THE CARIBBEAN: RETHINKING POLICY FRAMEWORKS IN THE WAKE OF THE RECENT FINANCIAL FAILURES

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Outline of Presentation

- Introduction
- Fiscal Analysis and Policy Before the Financial Failures
- Path to Financial Failure: Cases and Issues
- Aftermath of Failures, Mechanics of Government and Central Bank Intervention
- Impact of Failures: An Initial Assessment 2009-2011
- Agenda for Revamped Policy Framework
- Conclusions

Objective

- **Objective:** To re-assess policy frameworks and consider a revamped approach that incorporates closer linkages between fiscal and financial sector policies in light of the recent financial failures in the Caribbean.

- **Significance:** the study provides (i) a comprehensive account of the antecedents of the financial failure; (ii) an assessment of resolution mechanisms and status; (iii) estimates of costs and impacts; and (iv) elements of a revamped framework for greater cohesion of fiscal and financial sector policies.

Introduction

- Recent Macro-analytical work in the has focused mostly on fiscal/debt performance and adjustment programmes aimed at improving competitiveness.
- During the pre 2009 period, there was also widespread expert assessment that the region's financial systems were broadly sound.
- Policy frameworks were broadly segmented with fiscal policy framed through national budgets and programming exercises and financial/regulatory policy based at the central banks.

Introduction Con't

- The recent financial failures demonstrate that there are significant risks associated with the regulation and operations of financial conglomerates, non banks & commercial banks.

- This paper aims to set out the elements of an approach that incorporates closer linkages between fiscal policy and financial sector risks.

Pre Crisis Fiscal Policy Framework

- Fiscal context up until 2007 was underpinned by pro-cyclical fiscal policy stance in many countries

- This accommodative fiscal stance did not support long term debt sustainability and analysis shows that most countries would require significant adjustment to return to a path of sustainability.

- Consequently there was a clarion call by development partners during the pre-crisis period, but especially from 2007 for fiscal-structural reforms to be deepened to improve public finances, contain indebtedness, and entrench macroeconomic stability.

Pre Crisis Fiscal Policy Framework

- Antigua –National Economic and Social Transformation [NEST] Plan, 2005
- Dominica and Grenada: pursued reforms in the context of IMF Poverty Reduction and Growth Facility (PRGF)
- Barbados - National Strategic Plan (2005-2025) - *Major objective of developing a transparent and sustainable public management system.*
- Belize's programme focused on correcting acute fiscal and external imbalances
- Trinidad and Tobago's program focused on establishing a permanent oil fund.
- Bahamas did not have an explicit program, but reforms were implemented within the context of annual Budgets

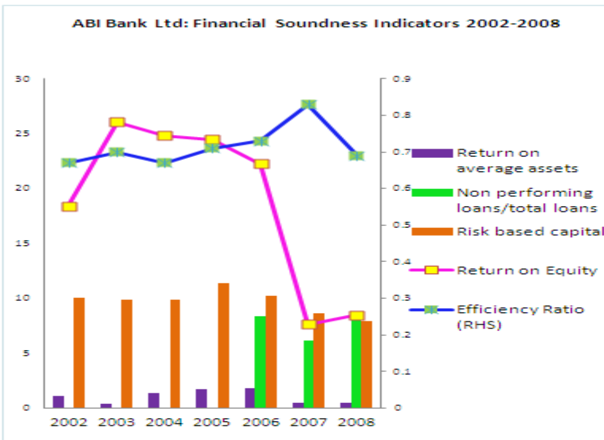
Path to Financial Failure: Cases and Issues – Bank of Antigua

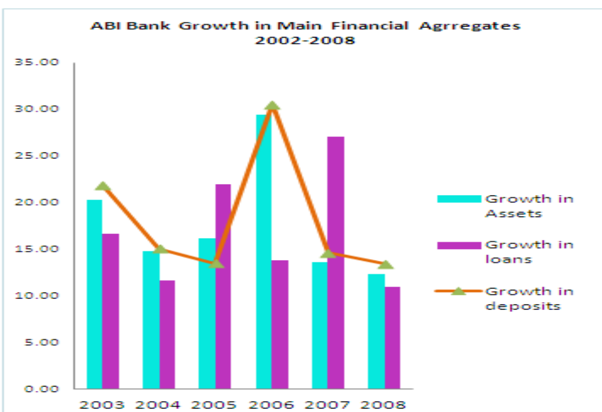
- BOA incorporated in 1981, was wholly owned by the Stanford Financial Group (SFG)
- SFG was placed in receivership on February 16, 2009 by US District Court (Texas)
- Bank suffered a classic run following the indictment of Sir Allen Stanford on charges of massive fraud (US8.5 b)

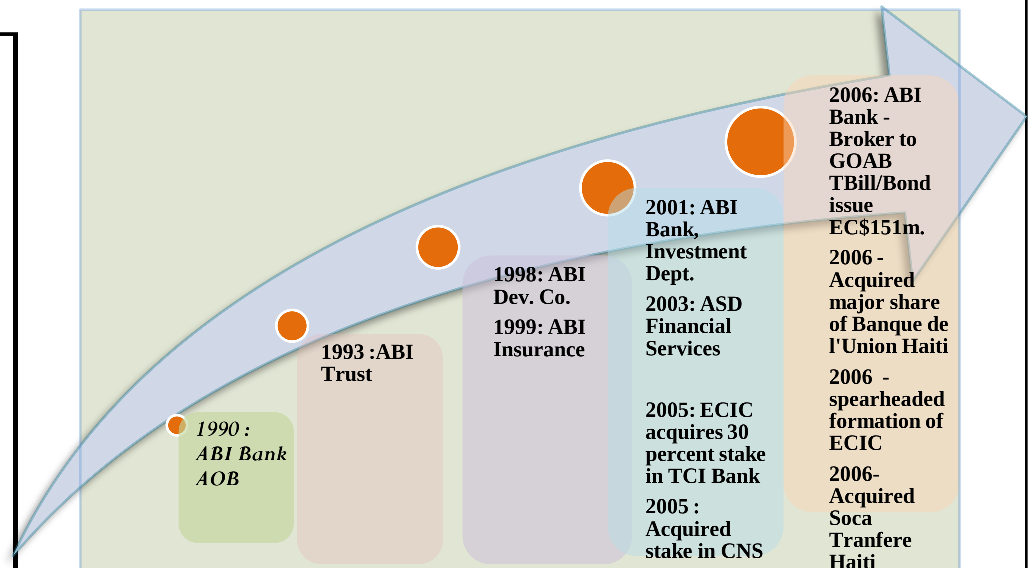
- Accounted for 7.5% of banking system assets prior to intervention
- Credit exposure to public sector was 47.3 percent
- NPL's stood at 5.6%
- Loans and advances past due (31-60 days) accounted for 32% of the loan portfolio
- Loans and advances to public sector past due (31-60 days) represented 28.6% of the loan portfolio

Main cause of failure – ***classic bank run on financially fragile entity***

ABI Financial Group

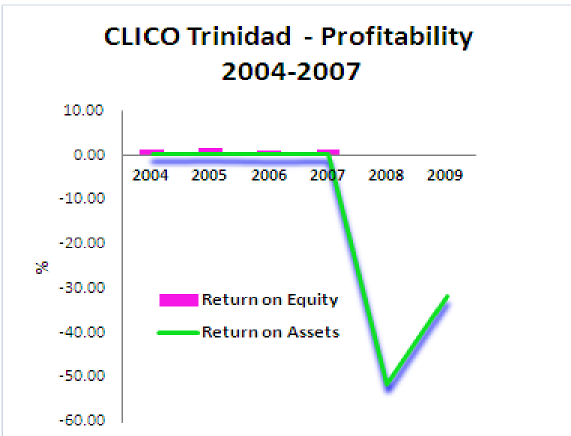


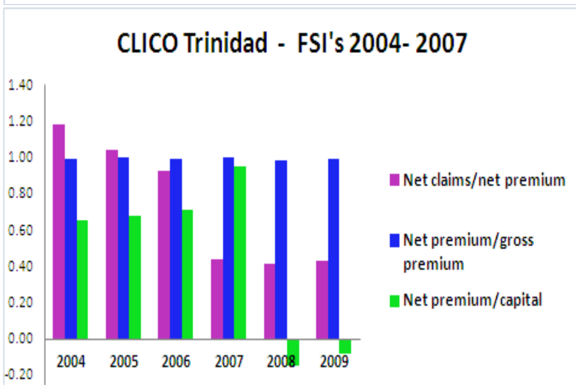




Main Cause of Failure – *Rapid group expansion, Liquidity pressures associated with role of broker to Gov't, impairment associated with key investments underpinned by declining profitability, high NPL, slow deposit growth in the post 2007 period.*

CLICO (Trinidad)





- Claims exceeded net premium revenue 2004-2005
- Risk retention ratio -0.99 for period 2004-2009
- Accumulated deficits wiped out entire capital base for 2008-2009
- Deteriorating profitability and negative returns in 2007-2009
- Statutory fund deficit in Feb 2009 stood at TT$10.03 billion
- Asset exposure to related parties 52.2% in 2004 to 81.4% in 2009
- Ratio of Insurance/Inv. Contracts to liquid assets moved from 87.6% in 2004 to 1047.5% in 2009
- FSI's indicate high leverage, high loss ratio, low profitability, shrinking liquidity and capital.

CLICO – Path to Failure and Intervention

CLICO Trinidad

- January 14 & 16 2009 Meeting with CBTT – high withdrawal requests, with liquidity constraints
- January 30, 2009 –Minister of Finance announces agreement of assistance to CL Financial
- February 13, 2009 Central Bank Emergency Powers Chap 79:02 utilized to take control of CLICO

CLICO Investment Bank

- Ratio of impaired loans 17.3% in Dec. 2008
- Net profit of TT$14.3 for first 3 quarters 2008 revised to net loss of TT32.6 after CBTT review
- CIB could not meet fixed deposit withdrawals of TT$2.8 billion
- Central Bank intervened, revoked license and operations ceased.

Main Causes of Failure :Trigger -Collapse of US Real Estate Markets and Methanol Prices Underpinned by Rapid Growth of Conglomerate, Poor Corporate Governance Structures, Lack of Internal Controls, Comingling of operations, Poor Fin. Performance

CLICO Bahamas and BAICO – Path to Failure

CLICO Bahamas

- Liquidity shortfalls manifested as CBL was unable to pay claims of US$2.6m in Turks & Caicos
- CBL had made loans of about US$73m to CEL to support subsidiary investment. – *Main asset of CBL*
- Net deficit of CLICO Bahamas of US$18 m as at April 2009
- Last loan of CBL to a CL subsidiary was effected on Feb 24, 2009 around the time of intervention in Trinidad
- Regulatory Approvals were not sought for transactions

BAICO

- Total liabilities for BAICO in the EC stood at US$300 m
- Main asset backing these liabilities was the Green Island Project – 6000 acres of dev property in Fl. USA
- Draft financials reveal that BAICO incurred loss of US$13 m in 2007
- Main asset for BAICO was US$51 m loan from CL Financial
- Witnesses reveal that it was possible that the loan to CLF could be non performing because of non payment of interest element
- Problems of BAICO were evident as far back as 2007 if not earlier

Resolution Status

- CLICO OECS and Barbados –ongoing
- CLICO Suriname, Guyana, Belize, Turks, Cayman Islands – Mostly resolved
- CLICO Bahamas, Bermuda – In Progress
- BAICO OECS - Resolved
- Bank of Antigua – Resolved
- ABI Bank – Under ECCB control
- CLICO/CIB Trinidad – Mostly resolved

Impact

Estimated Fiscal Cost (% of GDP)	➢ ECCU: 17% ➢ T&T: 8-11% ➢ Guyana: 1-3% ➢ Barbados: 1-2% ➢ Belize: 0.2%
Actual Fiscal Cost to date	➢ T&T: TT$ 20 billion ➢ ECCU: EC$89 million (BOA)
Financial Sector	➢ Compounded the dampening effect of global crisis on the sector ➢ Weakened FSIs
Financial Sector Reform	➢ Prompted new/revamped legislations ➢ Promoted the strengthening of supervision, regulation, and reporting
Social	➢ Loss of savings/investments ➢ Reduction in wealth ➢ Loss medical coverage ➢ Psychological effects

Implications of Failures for the Design of Macro Fiscal Policies and Financial Sector Supervision

Illusions Lost

- Self correcting financial markets would obviate the need for government intervention
- Pro cyclical tendencies of the financial sector once ignored is now being acknowledged
- Widespread delegation to rating agencies of the valuation of financial assets and risk assessment proved costly.
- Effectiveness of financial regulation highly over estimated
- Popular assumptions about skills, competence and caution of bankers/managers in failed entities was misplaced
- Operations of financial conglomerates was viewed as welcome financial integration without sufficient attention to the attendant risks associated with cross country operations

Agenda for Revamped Policy Framework

- Fiscal frameworks should include explicitly the actual and projected cost of government intervention in failed entities or support to weak entities, and the communication of these costs to the public.

- Periodic National Financial Sector Assessment (FSA) by Central bank and other regulatory authorities which quantifies financial sector risks, results of which, are factored into Financial Programming and other Macro Stabilization initiatives - *Integration of FSAP and Macro Stabilization Programmes*

Agenda for Revamped Policy Framework

- Greater collaboration between regulators and Ministry of Finance/Planning in the implementation of policies that may have pro cyclical tendencies

- Detailing ongoing and proposed actions to meet fiscal costs associated with failures and to address other contingencies

- Periodic regional FSA with quantification of cross border financial risks and agreement through CARICOM forum about underwriting of such risks should there be another failure of a systemically important financial institution

Agenda for Revamped Policy Framework

- Improved legal frameworks accompanied by supervision structure that provides clear mandates, independence and enforcement authority. Supervision Style to be more "intrusive, skeptical, proactive, and conclusive." (Viñals and Fiechter, 2010).

- Development of regional approach to regulating financial conglomerates with full engagement of Regional Colleges of Regulators and implementation of Consolidated Supervision intra and inter jurisdictions.

- Greater transparency, information and periodic disclosure to the public about costs of resolution, plans and progress on the reform agenda

Conclusion

- Three years after the collapse of CL Financial and BOA many countries in the Caribbean are still working on resolution.
- Failures were untimely –Gov'ts were engaged in fiscal consolidation efforts & the onset of global financial crisis
- Estimates of gross fiscal costs range from 1% of GDP in Belize to 11% in Trinidad and about 17% in the ECCU
- Striking aspects of episodes of failure – clear evidence of stress at the failed entities, and in some countries a lack of transparency about costs and the proposed resolution process.
- Failures call attention to the need for integration of the cost of the failures and financial risks explicitly into budgets and fiscal programming. Some aspects of regulatory policy into mainstream macro economic policy and macro stabilization frameworks
- The region does not appear to be much better positioned to respond to similar crises if they emerge in the post crisis period