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The International Financial Crisis: Implications for our Financial Sector Stability

Keynote Address from the Caribbean Actuarial Association Conference

By Ewart S. Williams

Thanks for inviting me to give the opening address at your 18th General Conference.

Let me congratulate the Caribbean Actuarial Association on becoming a full member of the International Actuarial Association. This is a commendable achievement and in my view, is testimony to your commitment to pursue and achieve a level of proficiency that is consistent with international standards. This achievement augurs well for our financial sector as a whole and for our insurance and pensions industries in particular.

I also want to extend my appreciation for your collaboration with the Central Bank, ATTIC and the Institute of Chartered Accountants of Trinidad and Tobago, to develop a standardized actuarial valuation methodology for the local insurance industry. The development and implementation of such a standard is of critical importance as we strive to enhance our ability to effectively supervise the insurance industry.

My topic today is "The International Financial Crisis: Implications for our Financial Sector Stability." While my references will be largely to our financial system (Trinidad and Tobago) I expect that participants from other countries in the region could also identify with my sentiments.

I would not be surprised if many of you are more than a bit tired of hearing about this "unprecedented" international financial crisis that the world is going through; and the fact that "it is the most severe financial crisis since the Great Depression." To be honest, these words are now so over-used that there is a risk that the whole thing is perceived as a big exaggeration, particularly for populations far away from the Center, as we are.

I will try not to go over all the "unprecedented" financial developments of September and October but rather try to pry a bit behind the simple explanations and more so importantly, focus on the more important lessons that the financial meltdown should have for financial regulators in the Caribbean and particularly for us in Trinidad and Tobago.

It has become commonplace to see the roots of the ongoing global financial turmoil in the sub-prime crisis in the United States, triggered by the turn of the housing cycle and increasing defaults on sub-prime mortgages. The fact is however, that the crisis had deeper causes including, in particular, the under-pricing of risks and debt-accumulation in several countries, during a period of low real interest rates and easy access to credit. All of this was grounded in the increasing macro-economic imbalances between the G7 economies, particularly the U.S., and the major emerging market economies.

According to this thesis, the years of accommodating monetary policies in the United States which led to rapid economic growth, a consumption boom and asset bubbles (particularly in the housing sector), also brought a widening external imbalance. Of course, the flip side to the U.S. deficit was the ballooning surpluses in many emerging market economies—mainly China, India and some of the major oil producing countries in the Middle East.

Now, the savings glut in these emerging economies led to the extraordinary flow of funds back to the developed world, and to the United States in particular. That in turn kept interest rates low, allowing the rapid growth of credit but fuelling an

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increasingly risky search for yield—for example, in sub-prime housing in the United States.

In this explanation, the villains were the extended period of low interest rates and the inflated aggregate balance sheets of the large banks all over the United States and Europe. And with interest rates low, these banks, which are driven by their bottom lines, became consumed in a search for higher yields and thus they expanded into assets, whose underlying value was uncertain and whose credit quality was exceptionally risky.

Moreover, in order to expand their balance sheets at the accelerated rate, these banks could not depend on deposits but rather increased reliance on wholesale funding (inter-bank loans), whose maturity was often short.

Two other elements added importantly to the brew: firstly, inadequate capital and liquidity buffers given the high asset and liability risks; and secondly, the under-appreciated but potent links between firms in the global financial system.

And as it turned out, with increasing defaults on sub-prime mortgages, the credit ratings of the structured products were significantly downgraded; this created uncertainty about the creditworthiness of the big banks worldwide, led to the now famous drying-up of the inter-bank market, and the credit crunch.

A long complicated story that is still evolving but in the meanwhile has led to a major global recession.

What are the main lessons of the crisis for Caribbean regulators?

As you know, the first round impact on the Caribbean financial system has been fairly limited for several reasons.

For one thing, our banks had not invested heavily in sub-prime mortgages and secondly, credit expansion of our financial institutions is based on deposit mobilization and only marginally on foreign loans. Some observers see our financial resilience as a reflection of the region's limited integration in global financial markets (which has turned out to be a benefit, this time around).

Of the countries in the region, Jamaica was perhaps the most seriously affected because of the decline in the value of its global bonds, much of which were held by domestic commercial banks. The Bank of Jamaica had to establish a US$300 million facility to provide assistance to the commercial banks. Jamaica, however, continues to face capital outflows and exchange rate pressures.

Of course all our economies are now suffering the effects of the crisis through the trade channel, but that is a separate discussion.

In terms of financial stability, what the crisis has certainly done is to remind us of the vulnerabilities of our financial sectors, underscoring the urgency to take corrective action.

For several years, we in Trinidad and Tobago had recognized the need to tighten financial sector regulation and supervision, and we have been doing it but "at our own good pace," which is a wee bit faster than very slow.

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After many years of discussion and preparation the Parliament finally approved a new Financial Institutions Act (FIA) on Tuesday; we are working on a new Insurance Act (the current one dates back to 1980) and new Securities, Pensions and Credit Union legislation is also expected over the next one to two years.

There is no doubt that our financial legislative framework is woefully inadequate and urgently needs to be upgraded. But the lesson from the crisis is that while robust legislation is certainly necessary, it is clearly not sufficient. So as we move more aggressively on the legislative front to bring our legislative infrastructure in line with international best practices, we need two other things to bolster financial stability.

- First, we need to shake the complacency that results from several years of continuous financial sector expansion and require our financial institutions to put robust risk management at the core of their operations (our institutions need to be reminded that the financial meltdown that happened to Jamaica in the late 1990s could happen here).

- Second, we need to reinforce our regulatory efforts by doing three things, getting a better balance within macro-economic policy; establishing a set of reliable early-warning indicators and developing, in conjunction with the government, a crisis management plan (to deal with systemic institutions).

The new FIA, approved Tuesday, would help us deal with many of the risk management issues that have traditionally plagued the financial system. The new FIA formalizes consolidated supervision, in order to identify and evaluate the group risk and the risk of contagion. It seeks to address related-party lending, which has been a traditional source of vulnerability of our financial institutions; the new FIA upgrades governance structures with such features such as requiring more independent Board directors, and an independent audit committee. It also gives more authority to the external auditors.

Very important from our vantage point, the new FIA gives more authority to the Central Bank to take early corrective and preventive action to protect depositors.

As noted above, new legislative structures are also urgently needed to reduce the vulnerability of the insurance sector. Currently this vulnerability derives in part from the absence of a standardized actuarial methodology to value insurance liabilities and the absence of an appropriate framework for setting capital requirements, commensurate with the risk profile of the particular institution.

One inescapable lesson from the global turmoil is the risk inherent in the operations of large unregulated financial institutions. Fannie Mae and Freddie Mac were perceived to be state institutions with an implicit government guarantee. In the absence of prudential supervision they were both driven to the edge of insolvency by the sub-prime crisis, and perception became reality. Both these institutions had to be taken over by the Federal government and the implicit guarantee has now become explicit.

As you may know, the investment banks—Bear Sterns, Lehman Bros, Merrill Lynch, Goldman Sachs and Morgan Stanley—were subject to minimal, if any prudential supervision. Three of the five got into serious financial difficulties and had to be absorbed by commercial banks. The other two converted into commercial banks subjecting themselves to rigorous prudential supervision.

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There are similar gaps in our financial system that we are seeking to address. The Home Mortgage Bank has already been brought under the supervisory ambit of the Central Bank. Consideration is being given to making similar arrangements for the Unit Trust Corporation. As I said before, we are in discussions with the Credit Unions to formulate legislation that will promote an appropriate prudential framework without compromising the unique cooperative character of the movement.

But there are lessons that can not be addressed by legislation. One such issue is ensuring consonance between monetary policy and financial sector regulation. It is a thorny difficult issue for most central banks. Take our case, the present anti-inflationary posture requires occasional increases in interest rates. However, under certain conditions, higher interest rates could lead to an increase in non-performing loans, which in the absence of adequate capital, could compromise the solvency of weaker institutions. There is no easy answer to this dilemma except through ensuring that increases in interest rates are contained by sharing the adjustment burden between fiscal and monetary policy and by ensuring that periods of high inflation are kept as short as possible.

A second issue that has come to the forefront and which has relevance to our situation is the inherent tendency for financial institutions to build-up risk in an economic upswing only to be forced to sharply tighten credit conditions in the downswing. Of course, the credit tightening further aggravates the economic decline. There is now on the table, (in the international discussion) a proposal, whereby banks would build-up general loss reserves during good times and draw on these reserves when the economy begins to deteriorate and actual losses are incurred. The resulting moderation in credit swings could serve to enhance financial stability generally.

The current crisis (as well as the last major regional crisis, in Jamaica in 1999), should make clear to us the need for identifying risks to the financial system at the earliest possible opportunity. Accordingly, the Central Bank is working on a more effective approach to detecting risks, through an early warning system. The system will, however, require more and better information from the financial institutions, closer collaboration between regulators and more detailed macro-economic analysis of both our economy and the international economy.

But, even after we upgrade our financial legislation, even after the banks improve risk-management, even after we introduce effective early warning indicators, it is more than likely that at some stage, our financial system will face serious stress. To prepare for such an unwelcomed eventuality, we need to put in place adequate crisis management and emergency lending arrangements. We need to face the fact that, in small countries like ours, even much more so than in the United States, there tends to be systemically important institutions, with disproportionately large market shares, which require more intense oversight but which must be provided for, in any crisis management plan.

We are working on a crisis management plan which carefully identifies those systemic institutions and assigns specific roles of the Central Bank, Deposit Insurance and the Ministry of Finance in the event of a crisis. Contingency planning takes on even great importance in cases where there are regional financial institutions operating in several countries (as presently obtains). Our regional banking structure will require a robust and predictable framework for consultation and for burden sharing among the various countries.

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Indeed, there are other lessons from the crisis but time does not allow me to cover all.

For instance, the crisis should bring home to us some of the risks of the "originate to distribute" model, which has already caused us problems here in the Caribbean. This is the model where a financial institution originates a transaction, in which the entire issue is pre-sold to other institutional investors. In many of these cases there may not be sufficient incentive for robust due diligence since the originator is passing on all the risk, after it makes his commission.

Then there is the issue of financial innovation which in the United States contributed to significant debt accumulation and an increase in the level of risk which was not fully appreciated. Clearly financial innovation should be encouraged since it could bring significant benefits, not least of which are lower financing costs and the spreading of risks. Innovation impacts are however invariably off-balance sheet and tend to avoid the scrutiny of the regulators. The issue is not to discourage innovation but to ensure that the contingent risks are recognized and covered through increased capital.

Where does all this leave us?

The current global financial crisis has clearly forced us to acknowledge the close link between macro-economic policy and financial stability. It has reminded us of the need for strong well-capitalised financial institutions with robust risk management and governance systems, a strong and transparent regulatory and supervisory framework, an (effective) early warning system and a comprehensive regime for crisis management.

We have to be careful lest the crisis leaves us so traumatized, that we change gears to a system of over-regulation; one that discourages risk-taking and punishes innovation. In the final analysis an efficient and stable financial system is a key for sustainable economic growth. An under-regulated financial system is a risk to financial stability and economic growth; but an over-regulated financial system will not be efficient and will not give adequate support to innovation or growth.

The challenge is simply finding the balance…and that is not so simple. □

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