Ewart S Williams: The future of the financial industry after the crisis

Opening address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at the 14th Caribbean Business Executive Seminar, Caribbean Centre for Money and Finance, Port of Spain, 30 April 2010.

* * *

Let me first thank the Caribbean Centre for Money and Finance for inviting me to make a few opening remarks at this their 14th Business Executive Seminar. Given the CCMF's mandate, the theme of your conference *"**The Future of the Financial Services Industry after the Crisis"*** is most timely**.** Let me also congratulate CCMF on assembling a most impressive cast of speakers, who could be expected to bring diverse perspectives and unique insights into how our financial sector is likely to evolve over the next few years.

Since the international financial crisis, governments and central banks in both developed and developing countries have been giving serious thought to the future of the financial services industries in their respective economies. In particular, a lively debate continues to rage on about the regulatory response to the crisis and on the measures needed to avoid a repetition.

The causes of the financial crisis have been well-documented and analysed and I don't plan to review that discussion here. Suffice it to say that there is widespread agreement that the legacy of the crisis will be long-lasting with significant changes expected in the global financial landscape going forward. There is perhaps less consensus on what shape the new landscape will take.

In respect of the advanced economies, where the crisis originated, and which suffered most from the ravages of the crisis, ***the good news is that the near-term outlook for the financial sector has improved significantly***. In the United States (US), bank stocks have rallied and those of the four largest banks have been among the best performers in the S&P 500 since the market hit bottom in March 2009. This month, four of the largest financial institutions in the US, JP Morgan Chase, Bank of America, Citigroup and Goldman Sachs reported healthy first quarter earnings.

Despite these indicators, there continues to be serious ***risks to financial stability in these economies***, arising from the withdrawal of government support, continued write-downs to compensate for further asset deterioration and funding pressures, as institutions seek to reduce leverage and raise capital and liquidity buffers.

In these advanced economies, debate is still raging on the long term financial sector outlook. For example:

- ***The optimal size of financial institutions*** – many experts expect that financial institutions will seek to scale down their global ambitions, focusing more on specific market segments, in which they have particular comparative advantage. In this context, the future of the investment bank is in doubt.
- Some analysts project that ***long term returns from banking*** would face a structural decline as banks reduce leverage and build up their deposit bases to reduce their dependence on wholesale markets.
- There are proposals for a ***return to basics*** as customers steer clear of the non-transparent exotic products that precipitated the crisis.
- And then there is the much publicized issue of ***compensation packages in the industry***. Here, the future is likely to see a shift away from pay incentives structures that encourage excessive risk taking and reward short-term profits. Instead, there is

the proposal that compensation packages be tailored more to long term performance, rewarding sound risk management.

There is also intense debate going on in the US on ***regulatory reform***. Two main issues here are a proposal to force banks to spin-off their risky derivatives business to reduce systemic risk, and whether future resolution strategies should specifically preclude government bailouts.

As regards the Caribbean, you may recall that we suffered only a limited contagion from the international financial crisis largely because:

- Like in most developing countries credit expansion in our banks is based on deposit mobilization rather than on inter-bank borrowing or overseas borrowing.
- Our banking systems tend to be generally conservative and for the most part, were not exposed to the sub-prime mortgages or to the exotic derivative instruments that were standard fare for banks in the advanced countries.

Of course, our regional financial system was more affected by the international recession that ensued and by the collapse of two regional institutions – the Stanford Bank in Antigua and the CL Financial conglomerate, which is headquartered in Trinidad and Tobago but with financial subsidiaries throughout the Caribbean.

Notwithstanding the limited contagion, the international financial crisis and our own regional financial distress have set in motion a new dynamic that is bound to lead to important changes in our financial landscape. It is difficult to be certain about what these changes would be. I would, however, like to hazard a few thoughts about the possible evolution of our financial landscape, based in part, on measures already in train, and the likely reaction to the distress that has left deep scars.

I expect that the recent financial crisis would lead to:

- ***Greater consolidation of the financial system –*** currently three large foreign banking groups dominate banking activity in the region (accounting for about 45 per cent of total banking assets). The remaining assets are held by smaller locally owned banks including a few state-owned banks. I would expect bank concentration in the region to intensify over the next few years. As part of this consolidation, I would expect the trend towards the disappearance of merchant banks, which are being absorbed into universal banking structures, to intensify.
- I would expect a similar trend towards consolidation in the insurance industry, though, led by regional insurance firms. In Trinidad and Tobago, for instance, the proposal in the draft Insurance Act for a significant increase in regulatory capital will certainly tend to promote consolidation.

The crisis could also provide impetus for greater recourse to:

- ***Technology and innovation*** – the general perception is that (apart from the expansion of ATMs) the region has not come close to maximizing the use of technology to increase efficiency and reduce banking spreads. It is therefore reasonable to expect that competition and the drive to maintain profitability will provide the necessary impetus to the greater use of technology.
- As regards innovation, I do not anticipate our relatively small conservative regional banking system will establish a market for exotic derivatives. I, however, expect an expansion in the markets for basic hedging instruments and the continued evolution of new banking products designed to facilitate greater credit expansion to the energy sector, to small businesses and to agriculture.
- ***Greater attention to customer service*** – this is an emerging trend which will become more commonplace over time. Financial institutions will continue to

increase their interaction with their customers through more active use of web-based social networking such as facebook and twitter. This will be extremely useful as institutions attempt to rebuild the trust and confidence that were eroded by the financial crisis.

- ***Rise in information portals*** – the increasing sophistication of customers and the availability of a wider array of financial products will lead to the expanding use of financial information portals.

There would also be important changes in the regional regulatory environment as a result of the international financial crisis.

Basically, as is now happening in several of the advanced economies, we in the Caribbean are likely to see a ***change in our regulatory philosophy***. For years, we have been taking a *"**soft touch**"* approach to regulation, aligned to the philosophy of the market mechanism. In the Caribbean, as elsewhere, this approach has led to the excesses, which caused the crisis. In the post crisis environment, I would expect regulation to be more comprehensive and much more intrusive, designed to include a macro-economic perspective.

If there is anything that the crisis in the CL Financial Group underscored it was the critical importance for updated legislation and regulation to match, as much as possible, the rapidly evolving of the operations of the financial institutions. As you know, the favored form of organization for the large financial institutions in the Caribbean is the conglomerate or holding-company structure. Unfortunately, up to now, most regional regulators do not have supervisory authority over bank holding companies. The lesson is that, in the future, systems should be in place to adjust the regulatory perimeter as needed and to ensure that legislation keeps abreast of developments in the financial sector.

In addition to the regulatory gaps, our recent experience also made it clear that ***poor corporate governance, weak risk management practices***, and ***inadequate management information systems*** also contributed significantly to the excesses that led to the difficulties faced by the CL financial group.

We in Trinidad and Tobago are involved in a comprehensive review of our financial legislation. We have recently completed a new Financial Institutions Act (FIA) and are well underway to completing a new Insurance Act (IA). Both pieces of legislation raise the bar with respect to the respective roles of Boards of Directors, external auditors and in the case of the insurance sector, actuaries. I would expect that all regional regulators will increase the focus on corporate governance in much the same way as is being done in Trinidad and Tobago and in the advanced economies.

The increasing complexity of investment products will require that financial institutions pay more attention to ***rigorous risk-management practices***. In the region, this will require a ***change in mind set***, as well as the hiring of individuals with the requisite expertise and knowledge. Going forward, companies will need to make greater use of stress-testing in order to better identify and manage risks.

Financial institutions in the region are beginning to recognize ***the crucial role of adequate and properly designed information systems***. These are necessary tools for management as well as the basis for oversight by Boards of Directors and the regulators. Robust information systems could add significantly to the company's costs. However, they invariably represent monies well spent as they could facilitate major improvements in the company's operations.

Finally, in the post-crisis world, I expect to see more attention being paid to ***compliance and sanctions***. New legislation and upgraded regulations will have limited effect unless there are provisions for meaningful sanctions and unless there is certainty that sanctions will be levied for non-compliance. In many cases, it is more efficient to rely on sanctions in the form of fines and other penalties administered by the regulator, than to depend entirely on recourse to the Courts which could be time-consuming. Also, Courts sometimes fail to grasp the seriousness of the breaches of financial regulations. Enforcing compliance with financial laws in the Caribbean will need a change in regulatory culture and a strengthening of political will. I am hopeful, however, that this will happen since the high cost of the recent crises (particularly CL Financial), has clearly provided ample rationale needed for much stricter enforcement of financial legislation.

This is what comes from my ***crystal ball***. In the course of your deliberations today there would be other views to which I anxiously look forward.