

**The Changing role of the Financial Supervisor in Today's Financial Environment**

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**ABSTRACT**

The financial landscape has undergone significant changes over recent years which warrant the need for fundamental changes in the manner in which various entities are regulated and supervised. Being cognizant of the fact that some industries have an official regulator while others are regulated by the market or self regulated, this paper seeks to review some of these changes to the financial landscape and what ought to form part of an official's regulatory response to these challenges.

In light of the global financial crisis the paper highlights the need for consolidated supervision; the need for there to be broad consensus across jurisdictions for the adoption of the recommendations and standards issued by BASEL, IAIS, IOSCO; the need for regulatory colleges for supervisors; great emphasis is also placed on risk based supervision across all operational area primarily to deter fraud, money laundering and terrorist financing; and training for industry personnel and regulators.

**Keywords:** Global Financial Crisis, Risk focussed Supervision, Consolidated Supervision, Regulatory Colleges.

## **1. Introduction**

Over the past three years, within the global financial system we have witnessed significant challenges across many financial markets. Given the interrelatedness of these markets and the associated contagion effects, the challenges experienced have had significant negative consequences in both developed and developing countries. In some quarters, authorities on the subject such as economists and financial experts have described the global financial crisis as akin to the experiences of the global depression of the 1930s. While some authorities on the subject believed that the lack of a macro view was more important to the origins of the crisis than any specific failure in supervisory process ( Turner/FSA 2009) there is still a general consensus that the crisis brought to the fore the need for regulatory reform at both the legislative and supervisory levels.

In light of the current discussions on the topic, this paper seeks to discuss the changing role of the financial industry regulator in today's financial environment. The paper is organized as follows: Section 2 deals with some of the current issues confronting financial supervisors in the wake of the financial crisis; Section 3 discusses reform measures at the legislative and supervisory levels; and Section 4 concludes the paper.

## **2. Current Issues Affecting Financial Supervision**

### ***Globalisation and Its Impact on World Economies***

In recent times the current issues challenging the financial supervisory framework across countries have been primarily as a result of one overarching factor namely- globalisation of the world economies and its accompanying deregulation and disintermediation. This phenomenon

has caused increased competition thereby influencing the convergence of products across financial institutions. See Vinals and Fiechter (2010). For example, changes have been noted in the traditional role of insurance companies and the growth in conglomerates combining banking, insurance services, securities business and real estate companies under one umbrella. Further with the advent of globalisation, there are also certain technological changes which have also affected the paradigm of financial supervision. As Trichet (2007) noted there would be no-low cost, instantaneous transmission of information, concepts and services at the global level without new information and communication technologies.” In the current financial environment it is noteworthy that a vast majority of financial flows across jurisdictions and institutions have used these technological advances to their advantage. As further support to this point, within the Caribbean for instance we are now seeing many institutions offering electronic banking services via the internet and mobile phones.

### ***Emergence of a Multiplicity of Financial Products***

At the micro level and with the advent of globalisation and its direct link to financial liberalisation, the financial regulatory architecture in many jurisdictions became constrained with the emergence of a multitude of financial products. Masciandaro and Quintyn (2009) argued for instance that liberalisation [in the financial sector] unleashed competitive forces that created pressure to take on more risk and research for innovations.” With these innovations emerged many new financial products and opportunities within the financial systems such as the emergence of securities associated with the subprime mortgage crisis. Invariably the associated cascading effects these developments had on global financial markets highlighted the need for regulatory reform to keep a pace with financial innovation. See also Hurley (2010).

***Non-existence of Overarching Supervisory Framework***

One of the primary issues confronting regulators in today's environment is that while many institutions have become increasingly exposed to entities which share a similar corporate structure, at the supervisory level there does not exist a framework of consolidated supervision. The lack of such a supervisory framework presents the likelihood of contagion risk within the system which could cripple a nation's economy and other jurisdiction depending on the inter-relatedness. Swaan (2000) in identifying the expected failures if such a situation exist stated that "conglomeration could also provoke moral hazard behaviour in the form of supervisory arbitrage, as institutions move certain activities to parts of the organization that are subject to less rigorous supervision [or no supervision at all]." Green (1999) in his study of the Jamaican Financial Crisis, cited similar shortcomings in this regard as being one of the contributing factors leading to the crisis.

This concern was noted in particular in the case of the CL Financial Group where notwithstanding the fact that four of the largest financial institutions in the Group managed assets that accounted for over 25 percent of the country of Trinidad and Tobago's GDP<sup>1</sup>, there was no consolidated supervision practices which covered the several industry sectors within the group which included banking and financial services, energy, real estate and manufacturing and distribution<sup>2</sup>. As a result of the inter company exposures and given the global financial crisis, the entire group's liquidity position was compromised which had spread throughout the region. Caruana (2005) placed the shortcoming of such a supervisory practice into perspective having

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<sup>1</sup>Extracted from the text of Trinidad and Tobago Central Bank Governor Ewart Williams' address at a press conference January 30<sup>th</sup> 2009.

<sup>2</sup>Extracted from the text of Trinidad and Tobago Central Bank Governor Ewart Williams' address at a press conference January 30<sup>th</sup> 2009.

asserted that [a] "...dichotomy...arises when we have on one hand, an industry that is becoming increasingly internationalised in nature and, on the other, a supervisory framework that remains predominantly based on national responsibilities and accountabilities."

### **3. Financial Supervision in Response to the Current Crisis**

#### ***Reform of Laws and Regulations***

The global financial crisis that has gripped most world economies since the latter part of the current decade highlighted the need for there to be an overhaul in the manner in which financial institutions are supervised. Within some jurisdictions the crisis has heightened the need at the macro level for there to be a reform of the laws and regulations governing the sector. Quintyn and Masciandaro (2009) in their paper – Reforming the Financial Supervision Architecture and the Role of the Central Bank, support this view with their statement that "...regulatory innovation is necessary to keep pace with financial innovation. Policy makers should be open to changes, including unification, and adopt reforms needed in their circumstances."

Within the Caribbean, the current crisis has shown the consequences a jurisdiction(s) could face if the requisite legislative changes are not made in a timely manner to keep a breast with the innovative market behaviour of the financial industry. The recent case of CLICO and British American Insurance Company Limited highlighted this point since whereas these companies operations had moved from mere insurance business to quasi banking operations, there were no provisions in the Trinidad and Tobago 1980 Insurance Act to effectively regulate these entities. Another telling example within the Caribbean of the consequences of failing to have regulatory and supervisory reforms was evidenced in Jamaica in the mid 90's, since this was posited as one

of the reasons for the crisis. See Henriques (2010). According to Henriques (2010), "Contrary to assertions in favour of financial laissez faire, the results [of the Jamaican financial crises] clearly indicate that, if left unchecked, the profit motive will lead to a financial sector crisis."

### ***Consolidated Supervision of the Financial Sector***

In the Caribbean and notably so with the debacle within the CL Financial Group, in a post crisis era, there is an urgent need for consolidated supervision. It is only through such a regulatory approach can the contagion risk in many entities that find themselves within a group structure be truly assessed. At the macro level dealing with the fact that there are cases where institutions operate across different borders, there now exists the need for stronger efforts to be made for the establishment of memorandum of understandings and information sharing agreements between home and host supervisors to effectively monitor the financial risks that exist. Swann (2000) supported this approach and argued further that there ought to be greater harmonisation and standardisation of regulatory rules.

The role of the Basel Committee Accord Implementation Group (AIG) which is mandated to work on practical implementation issues for achieving convergence of banking supervision practice at the international level as described in Trichet (2000) is a welcomed development in this regard. Swann (2000) also endorsed this development and indicated further that the Joint Forum on Financial Conglomerates, the International Association of Insurance Supervisors (IAIS), and the International Organization of Securities Commission (IOSCO) will also play a leading role going forward.

***Training and Retooling of Financial Examiners/Supervisors***

One of the primary requirements in response to the fallout from the global financial crisis is the need for constant training and retooling of financial supervisors. The emergence of varying financial products exposes the need for regular training of examiners if the industry is to be effectively regulated. Invariably, this necessitates a paradigm shift in financial supervision from what had been traditionally identified as accounting and auditing skills. See Espenilla Jr (2007). The need to analyze and interpret financial data and understand the essence of new financial products is key.

Swaan (2000) offered a different dimension to this view where he stated that in light of the complexity of financial markets it may be difficult for supervisors to monitor these risks effectively. In this regard he advocated further that with the necessary information, the financial markets could have a disciplinary effect on the financial industry and could serve as the most efficient and effective supervisory system. For such an approach to work this requires market discipline and transparency whereby institutions would have to make disclosure relating to their capital structure and its adequacy given the underlying on and off balance sheet risk exposures<sup>3</sup>. Invariably, whether the industry will be self regulated or if there is increased supervision, training and understanding of the risk inherent in existing and emerging financial products will be critical at the industry, supervisory and public levels.

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<sup>3</sup>Such an approach to the risk weighting of assets for instance is what is envisaged in Basel II.



***Adoption of International Best Practices***

Ensuring an effective supervisory framework exist in many jurisdiction requires strict compliance to the various financial and supervisory standards and recommendations as established by the International Financial Reporting Standards, the Financial Stability Forum, World Bank, the IMF, IOSCO, IAIS and Basel. Notably though, effective adoption of these core principles requires prior consultation(s) with the regulated entities that are going to be affected by the changes.

As it relates to Basel, there is now a move by many jurisdictions particularly in the developed and emerging economies to implement Basel II which is aimed at achieving greater sensitivity of capital levels to the different risks which banks are running. A welcomed development in this regard is that some jurisdictions in the Caribbean such as Barbados and the Cayman Islands have been making steady progress to implement Basel II. It is well publicised by advocates of Basel II that such an international standard can help protect the international financial system from the types of problems that have arisen with the global meltdown. Notwithstanding the foregoing in some quarters Basel II has been criticized as being procyclical (Turner/FSA 2009) and consideration probably ought to be given to a system which introduces significant counter cyclicity, requiring banks to build up substantial capital buffer in good economic times well above regulatory minimum.

For some jurisdictions within the Caribbean region, implementing a Basel II framework might be counterproductive given the size of the financial industry. This finding might be viewed in light of the internal systems and operational changes required to function under a Basel II framework.

As a result of this observation consideration could be given to other encompassing supervisory techniques such as stress testing at both the institutional or market wide financial level. Stress testing should become a routine exercise as part of any supervisory process particularly for systemically important institutions. Chairman of the USA Federal Reserve Ben Bernanke endorses the use of stress testing and recommended further that banks need to conduct their own stress tests since it is believed that such test will force bankers to think more thoroughly about scenarios that may be unlikely and thus may be otherwise dismissed cursorily by bankers. Winston & Strawn LLP Briefing (2010).

Eatwell (2003) also offered a differing view regarding the wholesale adoption of these varying core principles since differences in national legal systems, financial custom and practice and in the structures of corporate governance make the introduction of a common regulatory code not only difficult but potentially damaging. Alexander and Dhumale (2000) asserted in particular that uniform codes will expose the financial systems to different systemic risks in light of their different impact in different jurisdictions.

Eatwell (2003) in recommending a pragmatic approach to this development recommended two encompassing approaches the first being the construction of specific rules in those cases which refer to basic institutional tenets that are universal, and are necessary for the success of any regulatory environment; and secondly there is the advocacy for the creation of a set of general regulatory principles from which should be derived codes that are both flexible as circumstances change and reflect the peculiar legal and governance structure of individual countries. Such an approach can be considered plausible particularly for small states where the financial systems

lack depth and sophistication like those in developed countries. However, as Eatwell (2003) argued further, there will be differences in opinion as to whether a particular set of national codes accurately reflects shared principles.

***Emphasise Risk Based Supervision***

In the current operating environment the need for the financial regulatory framework to be one that is risk based rather than one that is compliance based cannot be over emphasised. Vinals and Fiechter (2010) underscored the fact that this ought to be the more pragmatic approach, since in the area of banking for instance, the business model has gone from straightforward deposit taking and loan making where the key concern then was credit risk. Banks today even within our own domestic environment are known to take on market risk arising from their trading activities, including positions in equity, debt, commodities and foreign exchange. Similarly, within the Caribbean we have seen cases whereby insurance companies have moved away from their traditional business model of underwriting risk to a more encompassing business model including raising deposits which are traditionally reserved for commercial banks and other quasi related institutions.

Risk focussed supervision should be the supervisory practice that is done both on and offsite. However as described by Vinals and Fiecher (2010), "to be effective, risk-based approaches need to ensure that resources are committed not simply to the highest risk, but to those which the supervisor has the best chance of mitigating." The need for such an approach to supervision and regulation can be further supported given the scarcity of resources both human and financial at many regulatory agencies.

As it relates to the offsite monitoring Espenilla Jr (2007) asserted that for such to work the mechanism must be effective to yield an updated assessment of the changing risk profile of an institution. Critical to the success of such a mechanism therefore is the quality and timeliness of data reporting by the institutions and a general understanding of the business model of each entity being supervised. With regard to the onsite process, more emphasis ought to be placed on evaluating the soundness of governance, risk management and the effectiveness of the audit function since as history would have shown deficiencies in these areas was one of the primary reasons for many institutions failing. History would have shown that if there is a lax corporate governance framework within an institution, this could ultimately lead to the failure of such an entity. The financial literature is a washed with celebrated cases of institutions failing such as the Barings Bank, Arthur Anderson, Enron and more recently Merrill Lynch and Lehman Brothers due to weak internal controls. Therefore ensuring this framework is reviewed thoroughly during an onsite examination will go a long way in averting financial failures.

#### ***Proactivity and Independence of Supervisory Agencies***

In the final analysis, effecting proper supervision whether it is done on or offsite requires the analyst to be proactive in the observations to developments in the sector(s) being regulated. Further the supervisory agency ought to be able to function freely from any political interference. Whereas it may be apparent that there are safety and soundness concerns at financial institutions, the late response by supervisory agencies only served to exacerbate the problem. As in the Jamaican crisis, Henriques (2010) asserted that, "the Jamaican Government was late in acting...to help troubled domestic financial sector. It did not intervene until early 1997...by that

time the capital base of the domestic financial institutions were wiped out or nearly so and the majority of the institutions were facing serious runs.”

### ***Establishment of Regulatory Colleges***

It is well documented that when situations arise whereby there is an entity operating across different jurisdictions then there may be challenges effecting proper supervision between home and host regulators. To mitigate the moral hazard, regulatory arbitrage and other issues associated, greater emphasis must be placed on the establishment of regulatory colleges. As cited in a British Bankers Association report (2008), “Colleges of supervisors [irrespective of the nature of the financial institution being regulated] will reduce regulatory duplication and inconsistency, improve subsequent bilateral dialogue between regulators, increase levels of trust and enhance the cooperation of supervisors.” The level of information sharing during meetings of such a body could tremendously reduce systemic risk which could have dire consequences on a country’s financial system. While it is recognized that there does exist such colleges in some respect within the Caribbean region and efforts are being made to establish same, the need for the effective functioning of these colleges cannot be overemphasized. While information exchange between supervisors is of primary importance for the functioning of these colleges, critical for its success is the need for formal information sharing agreements/memorandum of understanding.

#### **4. Conclusion**

Financial institutions albeit banks, credit unions, insurance companies or money transfers business play a very important intermediationrole in channelling the flow of funds and services from both sides of the money and capital market. Whereas greater emphasis is being placed on ensuring these markets function as freely as possible, the current financial crisis has underscored the need for strong regulatory oversight. Within the framework of this paper I have shown what ought to form part of a pragmatic approach in dealing with the regulation and supervision of the financial sector if we are to avert future financial crisis.

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