Challenges for Financial Stability: Risks and Rewards

By

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Outline

1. Structure of the Financial System
2. Impact of the Global Financial Crisis
3. Challenges: Efficiency, Growth and Stability
4. The Clico/CLF Crisis
5. Post-Crisis Reforms
6. The Unfinished Agenda
7. Conclusions
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)

<table>
<thead>
<tr>
<th></th>
<th>ECCU</th>
<th>Jamaica</th>
<th>Barbados</th>
<th>T&amp;T</th>
<th>Bahamas</th>
<th>Belize</th>
<th>Guyana</th>
<th>Caribbean Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Banks</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local</td>
<td>176</td>
<td>49</td>
<td>132</td>
<td>73</td>
<td>150</td>
<td>89</td>
<td>64</td>
<td>95</td>
</tr>
<tr>
<td>Foreign</td>
<td>79</td>
<td>24</td>
<td>0</td>
<td>n.a.</td>
<td>35</td>
<td>30</td>
<td>n.a.</td>
<td>19</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>245</td>
<td>109</td>
<td>1,246</td>
<td>158</td>
<td>7,404</td>
<td>137</td>
<td>71</td>
<td>1,236</td>
</tr>
<tr>
<td><strong>Credit Unions</strong></td>
<td>13</td>
<td>5</td>
<td>17</td>
<td>6</td>
<td>4</td>
<td>21</td>
<td>1</td>
<td>7</td>
</tr>
<tr>
<td><strong>Insurance Companies</strong></td>
<td>12</td>
<td>20</td>
<td>16</td>
<td>19</td>
<td>31</td>
<td>7</td>
<td>6</td>
<td>20</td>
</tr>
<tr>
<td><strong>Securities Firms</strong></td>
<td>n.a.</td>
<td>35</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>9</td>
</tr>
<tr>
<td><strong>Offshore Banks</strong></td>
<td>45</td>
<td>n.a.</td>
<td>1,082</td>
<td>n.a.</td>
<td>7,220</td>
<td>20</td>
<td>n.a.</td>
<td>1,080</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>245</td>
<td>109</td>
<td>1,246</td>
<td>158</td>
<td>7,404</td>
<td>137</td>
<td>71</td>
<td>1,236</td>
</tr>
</tbody>
</table>
Inter-connectedness has Strengths

In principle, the structure of the regional financial system carries several advantages and offers 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 reinforces 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 subs-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>
<thead>
<tr>
<th>Region</th>
<th>Banks</th>
<th>Credit Unions</th>
<th>Insurance</th>
<th>Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>ECCU</td>
<td>ECCB</td>
<td>National Supervisory Agencies (MoFs)</td>
<td>Eastern Caribbean Financial Services Regulatory Commission</td>
<td>Eastern Caribbean Securities Exchange</td>
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<tr>
<td>Jamaica</td>
<td>BOJ</td>
<td>Jamaica Cooperative Credit Union League</td>
<td>Financial Services Commission (FSC)</td>
<td>FSC</td>
</tr>
<tr>
<td>Barbados</td>
<td>CBB</td>
<td>Financial Service Commission (FSC)</td>
<td>FSC</td>
<td>FSC</td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>CBTT</td>
<td>Plan to apply CBTT’s supervision</td>
<td>CBTT</td>
<td>Securities Exchange Commission</td>
</tr>
<tr>
<td>Bahamas</td>
<td>CBoB</td>
<td>CBoB (ongoing)</td>
<td>Insurance Commission of the Bahamas</td>
<td>Securities Exchange Commission</td>
</tr>
<tr>
<td>Belize</td>
<td>CBB</td>
<td>CBB</td>
<td>Supervisor of Insurance (SOI)</td>
<td>International Financial Services Commission</td>
</tr>
<tr>
<td>Guyana</td>
<td>BOG</td>
<td>Plan to apply BOG’s supervision</td>
<td>BOG</td>
<td>Securities Council</td>
</tr>
</tbody>
</table>
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

<table>
<thead>
<tr>
<th>Financial Stability Indicators</th>
<th>2006-2008</th>
<th>2009-2012</th>
<th>% Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory Capital to Risk Weighted Assets</td>
<td>18.1</td>
<td>19.7</td>
<td>+8.9</td>
</tr>
<tr>
<td>Liquid Assets to Total Assets</td>
<td>21.1</td>
<td>26.9</td>
<td>+27.5</td>
</tr>
<tr>
<td>Non-Performing Loans to Total Loans</td>
<td>5.2</td>
<td>8.5</td>
<td>+63.9</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>25.6</td>
<td>16.7</td>
<td>-34.7</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>2.9</td>
<td>1.8</td>
<td>-37.9</td>
</tr>
<tr>
<td>Interest Margin to Gross Income</td>
<td>66.7</td>
<td>61.6</td>
<td>-7.6</td>
</tr>
<tr>
<td>Non-Interest Expenses to Gross Income</td>
<td>45.0</td>
<td>47.8</td>
<td>+6.2</td>
</tr>
</tbody>
</table>
Figure 1: International Comparison of Selected Prudential Indicators

(2012)
The Financial System, Growth, Efficiency and Stability
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**

<table>
<thead>
<tr>
<th>Country</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barbados</td>
<td>6.0</td>
<td>6.0</td>
<td>6.1</td>
</tr>
<tr>
<td>Jamaica</td>
<td>14.5</td>
<td>15.6</td>
<td>14.1</td>
</tr>
<tr>
<td>Guyana</td>
<td>12.3</td>
<td>12.5</td>
<td>12.3</td>
</tr>
<tr>
<td>Trinidad &amp; Tobago</td>
<td>7.8</td>
<td>6.5</td>
<td>6.2</td>
</tr>
<tr>
<td><strong>Selected Comparator Countries</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>2.4</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Mexico</td>
<td>4.1</td>
<td>4.0</td>
<td>3.6</td>
</tr>
<tr>
<td>Chile</td>
<td>3.0</td>
<td>3.7</td>
<td>4.3</td>
</tr>
</tbody>
</table>

*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 pro-actively 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.

- 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).