



# Challenges for Financial Stability: Risks and Rewards

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# Structure of the Financial System

## Bank Dominance and Inter-connectedness

- The financial sector is relatively large relative to the regional economy with total assets at **124 per cent of GDP**.
- Dominated by the commercial banks with assets equivalent to **95 per cent of GDP**; insurance companies (20 per cent of GDP); while assets of the credit union industry and the securities firms amount to 7 per cent and 9 per cent, respectively. (Figure 1).
- High level of inter-connectedness, reflecting the dominance of three Canadian banks and two regional insurance conglomerates with a network of subsidiaries and branches throughout the region.
- In addition, there are fourteen small indigenous banks, heavily dependent on public sector.

**Table 1. Banks dominate the financial system**  
(total assets in per cent of GDP)

	<b>ECCU</b>	<b>Jamaica</b>	<b>Barbados</b>	<b>T&amp;T</b>	<b>Bahamas</b>	<b>Belize</b>	<b>Guyana</b>	<b>Caribbean Total</b>
<b>Banks</b>	<b>176</b>	<b>49</b>	<b>132</b>	<b>73</b>	<b>150</b>	<b>89</b>	<b>64</b>	<b>95</b>
Local	79	24	0	n.a.	35	30	n.a.	19
Foreign	98	26	132	n.a.	115	59	n.a.	43
<b>Credit Unions</b>	<b>13</b>	<b>5</b>	<b>17</b>	<b>6</b>	<b>4</b>	<b>21</b>	<b>1</b>	<b>7</b>
<b>Insurance Companies</b>	<b>12</b>	<b>20</b>	<b>16</b>	<b>19</b>	<b>31</b>	<b>7</b>	<b>6</b>	<b>20</b>
<b>Securities Firms</b>	<b>n.a.</b>	<b>35</b>	<b>n.a.</b>	<b>n.a.</b>	<b>n.a.</b>	<b>n.a.</b>	<b>n.a.</b>	<b>9</b>
<b>Offshore Banks</b>	<b>45</b>	<b>n.a.</b>	<b>1,082</b>	<b>n.a.</b>	<b>7,220</b>	<b>20</b>	<b>n.a.</b>	<b>1.080</b>
<b>Total</b>	<b>245</b>	<b>109</b>	<b>1,246</b>	<b>158</b>	<b>7,404</b>	<b>137</b>	<b>71</b>	<b>1,236</b>



## Inter-connectedness has Strengths

In principle, the structure of the regional financial system carries several advantages and offer many opportunities. For example;

- The inter-connected network facilitates the flow of funds in the region and overcomes scale constraints.
- Affiliation to international parents brings transfer of knowledge and reinforce adherence to high prudential standards.
- Head Office is available to act as “lender of last resort”, if and when required.



## ...but carry systemic risks

- High inter-connectedness increases systemic risks and the scope for contagion.
- Vulnerability of the regional financial system exacerbated by:
  - (i) the ownership links between the various sub-sectors (between banks, insurance companies, securities firms and the state);
  - (ii) the sizable exposure to regional public sectors; and
  - (iii) dominance of a few conglomerates in the real economy and;
  - (iv) heavy reliance of the real sector on bank borrowing, given the small size of the regional capital market.

## Table 2: Fragmented Regulatory Structure

	<b>Banks</b>	<b>Credit Unions</b>	<b>Insurance</b>	<b>Securities</b>
ECCU	ECCB	National Supervisory Agencies (MoFs)	Eastern Caribbean Financial Services Regulatory Commission	Eastern Caribbean Securities Exchange
Jamaica	BOJ	Jamaica Cooperative Credit Union League	Financial Services Commission (FSC)	FSC
Barbados	CBB	Financial Service Commission (FSC)	FSC	FSC
Trinidad and Tobago	CBTT	Plan to apply CBTT's supervision	CBTT	Securities Exchange Commission
Bahamas	CBoB	CBoB (ongoing)	Insurance Commission of the Bahamas	Securities Exchange Commission
Belize	CBB	CBB	Supervisor of Insurance (SOI)	International Financial Services Commission
Guyana	BOG	Plan to apply BOG's supervision	BOG	Securities Council





# **Impact of the Global Financial Crisis**



## Resilience but Not Unscathed

- High level of financial resilience due to:
  - secure funding base (deposits as against market instruments);
  - High capitalization;
  - limited foreign exchange exposure

but...

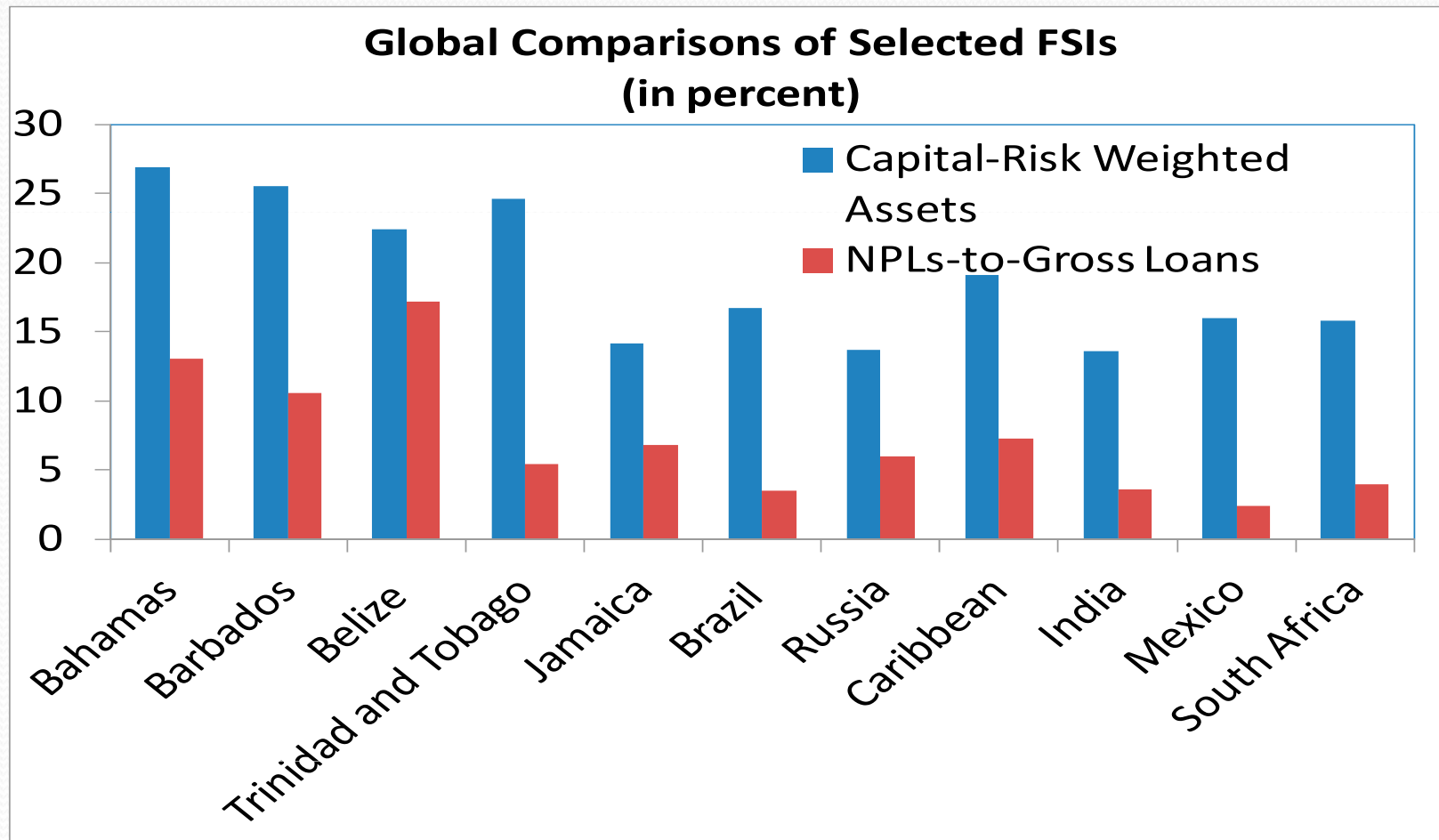
- Negative impact on growth, banks' portfolios and profitability.

### Table 3: Financial Stability indicators, Pre and Post Crisis

Financial Stability Indicators	2006- 2008	2009-2012	% Difference
Regulatory Capital to Risk Weighted Assets	18.1	19.7	+8.9
Liquid Assets to Total Assets	21.1	26.9	+27.5
Non- Performing Loans to Total Loans	5.2	8.5	+63.9
Return on Equity	25.6	16.7	-34.7
Return on Assets	2.9	1.8	-37.9
Interest Margin to Gross Income	66.7	61.6	-7.6
Non- Interest Expenses to Gross Income	45.0	47.8	+6.2

# Figure 1: International Comparison of Selected Prudential Indicators

(2012)





# The Financial System, Growth, Efficiency and Stability

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# Challenges Facing the Regional Financial System

Challenges facing the regional financial system are :

1. Increasing contribution to growth and transformation
  - Both tourism-dependent and commodity exporter Caribbean economies rely heavily on FDI
  - Limited domestic financing of corporates and large exposure to household sector.
2. Improving efficiency and service delivery.
3. Strengthening resilience through legislative reform; transforming the regulatory culture and greater regional cooperation.



## The Small Business Challenge

- The chronic excess liquidity in the banking system confirms that there is no shortage of loanable funds.
- However, almost every study on the regional development challenge identifies financing for priority sectors as one of the missing ingredients.
- In particular, bank credit for small businesses is generally not available or if at all, short supply on onerous terms.



## A Challenge for our Banks

- Small business financing is a complex issue. However, Do banks also have a responsibility to help find innovative ways of facilitating greater bank lending to priority sectors without compromising stability?
- Are banks' internal risk management systems part of the problem?
- Should the banking system be using its substantial strength to increase efficiency (to reduce spreads) and improve service delivery to consumers?



## Table 4: Indicators of Efficiency

### Interest Rate Spreads

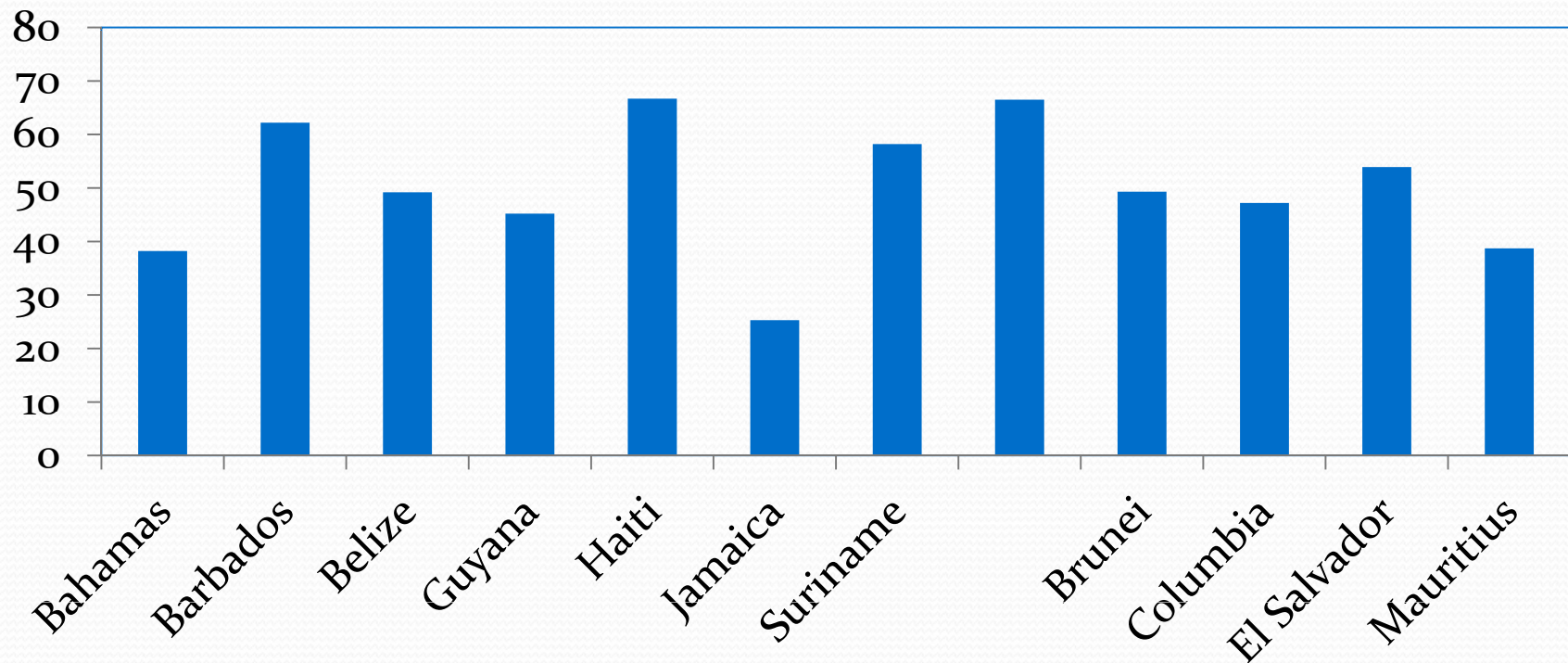
/Per cent/

	2010	2011	2012
Barbados	6.0	6.0	6.1
Jamaica	14.5	15.6	14.1
Guyana	12.3	12.5	12.3
Trinidad & Tobago	7.8	6.5	6.2
Selected Comparator Countries			
Canada	2.4	2.5	2.5
Mexico	4.1	4.0	3.6
Chile	3.0	3.7	4.3

Source: IMF Financial Soundness Indicators

## Table 4 (a): Efficiency Indicators cont'd

### Non-interest expenses-to-Gross Income (end-2012)





## Improving Resilience – The First Priority

Even if enhancing its contribution to growth and development and seeking efficiency improvements may be legitimate policy objectives.

- The widespread contagion and the exceptional cost of the CL Financial crisis make improving the resilience of the regional financial system should be our major priority.



## The CLICO/CLF Financial Crisis

- CLF was the region's largest conglomerate with total assets estimated at US\$16 billion ( approx. 23 per cent of regional GDP)
- CLF had financial and non-financial subsidiaries in fifteen Caribbean countries (Clico, British American and BAICO were the insurance subsidiaries).
- Entire region (except Jamaica and Haiti) suffered major contagion.
- Though resolution still is in progress, estimated to cost in excess of 20 per cent of GDP.



## Main Causes of the Crisis

- An antiquated legislative financial framework which did not keep pace with the rapid evolution of the insurance sector.
- Poor risk and liquidity management; inadequate capital; an excessive amount of intra-group transactions; mismatch between assets and liabilities; poor corporate governance.
- Lack of experience and know-how in insurance regulation. (regulators did not fully understand the complex tapestry of risks that CLF represented).



## Post Crisis Reforms

- Several jurisdictions have taken steps to upgrade banking legislation, though little progress on insurance.
- Greater collaboration between regulators (a formal college of regulators including both regional and international regulators; exchange of information etc.)
- More attention being paid to training and strengthening regulatory capacity.
- Increased emphasis on developing national and regional financial crisis preparedness plans and a more systemic study of regional financial interconnectedness.



# The Unfinished Agenda



## Reform Challenges

- Understanding the interactions between macroeconomic policies and financial stability.
- Formulation of a toolkit to address financial stability concerns (formal macro-prudential policy framework is absent).
- Minimizing the impact of sovereign debt restructuring on financial stability.
- Capacity constraints which impede formulation/revision and timely implementation of financial legislation.
- Regulatory collaboration.
- Agreement on a cross-border resolution regime.
- Financial institution restructuring.
- Changing the regulatory culture.





## Further Legislative Reform

- Need for harmonization of existing banking legislation and new regulations which keep pace with international developments.
- Most regional jurisdictions need to reform the regulatory framework for insurance.
- Need to broaden the regulatory perimeter to include other systemically-important non-banking institutions.



## Regulatory Collaboration

- Cooperation and sharing of information between local and regional regulators must be more than pro-forma, but needs to be meaningful in order to identify and proactively address risks.
- Greater interplay with international standard-setters (FSB, IOSCO, IAIS, etc.)
- Regulators also need to work closely with the auditors and actuaries who must be brought into the supervisory process.



## Stronger Resolution

- Goal is to reduce the need for bailouts and a disorderly winding-down of a failed institution.
- Tailor emerging international consensus on banking resolution (the FSB's Key Attributes) to regional realities.
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- There needs to be advanced planning for the prompt management of a crisis and for the longer process of winding down a failed entity.
- The establishment of a regional resolution mechanism will present major challenges. However, the Clico/CLF crisis clearly underscored the need for some regional coordinating mechanism with quasi-statutory authority and resources.



## Financial Institution Restructuring

- Consolidation of weaker entities, particularly in the insurance and credit union industries.
- Minimize state ownership in financial institutions to avoid possible adverse sovereign-bank feedback loops.
- Recapitalization of viable indigenous banks (Where should new capital come from and what form should it take?)
- Address legacy issues (the NPL overhang in some territories).
- Strengthen liquidity buffers.



## Changing the Culture

- Market discipline needs to become an important part of the regulatory process.
- Regulatory arrangements need to provide for enhancing transparency through stronger accounting and disclosure standards.
- Regulators need to be prepared to conduct more intensive and more intrusive supervision, especially for the more the largest and more complex institutions.



## Conclusion

- The financial system needs to play a greater role in the transformation of our regional economies.
- Modernise legislative framework and strengthen supervisory capacity.
- Intensify collaboration among regional regulators and between regulators and other stakeholders. One priority area would be a cross-border resolution mechanism.
- Most importantly, there is an urgent need to transform the regulatory culture (government, regulators, financial institutions and the wider public).