Jwala Rambarran: Strengthening financial stability in Trinidad and Tobago – staying ahead of the curve

Speech by Mr Jwala Rambarran, Governor of the Central Bank of Trinidad and Tobago, at a breakfast seminar, hosted by the CFA Society of Trinidad and Tobago, Port of Spain, 6 September 2012.

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Salutations,

At the outset, I would like to thank the CFA Society of Trinidad and Tobago for organizing this forum and for inviting me to speak on the very relevant and timely issue of financial stability.

Over the past decade, the CFA Society of Trinidad and Tobago has played an important role in promoting principles of ethics, education and professional excellence amongst our country's financial analysts, portfolio managers, and other investment professionals.

At a time when investigations are on-going behind the manipulation of one of the world's most iconic reference rates – the London Inter-Bank Offer Rate (LIBOR) – by top executives of several global banks, I commend the CFA Society for maintaining its strong ethical and moral thrust in the conduct of financial affairs.

I do hope CFA Charter Holders and those aspiring to Charter Holder status will continue to resist the temptation to engage in numbers-game manoeuvres to meet ambitious financial performance targets. Remember, you are not too big to jail!

As many of you are aware, on a mid-September morning four years ago, Americans awoke to discover the unthinkable: the nation's financial system was in free fall. In "***Too Big To Fail***", Andrew Ross Sorkin, the award-winning New York Times columnist, provides a blow-by-blow inside story of how Wall Street and Washington fought to save the financial system – and to save themselves. It is a cautionary tale for decades to come.

This true story is not only about financial institutions that were too big to fail – Lehman Brothers, Merrill Lynch, and AIG – but also a humbling human drama about the most powerful men and women in finance and politics who, motivated by ego and greed as well as by fear and self-preservation, thought they themselves were too big to fail. Unfortunately, they were behind the curve.

Confidence in global financial institutions and markets were badly shaken, igniting the worst financial crisis in generations. Since then, the global financial crisis has morphed and its new epicentre is in Europe, not the United States. Many argue that the crisis was similar to the attacks of September 11: a singular, unprecedented event, catastrophic and next to impossible to forecast. It was a black swan.

Renowned economist Nouriel Roubini, who was ahead of the curve in predicting the financial meltdown in the United States, and Stephen Mihm, a journalist and professor of economic history, in their New York Times Bestseller "***Crisis Economics***", argue otherwise. Far from being the exception, crises are the norm. Crises follow consistent trajectories and yield predictable results. All crises end, but their aftershocks can linger on for years, if not decades.

Like the Americans, Trinidadians experienced their own black swan event on January 30, 2009. By lunch time, the Central Bank had announced its intervention in CLICO, the largest local insurance company and one of the largest in the Caribbean, CLICO Investment Bank (CIB), and British American Insurance Company (Trinidad) Limited (BAT), all subsidiaries of the CL Financial conglomerate. Large scale government intervention was needed to support these subsidiaries and to prevent the eruption of systemic risks.

So, this morning, I want to talk about three things:

- **First**, some of the key risks and challenges to global financial stability occupying the world's attention four years after the free fall of the U.S. financial system;
- **Second**, current financial stability issues in Trinidad and Tobago, in the aftermath of our own CLICO crisis; and
- **Third**, the role of the Central Bank of Trinidad and Tobago in strengthening financial stability, enhancing economic confidence and staying ahead of the curve.

Risks to global financial stability

Let me begin with a brief overview of risks to global financial stability. Sadly, the news is not so good. The global financial system is facing a period of elevated uncertainty which is the Achilles' heel to an economic recovery that was not strong from the start.

The sovereign debt crisis currently unravelling in Europe has renewed financial turbulence, weakened investor confidence and may also threaten the fragile world recovery**.** The markets need the assurance that the European Central Bank and key partners in Europe will take bold and continued policy actions to avert a deeper crisis. The actions of the ECB at its meeting today will signal the outlook for the euro in the months ahead.

There is little doubt that the euro area's crisis remains the most immediate and most serious threat to global financial stability, and there is the fear that conditions could worsen, with many now contemplating the consequences of a black swan scenario in which Greece exits the euro zone.

In the United States, the upcoming Presidential election is characterized as "the economy elections", and the campaigning has kicked into high gear, even as the "fiscal cliff" looms dangerously near.

The Congressional Budget Office has warned that spending cuts and tax rises due to take place in 2013 could push the US economy back into recession. On the other hand, cancelling some or all of the scheduled tax increases and spending cuts would add to the widening US federal budget deficit and raise the odds of the United States facing a similar financial crisis to that which is occurring in Europe.

Although both the Republican and Democrat parties want to avoid falling off the fiscal cliff, the political brinkmanship – reminiscent of the August 2011 discussions on raising the US debt ceiling – suggest that a compromise may be difficult to reach in an election year.

Beyond these concerns, I would mention two other growing dangers to the global financial system. First, emerging market economies have not escaped contagion. Growth prospects in a few large emerging market economies have weakened, leaving them less able to deal with spill-overs from the euro area crisis or to address the build up of macro financial risks such as higher leverage, potential asset bubbles and inflationary pressures. For the first time in this century, China is likely to grow below ten per cent in 2012.

Second, an unprecedented severe drought in the United States and a dry summer in Russia, Ukraine and Kazakhstan have abruptly pushed up global food prices. According to the World Bank Group President Jim Young Kim, prices for maize and soybeans have reached all-time peaks, threatening the health and well being of millions of people, particularly in the Sahel and Eastern Africa regions. Almost 1 billion people are struggling with hunger every day. Most of them are children.

The IMF is expected to release its flagship World Economic Outlook (WEO) Report in late September, but I am fairly confident that the main messages will be that the global recovery remains at risk and crisis management is a top priority.

Financial stability issues in Trinidad and Tobago

Ladies and Gentlemen, this brings me to my second point. We, in Trinidad and Tobago, must be mindful of the challenges that the turbulent global economic environment poses and while our focus is growth, we must recognize the need for financial discipline.

As I indicated before, Trinidad and Tobago has not been immune from severe threats to financial stability, arising from the global financial crisis, the CL Financial debacle, and the prolonged domestic economic slowdown which started in 2009.

Notwithstanding these difficulties, banks which dominate the financial system in Trinidad and Tobago remain very well capitalized even during the crisis. As at March 2012, commercial banks' regulatory capital to risk-weighted assets stood at over 25 percent from 20 percent in 2009, and well above the statutory minimum requirement of 8 percent. These capital adequacy ratios are among the highest in the Caribbean region.

Credit quality has deteriorated but this is not system wide. Banks' non-performing loans rose to almost 7 percent of gross loans, up from around 1 percent at the end of 2007, prior to the onset of the global crisis. Some banks have seen their non-performing loan ratio increase above 10 percent, mainly reflecting the souring of a few corporate loans in the luxury segment of the real estate mortgage market. Excluding these loans, the system wide ratio of non-performing loans to total loans was much lower at around 5 percent in March 2012.

Notwithstanding the low interest rate environment, banks have successfully managed both their net interest margin positions and operating expenses, which supported profitability through the slowdown in economic activity, the fall in real estate prices and the difficulties of CLICO that required extra provisioning by some banks.

Commercial banks' profitability ratios were, on average, much lower than in previous years, but were still quite strong by regional and international standards. The return on assets fell to an annual average of 2.5 percent in 2009–2011 from around 3.5 percent during the period 2006–2008. The return on equity ratio slipped to an annual average of just over 18 percent in 2009–2011, from nearly 27 percent in 2006–2008.

While the direct exposure of local banks to foreign markets is low in relation to their asset base, continuing economic stress in a few countries calls for ongoing monitoring and vigilance. Total foreign country exposure fell to around 6 percent of gross assets at the end of March 2012, from just over 8 percent in 2007. Many banks, or the holding companies that own them, have extended their presence in other Caribbean countries. Exposure to the CARCIOM region, however, fell from almost 5 percent of gross assets at the end of 2007 to just over 3 percent at the end of 2011, before stabilizing at this fairly low degree of exposure at the end of March 2012.

In the case of the United States, local banks' exposure to Trinidad and Tobago's major trading partner increased from around 1 percent of gross assets in 2007 to almost 2.5 percent in 2011, before falling to a little above 2 percent in March 2012. Local banks, however, have little exposure to investment in the distressed Euro area.

Risks to bank stability seem relatively modest due to ample capital buffers, conservative provisioning, and high profitability. Stress tests conducted by the Central Bank confirm the overall strength of banks: credit risks appear limited while market and liquidity risks are generally low.

Ladies and Gentlemen, life insurance companies, excluding CLICO and British American, have generally strong capital positions and are profitable, despite the financial strains and sluggish economic environment of recent years. Capital adequacy indicators for the life insurance sector have been trending downwards since 2009, as the industry builds its actuarial reserves to meet the new capital rules in the proposed Insurance Bill. The ratio of capital to technical reserves for life insurance companies stood at just over 30 percent in December 2011, well above the international benchmark, which usually ranges between

7–10 percent. Return on equity in the life insurance sector increased from around 7.5 percent in 2008 to just below 10 percent in 2011.

In the general insurance sector, most large companies are well capitalized, although some are exposed to the occurrence of a major natural disaster such as hurricanes. Many general insurance companies have been ceding a significant portion of their insurance business to international re-insurers in order to mitigate very large claims arising from natural disaster risk.

Some small insurance companies specializing in third party motor insurance appear undercapitalized. In addition to poor market conduct, third party motor insurers engage in non-payment and under-reserving of claims. It is instructive to note that the Central Bank intervened to close one motor insurer in 2010, after addressing insolvencies in the previous years, and has issued compliance directions to several companies. Unless these smaller general insurance companies improve their pricing and capital positions, the Central Bank is likely to undertake further interventions in this part of the insurance sector.

The Insurance Act requires insurance companies to maintain assets in their Statutory Fund to cover liabilities for policies owned by residents of Trinidad and Tobago. With the exception of one life insurance and two general insurance companies, all other insurance companies were compliant with their Statutory Fund requirements. The Central Bank is working with the non-compliant insurance companies to correct the deficiencies in their Statutory Funds.

Strengthening financial stability and the Central Bank

I now turn to my third and final point – the work of the Central Bank in strengthening financial stability.

Although it does not have an explicit statutory financial stability objective, maintaining the safety and soundness of the financial system is a long standing responsibility of the Bank.

Ladies and Gentlemen, the Central Bank takes its sacred responsibility for financial stability in Trinidad and Tobago very seriously and is working assiduously to reduce the possibility of future financial crises, and to limit the consequences if they do occur.

I wish to remind the national community that this mandate of the Central Bank goes beyond the medium term horizon of the next parliamentary electoral cycle. We are guided, as an independent institution with national responsibility, by the long-term economic interests of the people and the state of Trinidad and Tobago.

As the country's prime financial regulatory and supervisory authority, I give you the assurance that the Central Bank is prepared to take early and decisive corrective actions to prevent a build-up of unmitigated risks in individual financial institutions, or in the financial system as a whole.

There are several ways in which the Central Bank promotes financial stability. One is laying the foundation for low and stable inflation. Another is helping to facilitate economic growth. Perhaps the most direct way in which the Central Bank promotes financial stability is through regulation and supervision. On the regulatory front, modernization of the laws pertaining to the financial services industry is taking place. We are focusing on the most important and urgent problems first. On the supervisory front, the Central Bank is strengthening its capacity. I now want to provide some details on key initiatives.

Following CLICO's failure, the Central Bank has made considerable progress in strengthening the regulatory framework for insurance. The current Insurance Act dates back to 1980 and is not designed to adequately address the types of risks that are inherent in the current suite of products and services provided by insurers today. A new Insurance Bill has been drafted following extensive consultations with the industry and is waiting to be laid in Parliament, which is expected to re-open this month.

The proposed Insurance Bill contains a modern approach to insurance regulation and supervision, strengthening corporate governance of insurance companies, and establishing more effective protection of policyholders. It will address fundamental prudential deficiencies and will include the following important requirements for insurance companies which are consistent with international best practice:

- Implementation of a new actuarial valuation methodology;
- Implementation of a risk–based capital regime; and
- Implementation of a stress testing regime.

Like the insurance industry, the credit union sector has operated within a legislative framework that is outdated. The present legislation covering the credit union movement (the Co-operative Society Act) dates back to 1971 and does not deal with prudential issues.

The case for stricter regulation of the credit union sector could not be more compelling. Credit unions account for more than 5 percent of total financial system assets, and have an extensive service foot print, reaching about one-third of the population. Some of the biggest credit unions have assets comparable to that of the smallest banks. A number of credit unions have taken on risky credit exposures and investments, which they do not have the capacity to properly address.

We have drafted a Credit Union Bill which was distributed to the sector in November 2011 and are considering comments from the industry prior to finalizing the document. The proposals took into account international standards set by the World Council of Credit Unions and best practices of jurisdictions with well developed credit union sectors. We expect to lay the revised Credit Union Bill in Parliament around the middle of 2013.

The private pension industry continues to account for a significant proportion of the assets of the financial system. Last month, the Central Bank issued a revised Policy Proposal Document for the Establishment of an Occupational Pension Plans Bill for further review and comment. The revised document takes into consideration the numerous comments received on previous drafts and incorporates notable revisions to the proposals in key areas such as:

- Rights of pension plan members and beneficiaries;
- Governance of pension plans; and
- Winding up of pension plans.

We plan to lay the Occupational Pension Plans Bill in Parliament in the first quarter of 2014.

Ladies and Gentlemen, some financial institutions outside of the banking and insurance sectors can be considered systemically important financial institutions (SIFIs). The size, complexity and inter-linkages with other financial institutions and markets mean that SIFIs are too important to fail, or ignore.

In Trinidad and Tobago, we have identified three additional SIFIs – the Unit Trust Corporation (UTC), the National Insurance Board (NIB), and the Home Mortgage Bank (HMB).

The UTC holds more than one-tenth of the assets of the financial system. It is the country's largest mutual funds provider, provides a full range of investment services and competes with not only investment banks, but also – at least according to public perception – with commercial banks.

The state-owned National Insurance Board (NIB), which is responsible for the national pension system, commands about one-fifth of the assets of the financial system. As the major shareholder of the Home Mortgage Bank (HMB), the Trinidad and Tobago Mortgage Finance Company (TTMF) and NIPDEC, NIB plays an exceptionally prominent role in the domestic economy and financial market.

Although the Home Mortgage Bank is the smallest in the SIFI group, it is the only institution responsible for providing secondary mortgage financing.

The Financial Stability Board, which has been at the forefront of discussions on global financial regulatory reform, has proposed stronger regulatory, supervisory and resolution frameworks for SIFIs. The elements of an adequate SIFI policy framework include the following components:

1. More stringent capital (possibly liquidity) requirements to limit contribution to systemic risk;
2. Proactive and intense supervision consistent with the complexity and riskiness of the SIFI;
3. Enhanced transparency and disclosure requirements to improve market discipline and monitoring;
4. An effective resolution regime to enhance orderly recovery and wind-down in the event of failure, including developing living wills or recovery plans; and
5. Equitable burden sharing with the private sector to internalize costs by creditors and shareholders.

The supervision of SIFIs must be fully encompassed and at the Central Bank, we are considering the scope of such regulation for the local institutions.

Ladies and Gentlemen, financial stability requires active and competent supervision. The Central Bank currently supervises the following entities:

- 25 banks and non-banks
- 6 active life insurance companies
- 16 active general insurance companies
- 9 active composite insurance companies (including CLICO and BAT)
- 256 active pension plans

And, as I indicated, the Bank intends to supervise some 100 active credit unions and consider the supervision of SIFIs not under its current purview.

It is clear that to effectively deliver on its challenging but crucial regulatory reform agenda, the Central Bank must strengthen its supervisory capacity.

The IMF's May 2010 Staff Position Note "***The Making of Good Supervision: Learning to Say No***" is what I consider a seminal piece of work on the future of financial supervision. It is a must read for Central Bankers. The paper focuses on the lessons drawn from failures in supervision during the global financial crisis that may help prevent future crises. The paper identifies 5 key elements of good supervision, all of which will inform how the function of supervision at the Central Bank of Trinidad and Tobago will adapt to the new regulatory framework.

These five elements and their application to the Central Bank are as follows:

1. ***Good supervision is intrusive***. Supervisors must not stay on the sidelines of regulated financial institutions, relying solely or mainly on offsite analysis. The Central Bank must be a presence that is felt continuously.
2. ***Good supervision is sceptical but proactive***. Supervisors must question, even in good times, the industry's direction or actions. Supervisors must have the capacity to identify risks, and to act on them. The Central Bank is most valuable when it is least valued.

3. ***Good supervision is comprehensive***. Supervisors must be constantly vigilant about happenings on the edge of the regulatory perimeter. The Central Bank must not confine its interests to risks faced by its regulated entities and must go beyond to risks posed by other parts of the financial system.

4. ***Good supervision is adaptive***. Supervisors must be in a constant learning mode to respond to new products, new markets, new services, and new risks. The Central Bank must adapt to changes at the regulatory perimeter, with an eye to new or unregulated areas.

5. ***Good supervision is conclusive***. Supervisors must follow through conclusively on matters identified as these issues progress through the supervisory process to their final resolution. The Central Bank must take every identified issue, however, small, to its conclusion.

Judgement, not rules, is the key here. Supervisors would do well to learn the secret to success of Julie Dickson, head of Canada's Office of the Superintendent of Financial Institutions, and who supervises the world's strongest banks. Ms. Dickson's secret to success is to focus on bearish forecasters like Nouriel Roubini, assume the worst, and avoid complacency.

Meanwhile, the Bank has augmented its supervisory expertise with specialists. Some of the more important initiatives included the establishment of an in-house Actuarial Unit headed by an experienced Actuary. This Unit allows the Bank to closely monitor, analyse and set direct attention to the sufficiency of actuarial reserves held by life insurers, as well as being able to verify the adequacy of outstanding claim reserves for non life companies. Going forward, the Actuarial Unit will be providing needed leadership in the development of an appropriate stress testing regime of the insurance industry. This, in turn, will support the Bank's financial stability initiatives.

The Bank has also increased its credit risk supervisory expertise. Over the past four years the Bank has been conducting thematic reviews of credit risk management in the banking industry. This is an important step since credit risk is one of the main risks commercial banks face and has generally been responsible for past failures internationally and even nationally. Going forward, the Bank will be recruiting specialists with expertise in market and operational risks.

At the national institutional level, we have begun work on the development of a ***National Crisis Management Plan*** to facilitate, if needed, a rapid response and coordinated action to financial crises. Work is also underway on the establishment of a ***National Financial Stability Council*** comprising officials from the Central Bank and other domestic regulators such as the SEC and FIU. At this high-level Forum, members will be able to share information and views, discuss issues where responsibilities overlap and, if the need arise, co-ordinate responses to potential threats to financial stability.

Conclusion

In closing, Ladies and Gentlemen, it is my respectful view that the Central Bank has performed quite well in carrying out its responsibility for financial stability. But we cannot ignore the public perception – which is usually as important as reality – that the Bank faltered in relation to the failure of CLICO, CLICO Investment Bank, and BAT.

Apart from balance sheet scars, the CLICO crisis may have left psychological scars on the population of Trinidad and Tobago. For many, memories of this failure are still fresh, causing an overestimation of the probability of a repeat disaster – the fear of fear itself.

For the first time in its 48-year history, the Central Bank, through the Commission of Enquiry into these failed financial institutions, will be subject to public scrutiny about its regulation of the financial system. At the Commission of Enquiry, the Bank will be transparent in accounting for its regulatory and supervisory actions in respect of these institutions.

As I close Ladies and Gentlemen, I once again, give you the assurance that the Central Bank will continue to work tirelessly to minimize the occurrence of another financial crisis in Trinidad and Tobago. In this way, the Bank will remain ahead of the financial stability curve, regaining and rebuilding public trust and confidence.

I thank you.