components of the overall picture. The Caribbean Technical Assistance Centre, and the Caribbean Centre for Money and Finance, in collaboration with the Caribbean Group of Banking Supervisors, the Caribbean Association of insurance Regulators, the Credit Union league and the Caribbean Group of Securities Commissioners, will hold a workshop in Trinidad on March 3–5, to develop an action plan for setting up an appropriate framework.

In summary

Financial stability is as central to the central Bank’s mandate as is the Bank’s economic intelligence function, because they both are essential to the preservation of the value of the currency. To evaluate the threats to financial stability, the Central Bank must look not only at the health of the banks which it regulates, but to all other financial institutions, to their regional partners, branches and subsidiaries, and to their head offices and activities outside the region as well. Surveillance must be undertaken in collaboration with other domestic regulators, and a framework must be set up to provide for regional financial surveillance on a sufficiently frequent basis. For this analysis and reporting, data collection and reporting must be more comprehensive, analytical tools will need to be strengthened, some international guidance will have to be revisited, and staff of regulators and financial institutions will need to be trained in the upgraded systems. There is much to be done, and it will be necessary to proceed on parallel tracks, in practical steps. The main items which the public can look forward to in 2010 are:

- An action plan for regional financial surveillance, to be undertaken as a collaborative effort of all Caribbean regulators, coming out of the March 3–5 workshop;
- The publication of financial soundness indicators online by the Central Bank of Barbados, starting with indicators for banks; and
- The publication of the inaugural financial stability report by the Central Bank of Barbados.

Financial stability is in all our interests, the regulators, the financial institutions and the general public. By actively working together with the institutions we supervise, the financial regulators will be able to keep the public up to date on the health of the financial system, and provide the facts, figures and analysis to support their assessment of its stability.