CENTRAL BANK OF
TRINIDAD & TOBAGO

Eric Williams Plaza, Independence Square, Port-of-Spain, Trinidad, West Indies
Postal Address: P.O. Box 1250
Telephone: (868) 625-4835; 4921; 5028; Fax (868) 627-4696; Telex: 22532; 22386
E-Mail Address: info@central-bank.org.tt
Website: www.central-bank.org.tt

"The Paradoxes Inherent in the Role of Central Banks: The Case of the Central Bank of Trinidad and Tobago"

Address to the British-Caribbean Chamber of Commerce

by

Ewart S. Williams
Governor, Central Bank of Trinidad and Tobago
March 11, 2009

Thanks to the British Caribbean Chamber of Commerce for inviting me to address your forum this morning.

My invitation listed a number of topics and the one that caught my eye was entitled, **the paradoxes inherent in the role of central banks**; I would therefore wish to take this opportunity to discuss the kinds of challenges that the Bank has been facing in the pursuit of its mandate. I will couch the discussion in the context of two current macro-economic challenges:

* The current economic slowdown
* The Clico/CIB crisis

Over the last few years, we have achieved rapid economic growth. However, as you know, the Central Bank has had to face the specter of unacceptably high inflation.

Since 2008, the international economy has been in the grip of an unprecedented financial crisis which has led to a pronounced global recession. Initially, like most developing and emerging market countries, the region faced only limited contagion from the international turmoil. However, as the international credit crisis persists, as commodity prices continue to sag, and as the global recession gets deeper, the region is finding itself on the cusp of a major economic slowdown with all its attendant consequences.

Several indicators point to a pronounced slowdown in the Trinidad and Tobago economy.

- Activity in the energy sector has declined sharply, with several firms forced to advance scheduled maintenance to contain layoffs.

- All the main construction indicators are down – local sales of construction materials, employment in construction : mortgage loans

On the demand side:

- The index of retail sales is trending downwards.

- Christmas and Carnival sales were much lower than last year.

- Automobile sales and purchases of consumer durables are sharply down.

- Several large firms (Mittal Steel, Digicel, Hilton Hotel) have announced layoffs.
- While reliable data are not available, the decline in regional and local demand could be affecting manufacturing output and exports.

Of course, there is some encouraging news on the inflation front as:

- Headline inflation has declined from a high of close to 15 per cent to 11.7 per cent; and

- Food prices seem to be coming down because of both external and domestic influences; and

- We are seeing a steady decline in real estate prices, in line with the cooling of the property boom.

Most developed and emerging market economies are resorting to expansionary fiscal and monetary policies to deal with a worsening world recession and sharp increases in unemployment. As you know, the decline in energy prices initially prompted a reduction in fiscal expenditures but as oil prices continued to fall the Government eschewed further expenditure cuts, opting for a small amount of deficit financing.

The Central Bank has not yet moved to ease monetary policy, **in part because inflation continues** to be unacceptably high and inflation expectations have not been sufficiently contained. We need to be careful about an inflation spiral.

However, as noted earlier, anecdotal evidence suggests that the incidence of lay-offs in the construction and services sector is increasing. As a practical matter, **if layoffs and unemployment continue to rise, both the fiscal and monetary stance may need to be revisited and the pace of inflation reduction may need to be re-considered**.

Of course, any temporary relaxation of the fiscal stance puts even greater pressure on the government to achieve medium term fiscal sustainability. That's in fact the problem in the US where President Obama's considerable efforts to provide fiscal stimulus to address the recession will need to be matched by a similarly bold program to reduce the fiscal deficit in the next few years.

On present projections, oil prices are expected to remain depressed for the remainder of the year and the fiscal deficit will lead to an increase in government borrowing. The CL Financial crisis will further add to our borrowing requirements. However, we are in a good position to handle this since we have fiscal space, a relatively low level of public indebtedness and considerable excess liquidity in the banking system.

We are in a similarly fortunate position as regards our foreign exchange reserves. Low energy prices have significantly reduced additions to these reserves. Further, the international credit crisis is affecting the normal credit lines that were available to banks such that they need to depend more on foreign exchange from the Central Bank. In addition, the global and domestic financial uncertainties may be contributing to some capital flight.

The Central Bank has the resources to meet the increased foreign exchange demands. Central Bank sales so far this year (over US$300 million) are more than double those for the comparable period of last year.

The Central Bank stands ready to meet all foreign exchange demands for its gross reserves which now stand at around US$9 billion, the equivalent of eleven months imports. **With that level of reserve cushion, rumours of an impending devaluation are misguided**.

I would like to make some comments about the challenges that the Central Bank, as Regulator, faces in a rapidly evolving financial system.

Several analysts have put the blame for the CLICO/CIB financial collapse squarely on inadequate regulation by the regulator, the Central Bank. Of course, **this is what happens whenever there is financial stress**. Invariably, the finger is pointed to the Regulator. Inadequate or the absence of regulation has been blamed for the collapse of financial institutions in the United States, as well as for the Madoff and Stanford scandals; the FSA has been faulted for the demise of the Northern Rock and the other failed institutions in the UK and the list goes on and on.

If you look across the world, it seems that regulators are busy trying to resolve some sort of financial calamity. But regulation of financial institutions is not new. Regulation has been in existence for over one hundred and fifty years. So why have Regulators not mastered the job of regulation. Well, I could think of three reasons:

1. Rapidly evolving innovation and creativity in terms of services and products being offered by financial institutions.

2. The recognition that risk taking should not be totally outlawed since under certain conditions it could benefit consumers.

3. The fact that laws cannot legislate good behaviour or by extension, good governance.

4. An ideological shift towards free markets and minimal regulation.

How does this relate to CL Financial and CLICO.

CLICO, in many ways, was a pioneer and a path-breaker on the local financial scene. For years it led in the provision of insurance services in Trinidad and Tobago and indeed in the region. For the most part, CLICO's expansion proceeded under conditions of limited regulation as the Office of the Insurance Supervisor, in the Ministry of Finance, lacked the resources to act as a Regulator.

As you know, in the early days insurance companies collected premiums and invested the proceeds in government securities and in mortgages. Over time, as incomes and the demand for savings-products increased and as our local capital markets did not expand in step, insurance companies had to look further afield for investment opportunities. **CLICO was the leader in this endeavour**.

By the time the insurance industry was transferred to Central Bank in mid-2004, CL Financial, with CLICO as its main financial company, had already become a major conglomerate in Trinidad and Tobago and in the region with 60 subsidiaries, operating in several fields, and spread over 20 countries – in the Caribbean, Central and North America and Europe.

The official data showed that **CL Financial** was an extremely strong and profitable conglomerate and that CLICO was the centerpiece of the Group. It was clear that the Group had major vulnerabilities, the most notable being the excessive amount of related-party transactions.

From the beginning, we recognized that regulation of the insurance industry, which was accustomed to being unregulated, was always going to be a major challenge. And we knew that CLICO, being the biggest company, would be in the forefront of this process.

Financial regulation is most effective when you have the confluence of a number of factors including **an adequate legislative and regulatory framework**; **an effective supervisory system**; including highly trained regulators; a regime of supporting and supportive institutions such as the accounting and auditing profession and support from an informed and vigilant investor community – or market discipline.

Even with all these pieces in place, any licensee who is committed to exploiting loopholes, to taking excessive risks with policyholders' and depositors' funds, and to bending the system could go undetected for a while and in so doing could do a lot of damage.

Our insurance legislation dates back to 1980 and is very archaic. By way of example:

- CLICO, with assets in excess of over $24 billion, **only requires capital of $3 million**. This compares for example with banks which must have capital equivalent to a minimum of 8 per cent of its assets. Thus, a bank **of CLICO's asset size would have at least $2.0 billion of capital**; regulatory capital requirements for the insurance industry is only now being developed.

- Even when the Central Bank formally took over regulation of the industry, **the legislation had limitations with respect to on-site supervision** (and formally it still does not);

- While the legislation did not restrict related party transactions, there were significant deficiency or loopholes and this was, perhaps CLICO's greatest vulnerability; and

- It is silent on the issue of actuarial methodology, which allowed companies to use their own standards which could result in a lower Statutory Fund requirement.

As the Bank and the industry proceeded to work on a new Insurance Act, we tried to achieve, by **moral suasion**, what would have been mandatory under appropriate legislation. Thus for instance:

- We insisted on on-site inspections of CLICO;

- In the face of concerns about risk management and inadequate controls, we insisted on the appointment of independent directors and other measures to improve corporate governance;

- Concerned about the excessive reliance on short-term funding, the Bank required CLICO to cease sale and the renewal of a particular deposit product;

- After facing resistance for many years, in early 2008, the Bank sought to enforce compliance with "the admissible asset regulations" that put restrictions on related party transactions on the balance sheet and in the Statutory Fund. Most companies had been adhering to the regulation. CLICO was one of the few that did not fully comply.

Some analysts (critics) have asked – why did the Bank not intervene in CLICO before? To this I affirm that for all the inherent vulnerabilities:

- CLICO met its Statutory Fund requirements in 2004, 2005, 2006; by our calculation there was a statutory fund deficit in 2007. However, up to the time the crisis broke, CLICO was challenging our calculation.

- CLICO had been given a clean bill of health by its auditors each year since 2004, when it came under Central Bank's regulatory control in 2004. (You may have read that Madoff used a small obscure firm to audit its books. **CLICO's auditors was a highly recognized international firm**).

- AM Best the renowned international rating agency for insurance companies downgraded CLICO in 2007 from A- to B+++; **B+++ is still a solid rating for an insurance company**.

- CLICO posted healthy "bank" profits in each year since 2004.

With these credentials, intervening in CLICO, notwithstanding its inherent vulnerabilities, would have been difficult to justify. **It would certainly have prompted a long dragged out legal battle which could have had serious knock-on effects both for CLICO and for the rest of the financial system**. With slow progress being made via moral suasion and with new legislation on the way the case for intervention was even less defensible.

There is no doubt that new legislation has taken far too long to come into being. This has been due, in part, to a fairly crowded legislative agenda and the shortage of legal drafting skills in the public sector. **I should note however, that**

the consultation process has dragged on for much longer than expected because of a certain reluctance of the industry to accept changes that have become standard in other jurisdictions.

Clearly some sections of the industry have been intent on jealously protecting the status-quo, resisting change even when this has meant bringing us in line with international best practices.

And then there are the consequences of limited market discipline. For **all its tremendous growth** over the last several years, **CLICO has remained a private company** which has shielded the company from the kind of scrutiny (through, for example the submission of quarterly accounts) to which public companies are exposed.

I would want to posit that the CLICO/CIB crisis represents a case of "systemic failure" from which we all can take invaluable lessons.

Clearly we need to upgrade our legislation as a matter of urgency. It is hoped that the recent international financial crisis as well as the recent stresses in both the credit union and the insurance industry would convince industry participants of the need for modern legislation to cope with a modern financial sector.

Two, directors and management need to take seriously their fiduciary obligation to protect depositors'/policyholders' funds. Independent directors have a special obligation to provide checks and balances and **play a 'whistle-blowing role**", if necessary.

Three, external auditors must also recognize their fiduciary responsibilities and must be held accountable. The self-regulatory bodies must set and enforce the highest auditing standards. **That's the legacy** of Enron and World com.

Four, as Regulator we need to continue to upgrade our skills and quickly achieve the level of competence in the insurance regulation as we have achieved in bank regulation. Of course, we have been in bank regulation for close to fifty years whilst we have only recently been doing insurance.

The CLICO/CIB crisis is a major setback for the financial sector in the region. We have been able to contain the contagion but the challenge of strengthening market confidence and ensuring that the cost to taxpayers remains minimal in the medium term is ongoing.

The CLICO/CIB collapse should be a lesson that serves to strengthen our financial system for the next several years.