

CARIBBEAN REGULATORY FRAMEWORK & INFRASTRUCTURE

- Creating an Enabling Environment

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Good morning, it is indeed a pleasure and an honour to be present here with you today to share my views on an evolving regulatory framework.

An environment that is complex, globalized, rapidly changing and characterized by increasingly mind-boggling product innovation is a difficult one to regulate because under these conditions anticipating potential problems and more importantly, devising effective solutions are

enormously challenging if not elusive. However, extraordinary times warrant extraordinary action. To deal with this challenge, any regulatory framework must be multi-faceted, dynamic and flexible if it is to contribute to an enabling environment for our financial institutions.

We have all been bombarded with reasons why the events of the international financial crisis occurred. In fact, we have been overwhelmingly led to believe that the causes lie at the feet of Chief Risk Officers. I beg to differ. The root cause of the problem is failure of effective governance in the Board rooms of financial institutions, but also regulatory bodies. This governance failure is of epic proportion. So I guess if I am going to make such a bold statement I should defend it.

Boards of financial institutions must never lose sight of the fact that their fiduciary responsibilities are equally as important as their entrepreneurial responsibilities and therefore a higher duty of care is warranted in the board rooms of our financial institutions. It is important for the

Board to set the right tone and culture at the top, starting in the Board room. The Board needs to cultivate a risk averse culture and aggressively take the appropriate steps to ensure that this culture permeates the organization. In other words, every last employee needs to be a risk manager – not just risk officers. Risk management is not a process – it is a mindset. This does not occur overnight, you have to nurture it.

Boards can nurture this mindset by setting the right example and by asking the right questions. They should ask the piercing questions repeatedly, if only to see if they are getting consistent answers. There needs to be healthy tension between senior management and the Board. They need to be comfortable with the manner in which risk is being managed and therefore a healthy sense of skepticism should characterize the relationships between these two stewards of consumers' money.

In order for Board Members to be fully comfortable that they understand all critical risks that the financial

institution is exposed to, there are other avenues they could exploit. For example, they should have access to independent experts. Mechanisms should be put in place for Boards to access this vital option with ease, and it should be utilized. This will prevent the securing of independent reports from becoming an event whenever they are called for.

So how does all of this relate to the recent crisis? Well, we all know that risk management failed and I just described what critical governance conditions were absent, thus contributing to this failure.

I would now like to touch on some of the specific elements of a regulatory framework and infrastructure that must be in place by both companies and the regulator alike.

The regulatory framework must be both reliance-based and anchored on an early intervention platform. Regulators must be reliance-based because we are on the outside looking in. As regulators we only become aware of the

business and the inherent risks after it has been put on the books. We are not making the day-to-day business decisions; this is the responsibility of management. Therefore we have to rely on auditors, (internal and external) management and Boards to do their job. Our role as regulators is to intervene on a timely a basis when problems are detected in order to mitigate undue losses to depositors.

The point at which regulatory intervention occurs is critical but we have to be realistic. The triggers for institutional or even systemic problems or shocks are not easily discernible. This is all the more reason why capital and liquidity management plans must be robust and relevant to the circumstances of the company. The ability to absorb the consequences of a disturbance will be easier. Having said that, capital is not a substitute for effective risk management.

What the current crisis has also shown is that greater attention has to be paid to liquidity management. This

means that companies need to pay greater attention to stress testing and incorporate scenarios that are creative but plausible. For example, institutions need to do more robust analysis and simulations of concentrations and correlations among risk exposures. The overall results of such an exercise should then drive companies' liquidity contingency plans and in turn determine the optimum level of required capital liquidity is the life blood of any institution.

On the matter of capital, the quantum is material but the more relevant issue is the quality. Companies need to start paying attention to Tier 1 capital or permanent capital.

I now want to touch on the need for compliance management systems. Globally, there is ample evidence of companies, including even venerable financial institutions being fined substantial amounts by regulatory bodies and/or incurred substantial losses as a result of severe breakdown in their compliance management

systems. So if anyone thinks that compliance management systems deliver nothing to the bottom line, they are wrong. If they think that it is just another routine and customary internal control requirement, they are in for a surprise. If they think that is not worth the time and focused attention of the Board and senior management, I would like to talk to them because compliance is critical to the success of any company. But in the financial services industry, the need for an effective compliance management system is even more important given that public confidence is a critical asset.

One of the most important elements of a compliance framework is the code of ethics or code of conduct which outlines the organization's overall attitude towards compliance and serves to sensitize employees to the control culture and expectations of the organization.

I would now like to touch on essential requirements for regulators. I would highlight two aspects: co-operation and co-ordination and crisis management.

Given the fact that many financial institutions operate across the region it is essential that cross border co-ordination, co-operation and information sharing mechanisms be put in place because a disturbance in one jurisdiction can quickly transcend national boundaries. However, the experience of the recent international crisis has shown that while the nature and magnitude of the problems were not anticipated, sheer creativity and unprecedented levels of coordinated and decisive actions were put into play very effectively. Therefore, whatever plans we put in place in the Region must be nimble in order to respond to the realities of the situation.

Regulators also need to engage in their own stress testing and financial crisis simulation exercises. This should involve organizations such as the compensation fund and relevant government departments. This should be done not

only to test selected companies' abilities to withstand a shock but also to test the resilience of the financial system as a whole.

I now like to touch on legislative developments that are underway in Trinidad and Tobago. The new Financial Institutions Bill (FI Bill) which is now before Parliament includes provisions to enhance the compliance and risk management functions of financial institutions. For example, the FI Bill requires a financial institution, on an annual basis, or upon request, to submit a report with a statement signed by its chief executive officer and chief financial officer, which acknowledges management's responsibility for:

- (i) preparing financial statements;
- (ii) establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
- (iii) complying with regulations and guidelines issued by the Central Bank.

In addition, the institution is required to submit a statement, signed on behalf of its Board of Directors, as to whether it is satisfied that the risk management systems and internal controls are adequate for managing its risks and are being properly applied in order to certify that the financial institution is in compliance with the laws and regulations.

That brings me to my final point. New and enhanced legislation and supervisory frameworks, crisis management plans, etc. cannot substitute for the critical importance and need for frank and open lines of communication between the regulator and the licensee. At the base of such relationship is the reliance on moral suasion by which the financial institution “does the prudent thing” or “ceases from doing the imprudent thing”. This is what has worked for us in the past.