Jwala Rambarran: The Trinidad and Tobago financial sector – creating the future we want

Keynote address by Mr Jwala Rambarran, Governor of the Central Bank of Trinidad and Tobago, at the Trinidad & Tobago Coalition of Service Industries (TTCSI) National Services Week, Port of Spain, 6 November 2013.

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Good morning Ladies and Gentlemen,

Let me first thank the Board of the Trinidad and Tobago Coalition of Service Industries (TTCSI) for the kind invitation to deliver the keynote address on my vision for creating a future financial system we all desire. I also commend TTCSI for continuing to stage "National Services Week". Services remain integral to Trinidad and Tobago's diversification and competitiveness thrust. The services sector employs one in eight persons and contributes more than 45 percent to the country's GDP.

The finance industry, of course, is part of the services sector. In the finance profession, most people remember September 15, 2008. On that day, the venerable US investment bank Lehman Brothers considered "too big to fail" collapsed and ignited the worse financial crisis in generations, a crisis whose reverberations are still being felt in different forms and with varying impacts on people's lives.

Here at home, we also experienced our own "Lehman" meltdown. I am sure many of you remember Friday January 30, 2009. On that day, the Central Bank announced that it was assuming control of CLICO, the largest insurance company, and of CLICO Investment Bank (CIB), the largest investment bank. Both financial institutions were subsidiaries of the CL Financial Group, the largest conglomerate in the Caribbean. Large scale public support would eventually be needed to prevent widespread disruption and loss of economic confidence.

The CL Financial crisis came six months after the financial implosion of the Hindu Credit Union, which also left thousands financially stranded and struggling to cope. The CL Financial crisis has cost this country over $20 billion dollars, while the HCU collapse though smaller, but just as devastating, was a burden to the tax payers in the long run, just as well.

I will focus on the larger CL Financial crisis, which was a bigger blow to the Treasury and to the financial system, and from which two questions naturally emerge.

First, "How did it all happen?" and, second, the question I have been asked most often since I assumed office, "What is being done to prevent a similar event from happening again?"

Obviously these two questions are closely interlinked and quite justified. We have to learn from the past in order to shape the future of our financial system.

So this morning, I want to speak about two things:

- First, I will briefly outline my understanding of the causes behind the events which unfolded on January 30, 2009 and what the CLICO/CIB crisis has taught us; and
- Then, I will discuss five major initiatives the Central Bank has been undertaking to avoid another crisis. These initiatives will not just protect our financial system, but also help shape its future direction.

Learning from the past – what the clico/cib crisis taught us

Ladies and Gentlemen, at the outset I wish to indicate that the CL Financial failure is the subject of three major investigations. First, the Central Bank commissioned a forensic investigation which resulted in the filing of a civil suit claiming damages against former leading CL Financial executives and their related companies. Second, the Director of Public Prosecutions is investigating the prospect of laying criminal charges against these former leading executives. Third, a Commission of Enquiry has completed its deliberations and is expected to produce a report into the circumstances behind the failure of CL Financial.

As you may appreciate, these investigations quite naturally constrain my public disclosures on the causes of the CLICO/CIB crisis. I will therefore, confine my discussion to the public statements made by Central Bank officials at the Commission of Enquiry. My reading of those public statements suggests that the following could be interpreted as some of the reasons behind the failure of the CL Financial Group:

- CL Financial reflected a highly complex and opaque business model. Poor corporate governance and weak risk management practices made it difficult to assess the extent of exposures and potential spillovers. It was difficult to determine who was dancing with whom, and how closely. This opacity magnified the shock to confidence as the CLICO/CIB crisis unfolded;
- the CL Financial Group became highly over leveraged and heavily interconnected. Both CLICO and CIB used aggressively high interest rates to finance equally high risk investments, much of which were in illiquid assets including real estate;
- actual leverage of the CL Financial Group was even greater than immediately apparent. Distorted incentive structures encouraged excessive related-party transactions, which were not specifically prohibited in regulation, but which carried significant contagion risks;
- liquidity risk was higher than recognized. CLICO and CIB took on excessive maturity mismatches while failing to build adequate liquidity asset buffers;
- capital, therefore, was inadequate as a buffer against the sharp drop in asset prices, especially a rapid fall in methanol prices (a major source of dividends for the Group) and plummeting real estate values;
- the interconnectedness of institutions meant that these shocks were propagated across the Group, both in Trinidad & Tobago and the Caribbean; and
- CL Financial enjoyed the benefits of being “too-big-to-fail.” The implicit understanding was that if the Group ran into difficulties, the government would step in to prevent a systemic crisis. This made the too-big-to-fail problem even bigger. No one really knew what exactly needed to happen if a large systemically important institution became insolvent. At the end of the day, the decision to either bailout an institution or let it go bankrupt became a political not economic one.

My brief discussion has most certainly not fully captured all the details and the complexity of the CL Financial crisis. But even this brief overview provides some valuable lessons for shaping our future financial system.

We learnt the hard way about distorted incentives, we learnt about a severe lack of transparency, about inadequate capital and liquidity buffers and, most importantly, about the problem of “too-big-to-fail”.

We must also learn that this failure partly resulted from systemic weakness in the regulatory architecture and partly from excessive risk taking, both in regulated institutions and those outside the perimeter.

Looking to the future – how to prevent another crisis

Ladies and Gentlemen, as the country’s prime financial regulator, the Central Bank has an almost fifty year record of maintaining the safety and soundness of the financial system. As an independent institution with national responsibility, we are guided by our statutory obligations and by the long-term economic interests of the country. Our mandate goes well beyond the medium term horizon of the electoral cycle.

Only one thing is important: we need to enhance the resilience of the financial system to withstand shocks, no matter from which direction they emanate.

The first of the five initiatives we are spearheading to enhance the resilience of the financial system is regulatory reform.

Regulatory measures/reform

Many of our financial reforms in the last ten years have been triggered by recommendations made in a June 2004 document entitled *"Reform of the Financial System of Trinidad and Tobago: A White Paper."* On the regulatory side, we saw passage of key legislation to improve oversight by the two main regulators – the Central Bank and the Trinidad and Tobago Securities and Exchange Commission (TTSEC).

Passage of the Financial Institutions Act (FIA) 2008 allowed for enhanced supervision of commercial banks and non-banks, as well as strengthened the Central Bank's enforcement powers. More recently, passage of the Securities Act 2012 saw adoption of recommendations to improve supervision of the securities market by the Trinidad and Tobago Securities and Exchange Commission (TTSEC).

While the White Paper has served our financial services industry well, it is now dated. Crises such as CL Financial and Lehman, which erupted in the last six years, could not have been anticipated ten years ago when the Paper was written. Clearly, we need a new White Paper on the Financial System to provide a new roadmap for the next generation of financial reforms.

For this reason, the Central Bank has been spearheading efforts to develop a Green Paper on the Financial System, as a precursor to the creation of a new White Paper.

In the insightful words of Independent Senator the Honorable Subas Ramkhelawan during his December 2012 contribution to the debate on the Securities Bill, "*financial regulation on the whole is like the building of a fortress, and it is important in the building of a fortress that all the walls must be equally fortified, because the marauders at the gate will always look for the weakest point to infiltrate*."

A major weapon in the building of our regulatory fortress is the Insurance Bill 2013.

New insurance legislation is coming. I want to stress the Insurance Bill is not in limbo. It is not collecting dust on a shelf in a government office.

The Central Bank has been championing the Insurance Bill 2013, which is a meaningful and substantial piece of legislation. It contains a modern approach to insurance regulation and supervision, calls for strengthening corporate governance of insurance companies, and establishes more effective protection of policyholders. The Insurance Bill will address fundamental prudential deficiencies and will include important requirements for insurance companies which are consistent with international best practice.

The Honourable Minister of Finance and the Economy is expected to lay the Insurance Bill before a Joint Select Committee of Parliament before the end of the year.

Other regulatory reforms relating to the credit union sector and private pension funds are currently being addressed as the respective pieces of legislation are substantially complete.

While regulatory measures will give us a bigger bite, we are approaching the protection of our financial system from various angles.

The CL Financial crisis taught us that vigilant supervision is critical. This is the second area in which the Central Bank is spending considerable time and resources.

Good supervision

Good supervision is an extremely challenging and often underappreciated task. Two initiatives are supporting good supervision at the Central Bank: the ability to act and the will to act. The Central Bank currently regulates the banking, insurance and private pensions sectors of the financial system. As I just shared with you, we are also planning to regulate credit unions and other financial institutions.

As the regulatory rulebook becomes more challenging, we do not have the luxury of time to grow supervisors from entry level to seasoned professionals – a process that can take upwards of a decade. The country will not tolerate the excuse of not enough competent and highly-skilled supervisors.

We have, therefore, adopted a more pragmatic approach to building supervisory capacity and shortening the time period for creating seasoned supervisors. Over the past year, we have been recruiting top talent from our private financial sector and placing them in key supervisory positions within the Financial Institutions Supervision Department (FISD) of the Central Bank.

We have recruited a Second Deputy Inspector, brought in a highly sought after Chief Actuary and for the first time we have hired a Pension Fund Specialist and a Credit Risk Specialist. We will continue to head-hunt respected talent from the private sector.

The CLICO crisis has also taught us that it is even more important for supervisors at all levels to keep their eyes on the ball, at all times. The Bank is, therefore, deepening its approach to supervision in five ways.

First, our supervisors must not be afraid to be intrusive. They will not stay on the sidelines of regulated financial institutions, relying solely on the results of institutions' internal controls and risk management systems. The Central Bank is ensuring its presence is continuously felt, keeping in mind the unique relationship between supervisors and the financial services industry.

Second, our supervisors must be skeptical yet proactive. They will question the direction or actions of the financial services industry, especially in good times. The Central Bank is most valuable when it performs the unpopular role of taking away the punchbowl just when the party is about to rock. Let me just say we have indeed taken away a couple of punchbowls over the past year, particularly in the insurance industry. We are not in a popularity contest.

I am going through the details of how we do what we do, so you can have confidence not just in the Central Bank, but in our financial system. When you walk out of here today I want you to leave feeling convinced the people in the Central Bank tower are not asleep behind the wheel. (We take the punchbowl away, we don't drink from it!)

So if you would indulge me a bit more I want you to know our supervision will be comprehensive. The Central Bank is not simply confining its interests to risks faced by its regulated entities. Our supervisors will go beyond to risks posed by other entities in the financial system.

Fourth, our supervisors must be adaptive. The Central Bank is adapting to changes at the regulatory perimeter, with an eye to new or unregulated areas.

Finally, Central Bank supervisors must be conclusive. Supervisors will not be afraid to follow through conclusively on their inspection findings and to ensure matters identified reach their final resolution. The Central Bank is taking every identified issue, however small, to its conclusion.

The Central Bank is ensuring that its supervisors have both the will and the ability to act in order to prevent individual financial institutions from getting into trouble. What really defined the CLICO crisis, however, was the systemic aspect of a large financial institution failing and dragging others with it into the abyss.

This brings me to the fourth initiative the Central Bank is undertaking to manage our financial system. I speak about the Systemically Important Financial Institutions, or SIFIs

Systemically important financial institutions (SIFIs)

Both the global economic crisis and our own CLICO crisis demonstrated that failure of systemically important financial institutions ("SIFIs") had the potential to disrupt the smooth functioning of markets and the economy. Accordingly, the regulation of SIFIs has been placed at the top of our regulatory reform agenda.

The Central Bank has deemed five financial institutions as SIFIs. These are as follows:

1. Unit Trust Corporation (UTC);
2. Home Mortgage Bank (HMB);
3. Board of Management incorporated under the National Insurance Act (the NIB);
4. Trinidad and Tobago Mortgage Finance Co. Ltd (TTMF); and
5. Agricultural Development Bank of Trinidad and Tobago (ADB)

In the case of the UTC, its asset size (TT$23 billion) is about one-tenth the assets of the financial system. This is twice as much as the total assets of all institutions licensed to conduct the business of a financial nature under the FIA. The UTC is the country's largest mutual funds provider. A collapse of UTC would threaten the smooth functioning of both the financial market and the local economy.

It is important to note that in his Budget Statement of 2011, former Minister of Finance, the Honourable Winston Dookeran stated that the regulatory framework governing the Unit Trust Corporation is to be strengthened by, inter alia, placing the Corporation under the regulatory oversight of the Central Bank.

The state-owned National Insurance Board (NIB), which is responsible for the administration of the country's National Insurance System, commands around one-tenth of the assets of the financial system. The last actuarial review of the National Insurance System revealed a substantial shortfall in accumulated assets at the end of June 2010, essentially due to lower than expected investment returns. Since then, interest rates have fallen even lower and this is expected to further widen the deficit of the NIS Fund.

Given the volume of financial services offered by the NIB, its linkages within the financial system and the real economy and the need to ensure that the fund deficit is effectively managed and eventually eliminated, the Central Bank has deemed the institution to be systemically significant.

In respect of the other SIFIs, while their asset bases may be relatively small, these institutions have significant linkages within the financial system and the real economy. They also have specialized mandates to help advance Government's policies in areas such as housing and agriculture, thereby making it difficult for other financial institutions to carry out their functions.

I also wish to point out that some of these financial institutions accept deposits from the general public but are not subject to prudential supervision by the Central Bank. These institutions form part of what is usually referred to as the "shadow banking" system.

The Central Bank has commenced the process of seeking Cabinet approval to deem these five local financial institutions as Systemically Important Financial Institutions or SIFIs.

We want to bring the UTC, NIB, HMB, TTMF and the ADB into the regulatory perimeter of the Bank. If successful, the Central Bank would be responsible for regulating almost all of the financial system.

We have, therefore, reached a critical juncture in which it is important to consider whether a single financial regulatory authority is the optimal model of financial regulation in Trinidad and Tobago. This is our fifth initiative for securing the financial system.

Single financial regulatory authority

Ladies and Gentlemen, the CLICO crisis was partly due to regulatory arbitrage across the two main regulators – the Central Bank and the TTSEC. I fully understand and appreciate the merit in having checks and balances and healthy tensions across multiple regulators. However, a single financial regulatory authority can facilitate coordinated and comprehensive oversight of the entire financial services industry in the interest of promoting financial stability and more orderly markets.

Since the global financial crisis, the issue of integrated financial supervision has been engaging the attention of policymakers worldwide. Unfortunately, there is no global consensus on the best model for financial regulation.

A few countries have made the transition to a single regulatory financial authority using their central banks. These are Ireland, Russia and Singapore. Other countries have established a single regulator to co-exist alongside their central banks. These include Barbados, Canada, Colombia, Germany, Japan, Qatar and South Korea. Some countries have opted for the "twin-peaks" model which relies on two separate regulators: prudential regulation and consumer protection. These include Australia, the Netherlands, South Africa and the United Kingdom.

For this reason, the Honourable Minister of Finance and the Economy in his Budget 2013/2014 presentation indicated that the issue of the single financial regulator would be deliberated upon in the coming year.

I wish to affirm that the Central Bank stands ready to work with the Ministry of Finance and the Economy and the TTSEC to undertake research and consultation to determine whether a single Financial Regulatory Authority is the most feasible model for integrated financial regulation and supervision in Trinidad and Tobago.

Conclusion

Ladies and Gentlemen, suffice it to say that there is general consensus that the legacy of the CLICO/CIB crisis is expected to generate significant changes in our local financial landscape. There is perhaps less agreement on what shape the new financial landscape would take.

Five years after the CLICO/CIB crisis, the Central Bank is translating many of the lessons from the crisis into a new oversight framework. We are on the right path, but we have not yet reached our destination. At the Central Bank we are:

- hiring new specialized supervisory staff;
- deepening our approach to supervision;
- seeking passage of stronger legislation such as the Insurance Bill;
- seeking control over systemically important financial institutions such as the Unit Trust Corporation; and
- examining the feasibility of a Single Financial Regulator.

These are just a few of the initiatives the Central Bank has been working on over the last fifteen months to rebuild confidence, strengthen financial stability and to help create our future financial system.

However, I wish to make one thing abundantly clear. We cannot regulate virtue. Financial stability must reside in the hearts and minds of those who work in finance: bankers, investment analysts, insurance agents, insurance executives, brokers, and financial advisors. Financial stability must reside in the hearts and minds of our university students who eventually enter the financial workplace. Financial stability must also reside in the hearts and minds of our politicians and policymakers, who are called upon to make life-changing financial decisions.

We need a change of culture. The financial rakhshas (demons) who believe “greed is good” must be conquered. Only then would we see a financial system that is a true servant to the needs of the real economy. Subscribing to this notion is perhaps the most important step towards crafting the financial system we all want to see.

I thank you.