THE ROLE OF REGULATION
IN
ENSURING FINANCIAL SECTOR STABILITY AND DEVELOPMENT IN A MONETARY UNION: ECCB'S VISION

GARFIN'S 5TH ANNIVERSARY ACTIVITIES

"BUILDING A STRONG FINANCIAL SECTOR IN THE FACE OF CHALLENGING TIMES THROUGH EFFECTIVE REGULATION"

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The First Annual GARFIN Public Lecture

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1.0 INTRODUCTION

It is indeed a pleasure to join you in celebrating GARFIN's Fifth Anniversary and to address you at GARFIN's first Public Lecture. I am particularly pleased that this Lecture is taking place at my alma mater – The Grenada Boys' Secondary School where I hold fond memories.

I congratulate GARFIN on its 5th Anniversary and its contribution to the safety and soundness of the financial system in Grenada and by extension the Eastern Caribbean Currency Union (ECCU). I celebrate with you under your theme ***"Building a strong financial sector in the face of challenging times through effective regulation",*** a topic that is most appropriate in this challenging and uncertain environment.

These are very challenging times and we have to understand the global environment in which we live and its impact on our economies and societies.

The international financial and economic crisis has had a marked impact on all countries and some have been able to withstand its effects better than others. The Caribbean countries have not fared as well as others, not having the raw materials which are in demand by economies such as China which is in a high growth phase; and lacking large populations which are attractive to foreign investors.

The poor growth performance of the Caribbean countries as a consequence of the recession has negatively impacted government revenues, debt to GDP ratios, and the financial sector through rising non-performing loans and diminution of capital.

The financial sector itself has been identified as the primary cause of the recession through the over leveraging of financial institutions, particularly investment banks and the crash of the subprime mortgage market.

A fundamental issue is the nature of finance, as it has transformed itself from simple intermediation to a wealth creating sector in its own right. There has been a divergence of resources to this sector at the expense of the real sector with the downside effects of increased instability and the opportunity cost of innovation and growth.

The need for a careful assessment of our current financial system and our view of its future role and function is of extreme importance to us at this time. We need to be innovative, yet pragmatic, as we go about restructuring the system to facilitate our growth and development.

Ladies and gentlemen, the topic that I have been asked to speak on tonight ***"The Role of Regulation in Ensuring Financial Sector Stability and Development in a Monetary Union – ECCB's Vision***" and the theme for these celebrations is inextricably linked.

An efficient and stable financial sector is at the core of a well-functioning economy. "*Efficient, well-functioning financial systems are crucial in channelling funds to the most productive uses and in allocating risks to those who* *can best bear them, thus boosting economic growth, improving opportunities and income distribution, and reducing poverty"*[1].

The system must be grounded in a sound legal and regulatory framework that fosters efficient, economical, and productive social and economic interactions that facilitates savings and investment, market reforms and economic growth.

Financial stability refers to the state of the financial system that will predictably facilitate and/or enhance economic processes, characterised by orderly management of risks and absorption of shocks. A stable system suggests that there are no serious failures or undesirable impacts on the present and future development of the economy. The manifestations of financial stability would include:

- A general state of solvency of system participants;
- Settlement of clearings obligations (both bilateral and multilateral) as a matter of course and/or with mild supervisory interventions such as Lender of Last Resort activities; and
- A general show of confidence in the financial system by the public.

Although regulation is ultimately geared towards ensuring the safety and soundness of the financial system, the ultimate goal is to safeguard confidence. A sound regulatory structure is a critical part of the financial system providing certainty and credibility to depositors, creditors and investors.

[1] Finance for all Policies and Pitfalls in Expanding Access 2008 – A World Bank Policy Research Report

An effective and efficient regulatory framework finds expression through legislation which must have the following characteristics:

1. It must be dynamic, constantly adapting to meet the changing needs of the financial sector by facilitating new entrants and ensuring access to markets, and fostering the development of a competitive and reputable financial sector.

2. It must consist of appropriate, certain or transparent practices and procedures.

3. It must consist of suitable and adequate mechanisms and administrative structures or systems to enforce rules and regulations and provide for the speedy and effective resolution of disputes.

4. Finally, within the context of the ECCU, a multi-state jurisdiction and consistent with the creation of a single economic and financial space within the OECS Economic Union, it must consist of harmonised laws creating certainty in the application of relevant provisions of the law across jurisdictions. This overcomes the problem of territoriality by creating a legal and institutional environment for regional and international transactions that can be treated as national transactions.

The importance of a sound legal and regulatory framework has been heightened by the global recession and financial markets in advanced economies have been impacted by uncertainty and instability following the economic and financial crisis which started in 2008.

Unregulated or insufficiently regulated complex financial products/techniques, insufficient oversight, failures in assessment of risk by both firms and regulators, failures in corporate governance, insufficient focus on macro-systemic risks and limitations in national and cross border supervision have, inter alia, been put forward as causes of the financial crisis. The result is that damage has occurred to our global and regional financial systems, the effects of which continue to have a deleterious effect on the economies of the Eastern Caribbean Currency Union (ECCU).

The challenges that confront advanced countries such as, the United States of America, the United Kingdom, and Europe are generally similar to ours, namely, financial stability, high levels of sovereign debt, and low growth linked to low productivity and competitiveness.

As a result of the crisis, the ECCU member countries face three main challenges:

1. To achieve and maintain fiscal and debt sustainability;

2. To restore financial stability and create a financial system and regulatory framework that facilitates growth; and

3. To reverse the secular decline in growth through the transformation of the ECCU economies into adaptive, innovative and competitive entities

through appropriate government policies and the creation of a dynamic private sector.

The crisis has spurred significant changes in the global financial landscape and in the regulation of financial markets, institutions and instruments. New regulatory changes globally have led to new policies, procedures and the establishment of committees on macro prudential regulation and supervision to ensure the future stability of the financial sector.

Within the ECCU, the most difficult and immediate issue is financial instability. The Eastern Caribbean Central Bank (ECCB) has had to respond to severe threats to financial instability in the banking sector where the Central Bank has had to use its emergency powers on two occasions to intervene in a bank which was experiencing a classic run on its deposits, and another which was experiencing challenges in carrying out normal banking functions due to an inadequacy of liquid assets.

In the insurance sector, two major companies operating in the region, CLICO and BAICO have gone into bankruptcy. This has left individuals, business firms, banks, credit unions and social security systems in the Currency Union with very large exposures. These developments have brought the issue of the under regulation of the sector to the fore.

2.0 RISKS IN THE ECCU FINANCIAL SYSTEM

The ECCU financial system is comprised of forty (40) commercial banks, one hundred and sixty two (162) insurance licensees, sixty one (61) credit unions and other non-bank financial institutions such as building societies.

The ECCU domestic banking system is open and includes twenty five (25) Canadian bank branches, one (1) subsidiary of a Trinidadian bank and fourteen (14) indigenous banks.

Preliminary data as at December 2011, indicates the banking system in the ECCU contributes 6.8 per cent of GDP[2], with \$17.3b in deposits and \$26.0b in total assets.

For small island populations which range from 5,000 to 170,000 people this represents diseconomies of scale that must be addressed within a single finance space.

Recent events in the regional and international financial markets have underscored the importance of the adoption of a comprehensive risk focused approach within the financial system of the ECCU. The complex nature of modern financial institutions and the interconnectedness of financial markets and institutions necessitate the creation of a well-developed and integrated regulatory framework.

[2] Estimated GDP data in current prices for 2011

This framework must be underpinned by comprehensive legislation and transparent rules that are enforced. The framework must be premised on and incorporate tools to monitor and minimise systemic risk.

A macro prudential approach to financial sector stability has become more relevant given the interconnectedness of the banking and non-bank financial sectors. The ECCB, in close collaboration with other regulators, has a key role to play in maintaining a sound macro-prudential system through regulatory cooperation and joint surveillance of the financial system.

The completion of the legal and regulatory framework within the ECCU is critical to ensure that supervisors have the wherewithal to regulate their respective spheres and take enforcement action when needed. Where the framework is incomplete this stifles the continued development of the market and exposes market players and the financial system to contagion risk.

3.0 FINANCIAL SECTOR DEVELOPMENTS IN THE ECCU

The ECCU has made significant inroads in ensuring a well regulated financial system.

Recognising the positive impact of financial sector development on real sector growth, the ECCB embarked on financial sector development in the ECCU under the direction of the Monetary Council.

This involved:

(1) Strengthening the financial sector to ensure compliance with internationally accepted standards and procedures; and

(2) The creation of dynamic and well-regulated capital markets.

Pursuant to Article 3(2)(e) of the ECCB Agreement, the ECCB regulates banking business in the ECCU. The Banking Act in the ECCU brings the region in line with internationally accepted best practices and standards for Banking Supervision, in particular, the Basle Core Principles for Bank Supervision which serves as the reference point for effective banking supervision and for assessing financial system soundness.

Recognising the under regulation of a number of financial institutions[3] that operate within the financial system, the ECCB in October 2000 proposed the implementation of an integrated financial services supervisory framework in the ECCU. This initiative includes the ongoing thrust to establish Single Regulatory Units (SRUs), as a means of eliminating regulatory gaps in the financial sector by bringing all non-bank financial institutions under a single regulatory umbrella.

The establishment of these SRUs also requires the enactment of Legislation to provide for the effective regulation and supervision of these sectors.

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[3] Insurance companies, credit unions, offshore institutions, development banks, and NBFIs.

Member Governments also collaborated with the Caribbean Financial Action Task Force to counter the use of the region's financial system for money laundering. This has resulted in the enactment of anti-money laundering legislation, the establishment of financial intelligence units and the issuance of anti-money laundering guidelines to ensure that the region is in compliance with international standards.

In accordance with articles 4(3) and 4(4) of the Eastern Caribbean Central Bank Agreement (Agreement), the Bank is charged with the following development mandate for the ECCU countries:

4 (3) "To promote credit and exchange conditions and a sound financial structure conducive to the balanced growth and development of the economies of the territories of the Participating Governments;" and

4 (4) "To actively promote through means consistent with its other objectives the economic development of the territories of the Participating Governments."

Accordingly, the ECCB under the direction of the Monetary Council, embarked upon the mission of developing and integrating the region's money and capital markets into a single financial space within the Currency Union. This market development programme involved the creation of both markets and institutions inclusive of appropriate legislative and regulatory reform to govern the sector.

This has provided the basis for the development of regional money and capital markets and institutions, namely the Eastern Caribbean Home Mortgage Bank

(ECHMB), the Eastern Caribbean Securities Market (ECSM), the Regional Government Securities Market (RGSM) and the Eastern Caribbean Securities Exchange Limited (ECSE), the Eastern Caribbean Central Securities Registry Limited (ECCSR) and the Eastern Caribbean Central Securities Depository Limited (ECCSD).

The ECCB continues to make progress with its efforts to develop the Eastern Caribbean Enterprise Fund (ECEF) which will provide financing and technical assistance to private sector enterprises in the ECCU with growth potential. It is envisioned that the ECEF will serve as the premier institution within the ECCU for financing the productive sectors in the ECCU. In this regard, the Fund is expected to play a key role in transforming the region by serving as a catalyst to (i) create and lead the investment in a number of 'flagship' companies and SMEs in sectors with a competitive advantage; (ii) establishing linkages with regionally and globally relevant strategic partners; and (iii) developing entrepreneurial standards in the region. In addition, as the first regional fund of its type in the ECCU, the ECEF will also play a key role in the promotion of a private equity/venture capital industry in the region.

In an effort to further develop the ECSM and foster economic growth and development in the region, the Bank is seeking appropriate partners within the region for the establishment of the Eastern Caribbean Unit Trust (ECUT). The ECUT is expected to facilitate the efficient mobilisation and allocation of savings in the region by providing small investors with greater investment options in the regional markets. It is envisaged that the development of the ECUT would ultimately broaden and deepen money and capital markets in the ECCU by expanding the region's investor base.

The primary objective of these initiatives is to facilitate more effective mobilisation of financial resources across the region, efficient allocation of liquidity within the financial system and to provide support for private sector activity for sustained growth and development across the region.

In support of the development of the Eastern Caribbean Securities Market, the Eastern Caribbean Securities Regulatory Commission was established and uniform legislation governing the securities market enacted.

4.0 RESPONSE

The region continues to strengthen the policymaking framework and architecture and the regulatory regime to develop the financial sector and maintain financial sector stability. In this regard, the Member Governments of the ECCU established two critical instruments, namely:

1. The new Treaty of Basseterre establishing the OECS Economic Union; and

2. The ECCU Eight Point Stabilisation and Growth Programme.

Article 4.1(e) of the new OECS Economic Union Treaty provides for the establishment of a single economic and financial space which would provide:

1. Economies of scale and scope in production, marketing, distribution and public administration;

2. The reduction and mitigation of country risk by spreading it over a wider physical space and larger population; and

3. The increased capacity to negotiate with third parties in the public and private sectors.

In support of the OECS Economic Union, the ECCU Eight Point Stabilisation and Growth Programme proposes several measures for financial sector reform, public sector reform including rationalisation of social welfare systems and restructuring of ECCU sovereign debt. The components of the Eight Point Programme are as follows:

- Components 1, 2 and 3, which are Financial, Fiscal Reform and Debt Management Programmes facilitates the achievement of *macroeconomic stability*;

- Concurrent with this, points 6, 7 and 8 address *financial sector stability*, and is comprised of financial safety net programmes, amalgamation of indigenous commercial banks and rationalisation, development and regulation of the insurance sector; and

- Components 4 (Public Sector Investment Programme) and 5 (Social Safety Nets) are essential prerequisites for *sustaining growth* and socio economic development. These are required to improve poverty and human development indices and transform the region's economies.

For the financial system Point 6, financial sector safety net programmes, articulates a plan of action to support financial sector stability inclusive of the following:

1. the single financial space;

   The single financial space would facilitate the development of the infrastructure for a modern and sophisticated financial sector comprised of the following:

   a. Exchange platforms for money and equities
   b. Credit Bureaux
   c. Efficient Payment Systems
   d. Development of Accounting and Auditing Standards
   e. Financial Sector Experts
   f. Rating Agencies

2. an integrated regulatory framework that covers all financial institutions, markets and instruments in the Currency Union;

   This comprises of uniform laws and regulations that govern the regulation and supervision of the financial system.

3. a consolidated supervisory framework which could deal effectively with the increasingly complex nature of financial institutions;

This framework is geared towards providing oversight of the financial institutions and markets; and the organisations which will execute these arrangements.

4. the rationalisation of liquidity facility arrangements across the Currency Union involving the Interbank market (IBM), Regional Government Securities Market (RGSM), Eastern Caribbean Home Mortgage Bank (ECHMB) and the Eastern Caribbean Central Bank (ECCB);

5. an investigation of the appropriateness of Deposit Insurance Systems; and

6. the creation of the Resolution Trust Corporation, an institution to restructure and recapitalise financial institutions and manage troubled assets.

The global economic and financial crisis has brought to the fore some structural weaknesses within the financial system. The diseconomies of scale caused by the number of financial intermediaries within the ECCU must be addressed particularly as we advance into an OECS Economic Union. Accordingly, Point 6 of the Eight Point Programme is buttressed by Points 7 and 8 which refer to the amalgamation of the indigenous banks and the rationalisation, development and regulation of the insurance sector.

In respect of the amalgamation of the indigenous banks, Point 7 of the Eight Point Programme, the Monetary Council of the ECCB at its 1st Special Meeting held on 28 July 2011, developed a ***Policy Statement on Indigenous Banks*** which focused on the following four key objectives:

1. The indigenous commercial banking sector should be stable, safe, and sound to provide a safe environment for depositors, creditors, and investors in order to encourage the mobilisation of domestic savings and the inward flow of investment capital;

2. ECCU indigenous commercial banks should play a prominent role in the financial sector in the single financial space and provide high quality banking services;

3. The ECCU indigenous commercial banks should be organised to facilitate intra-ECCU trade, as well as trade with the rest of the world and to stimulate economic growth in the currency union; and

4. The indigenous commercial banks should assist in the development of money and capital markets in the single financial space and in particular the Regional Government Securities Market.

It is anticipated that reform of this sector will take place in accordance with the Council's vision for the indigenous banking sector.

To achieve the objectives enunciated in the Eight Point Plan, a number of institutional arrangements have been created.

Subcommittees of the Monetary Council have been established for the following sectors:

- Banking
- Insurance
- Credit Unions
- Offshore Financial Services

A Regulatory Oversight Committee (ROC) has been established to bring congruence to cross sector regulatory issues. The ROC is mandated to:

1. Facilitate information sharing among regulatory bodies;

2. Facilitate the harmonisation of legislation affecting the financial sector;

3. Identify overlapping or duplicated regulatory roles and responsibilities; and

4. Coordinate and recommend the implementation of policies to mitigate threats to financial sector stability.

In carrying out its mandate the Regulatory Oversight Committee seeks to:

1. Facilitate the exchange of information among the various regulatory bodies;

2. Advocate unified financial legislation across the currency union;

3. Develop complementary initiatives and harmonised solutions to regulatory issues;

4. Identify and eliminate conflicts, redundancies and supervisory gaps in financial sector supervision;

5. Establish regulatory standards and promote regulatory cooperation;

6. Develop and source training programmes;

7. Coordinate financial sector supervisory activities; and

8. Develop policy responses to cross-sector and cross-border regulatory issues and systemic risk factors.

These institutional arrangements have helped immensely to address the impact of the financial crisis on the ECCU member countries and to strengthen the regulation of the system.

5.0 CONCLUSION

The global economic and financial crisis has created an ideal opportunity to restructure the financial system and determine new paths for the transformation of the ECCU economies. The crisis has heightened global awareness of the interconnectedness across institutions, markets, sectors and countries.

The crisis has bolstered a rethink of the importance of a system wide approach to regulation. The ECCU, in implementing the single economic and financial space, must resolve to maintain the standards that we have achieved over the years.

The creation of a modern, innovative, first world system of financial instruments, institutions and markets that are safe, well regulated and in accord with international standards should be our constant goal.

As I close, I commend GARFIN for its efforts towards maintaining these standards within Grenada for the past five years. The success of these initiatives has been through the support of member governments, market participants and the public.