Developing a Comprehensive Regional Financial Stability Architecture for the Caribbean

BY

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Outline of Presentation

1. Defining the financial stability architecture
2. Structure of the financial system and the regulatory and supervisory systems in the Caribbean
3. Best practices and main trends in financial stability architecture around the world
4. Current Caribbean financial stability architecture
5. Regional financial stability architecture models
6. Summary

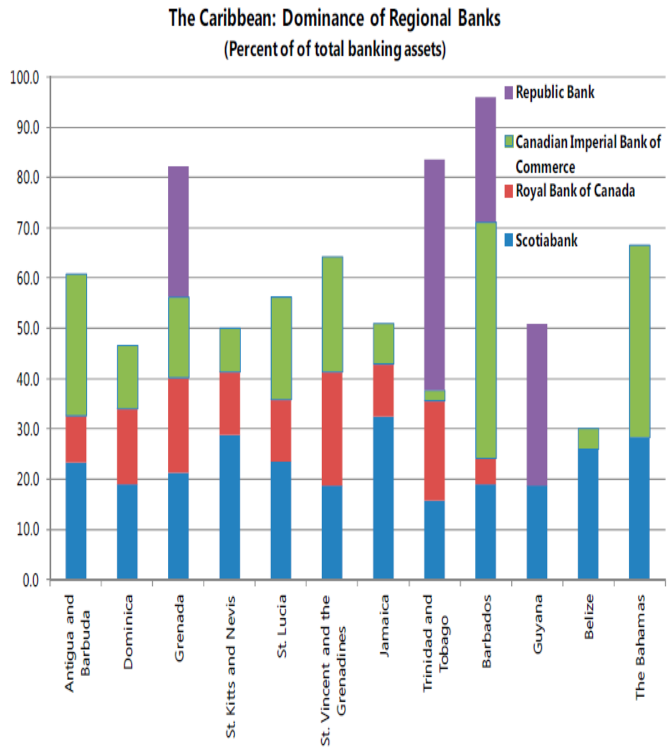
Defining financial stability architecture

- Financial stability architecture refers to the set of institutions, laws, conventions, data systems and executive decision making protocols which work together to monitor, report and implement policies to maintain financial stability
- This architecture is normally set within the jurisdictional boundaries of a country but the intensification of financial integration has required policymakers at national, regional and international levels to start developing financial stability architecture at the wider regional and international levels to effectively deal with financial contagion risks challenges
- Irrespective of the optimality of a particular model regional FS architecture will have to adapt to regional realities
- Regional financial stability architecture would involve
  - Institutions - regional financial stability committee(s) or new institution(s) with a specific mandate for regional financial stability
  - Monitoring and reporting systems – data systems for measuring and monitoring regional financial risk exposures and reporting through a regional financial stability report (RFSR)
  - Decision making frameworks – executive protocols for intervention at the regional level including standards for intervention triggers and the sharing the burden and costs of intervention (regional crisis management plan)
  - Liquidity mechanisms or financial safety nets arrangements to fund bailouts
  - Laws – to give force for cross-border information sharing and regulatory action
  - Accountability mechanisms for institutions taking executive action which require use of public funds

Structure of the Financial System in the Caribbean

- The liberalization of financial systems in the region has led to increasing regional financial integration and the intensification of cross-border financial activity
- A key feature of the Caribbean financial landscape is the dominance of large and entrenched conglomerates and financial groups which are often connected through ownership and business interests
- In spite of the presence of these large groups, regional financial markets are still relatively thin and underdeveloped and dominated by the commercial banking sector
- This complex, concentrated and interconnected system coupled with markets that are still relatively underdeveloped and legislative systems which require updating complicates the task of designing and enforcing macro-prudential regulations
- These developments now mean that national regulators cannot adequately manage risks and promote financial stability in their national jurisdiction without reference to developments in and cooperation with regulators in connected countries

Structure of the financial system - Interconnectedness



Source: Bankscope and Fund staff calculations.
Note: ECCU (June 2011); Trinidad and Tobago (March-April 2011); Jamaica (December 2010); The Bahamas (April 2011); Barbados (2010); Belize (September 2011); and Guyana (Republic Bank: 2010; and Scotia Bank: October 2011).

- CL Financial showed how connectedness could amplify and propagate crisis – could be positive in the absence of frictions (Allen and Gale, 2005)
- Some attempt to study this in the region but the data is not available
- Canadian banks dominate - The conservative corporate culture of these banks may have helped the Caribbean
- However, Canadian banks would be considered a node in a connectedness map – the failure of one could take down many countries

Structure of the financial system - High Concentration would amplify the impact of a failure

Major Financial Conglomerates With Cross Border Operations in the Caribbean
As of end-2010

	Assets (US$ mil.)	No. of Caribbean Countries	Percent of Total Caribbean Banking Sector Assets
RBC Financial	11686	20	22
Scotia Bank	10145	21	20
First Caribbean International Bank	9766	18	19
Republic Bank	9315	6	14
SAGICOR Financial Group	4867	22	NA
First Citizens Bank	4015	4	8
Guardian Holdings	3281	4	NA
JMMB	1318	3	NA

Source: Caribbean Center for Money and Finance Newsletter, March 2012

Properties of a well-functioning regional financial stability architecture (RFSA)

- Its possible for many architectural models to be optimal for a particular region so it's a good idea at the onset to outline some general properties of a well-functioning regional architecture for financial stability
  - All functional objectives of the RFSA must be assigned to specific agency
  - Internal consistency of functions to realize synergies and reduce inter-agency conflict
  - Reduce duplication by limiting the number of institutions and creating strong mechanisms for inter-agency cooperation
  - Assign tools, *powers* and *resources* commensurate with their function in the RFSA
  - Reduce compliance cost to the industry – avoid complex arrangements and minimize the number of regulatory agencies the industry must interface with
  - Must be consistent with the structure of the financial system, the level of financial development in the region and the availability of adequate resources (human and financial) to make it feasible
  - Must take account of the political economy nature of the RFSA to get the consensus needed for implementation – particularly sensitivity to the ceding a degree of national sovereignty in some areas and the relationship between regulatory agencies and the treasuries of members of the RFSA – may need to be very incremental to move the ball forward

Models for the development of financial stability architecture

- Over time thinking on the best model for the development of financial stability architecture in particular has evolved (Nier, Osinski, Jacome and Madrid, 2011) particularly after the international financial crisis with different models differentiated by factors such as:
  - The degree of integration of the central bank and other supervisory agencies
  - Ownership of the macroprudential mandate
  - Role of treasuries or ministries of finance
  - Separation of policy decisions and control over instruments
  - Existence of a separate coordinating mechanism (committee)
- These dimensions are not mutually exclusive in practice so a much smaller number of broad models are observed relative to the number that is theoretical possible
- The result of a survey conducted by the IMF in 2011 indicated that in most emerging and developing countries a partially integrated model existed, that is the central bank was responsible for banks with other regulatory agencies responsible for regulating other institutional types
- In multi-agency set-ups less than 33% had a coordinating committee with a substantial number of these including the treasury/MOF with the treasury sometimes chairing the committee – this may reflect the fact that these committees have a crisis management function which implies liquidity support from the treasury
- These committees are underpinned by an MOU or executive decree rather than codified in statute (only the UK FPC, the US FSOC) which means they often serve only a coordinating role and executive action or actual intervention is executed by a specific agency
- Institutions accountability for their macroprudential role is done in most cases through the publications of an FSR but can also involve testimony before the parliament and the publishing of information on its decision making process but generally only in cases where the financial stability mandate is codified in statute

Models for the development of financial stability architecture

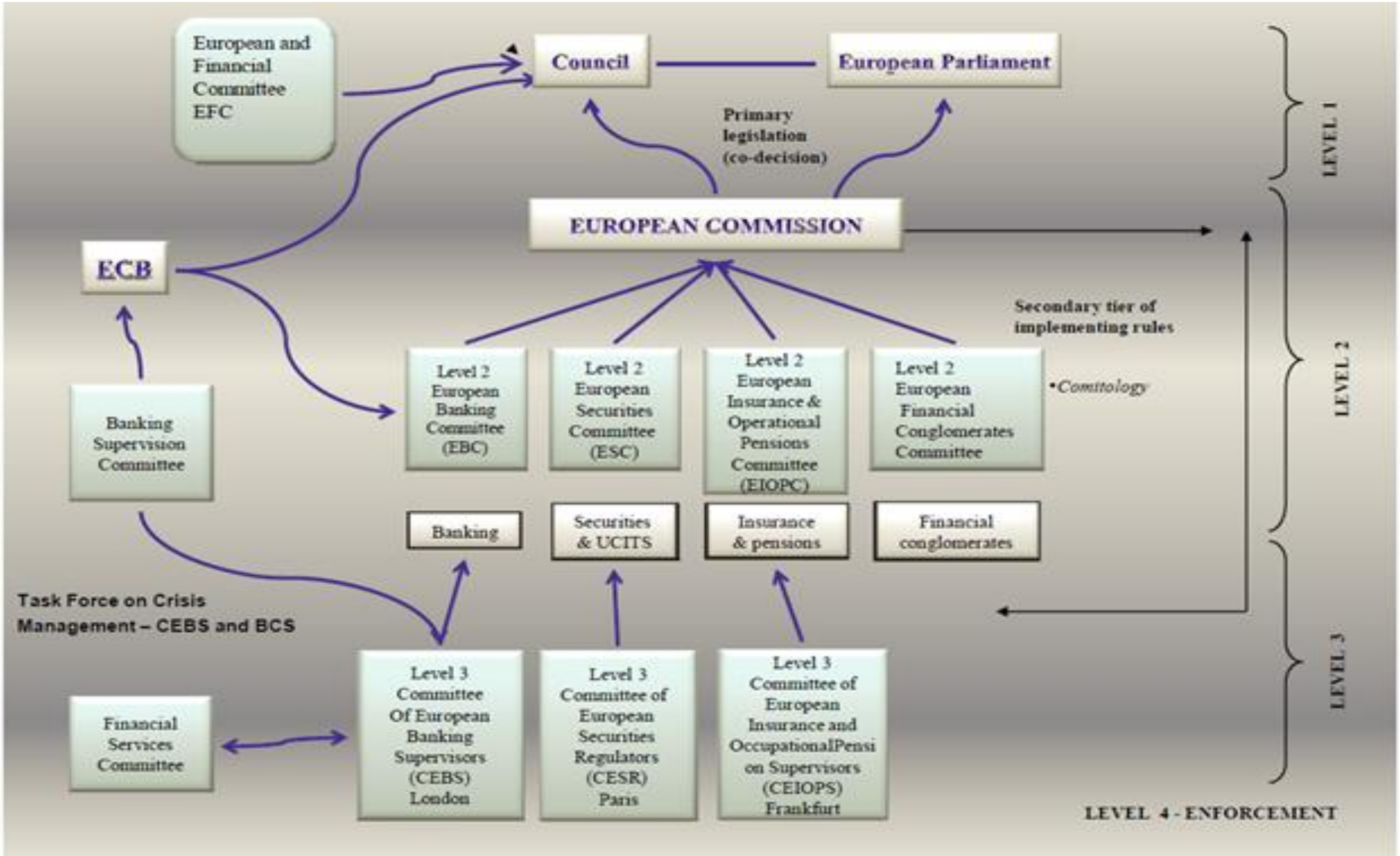
Table 1. Stylized Models for Macroprudential Policy

Features of the model/Model	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model R 1
1. Degree of institutional integration of central bank and supervisory agencies	Full (at a central bank)	Partial	Partial	Partial	No	No (Partial*)	No	No
2. Ownership of macroprudential policy mandate	Central bank	Committee "related" to central bank	Independent committee	Central bank	Multiple agencies	Multiple agencies	Multiple agencies	Committee (multinational; regional)
3. Role of MOF/ treasury/government.	No (Active*)	Passive	Active	No	Passive	Active	No (Active*)	Passive (European Commission; Economic and Financial Committee)
4. Separation of policy decisions and control over instruments	No	In some areas	Yes	In some areas	No	No	No	Yes
5. Existence of separate body coordinating across policies	No	No	No (Yes*)	No	Yes	Yes (de facto**)	No	No
Examples of specific model countries/ regions	Czech Republic Ireland (new) Singapore*	Malaysia Romania Thailand United Kingdom (new)	Brazil* France (new) United States (new)	Belgium (new) The Netherlands Serbia	Australia	Canada Chile Hong Kong SAR* Korea** Lebanon Mexico	Iceland Peru Switzerland	EU (ESRB)

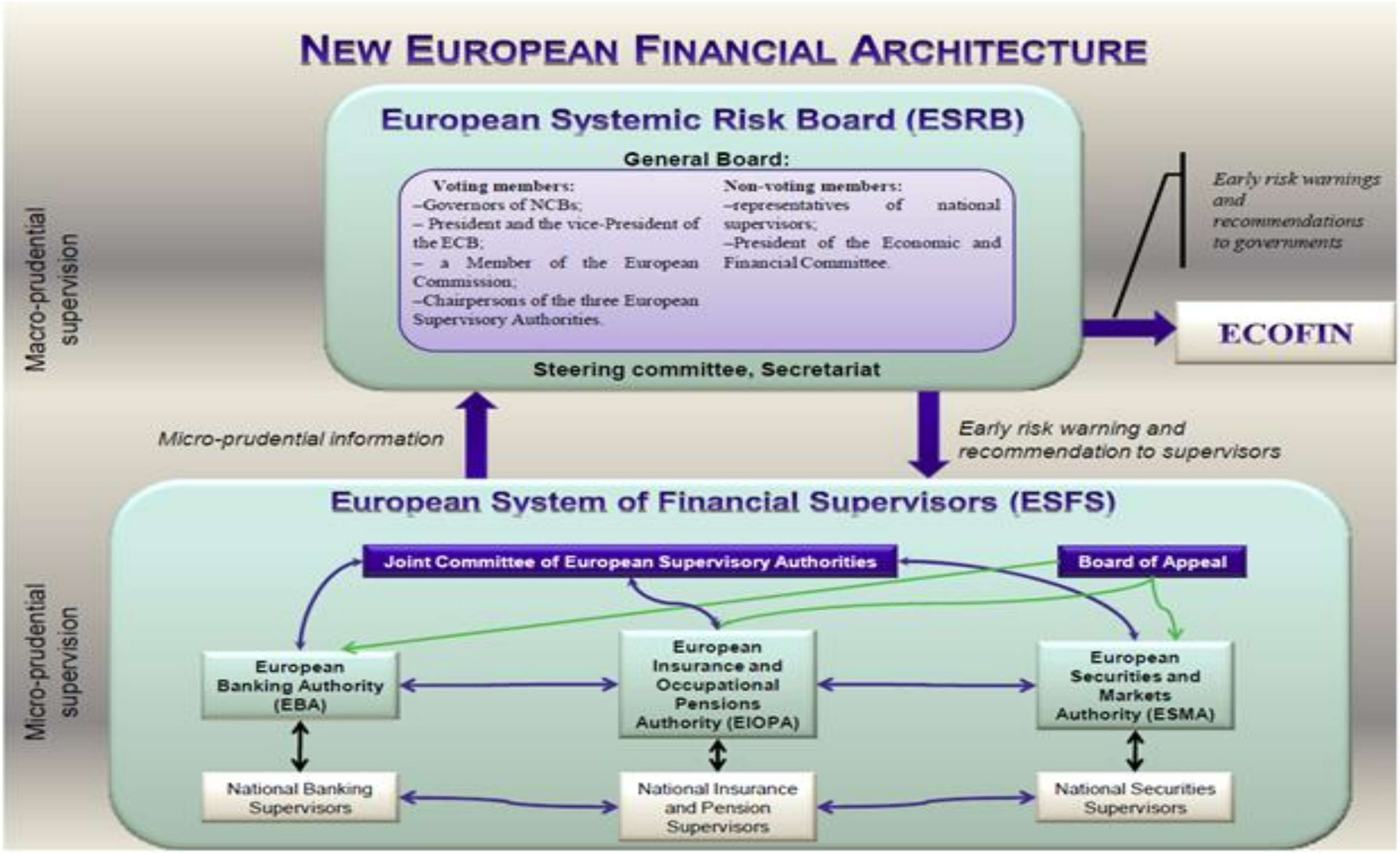
Models for the development of financial stability architecture

- There are three basic types the *fully integrated, "twin peaks"* and *no integration* regulatory models
- These models identified in the table speak more to national arrangements and their pros and cons (see Goodhart and Schoenmaker, 1995) are not the focus of this presentation but they are important for a regional architecture since they would form the building blocks of the regional system with the specific form at the national level determining the ease with which the regional architecture can be built from these national structures – fewer national agencies in principle should make it easier to structure the regional architecture
- The table does identify the one supranational or regional arrangement for financial stability in existence, the European Systemic Risk Board (ESRB) which is more directly relevant to the architecture being considered for the Caribbean

The European Model 1 – Prior to 2011



The European Model 2 – Post 2011



European Models

- Model 1 based on the recommendations of Alexandre Lamfalussy while model 2 based on recommendation of a committee headed by Jacques de Larosière which was triggered by the weaknesses in model 1 laid bare during the international financial crisis
- Both models based on the principles of decentralization, cooperation and segmentation
- Decentralized at the national level with home country control and mutual recognition of prior regulatory harmonization
- Segmentation because institutional types still regulated in silos

Model 1

- Model 1 very complex with a multitude of agencies and committees involved at different stages in the process
- Model 1 catered to a lot of heterogeneity in structures across member countries and allowed national jurisdictions to keep their supervisory structures making consensus easier to achieve
- The number of committees and agencies mean that coordination problems could pose significant challenges
- Model 1 had more accountability built in since it reported to the European Commission and Parliament but less susceptible to political inflances affecting financial stability policy

European Models

Model 2

- Simplified the structure by eliminating the need to go to the European Commission and Parliament while reducing the number of committees by creating the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) to cover the functional areas of banking, insurance and pensions and the securities market
- The European Systemic Risk Board (ESRB) was also created to sit at the apex of this new architecture with the ECB being charged with specific tasks relative to the ERSB
- Regulatory structure still segmented by institutional type so coordination costs and challenges would still exist even if reduced by the rationalisation of the number of committees
- Placed more power in regional bodies while still maintaining the national character of supervisory agencies
- ERSB's recommendations still not legally binding but could make its recommendations public in particular circumstances
- Still relatively loose framework for compliance which facilitate the exchange of information and for developing consensus but imply a limited ability to enforce decisions as institutions and jurisdictions don't have to comply with decisions not strictly in their own interests

Current state of development of the Caribbean financial stability architecture (CFSA)

Challenges

- A variety FS architecture at the national level – have to build regional architecture out of differential regulatory models, legislative frameworks, different levels of financial development and different capacities in terms of expertise and financial stability indicators
- Challenge in getting regional consensus in this environment, especially in the context of the political economy dimensions of creating a regional FS architecture
- Lack of data on regional financial interconnectedness, exposures and contagion probabilities
- Scarce resources both human and financial in countries already beset by fiscal challenges
- Tentative steps at institutional development not codified in law so only able to get traction on issues which are in the self interest of all stakeholders/members

Current state of development of the CFSA

Advantages

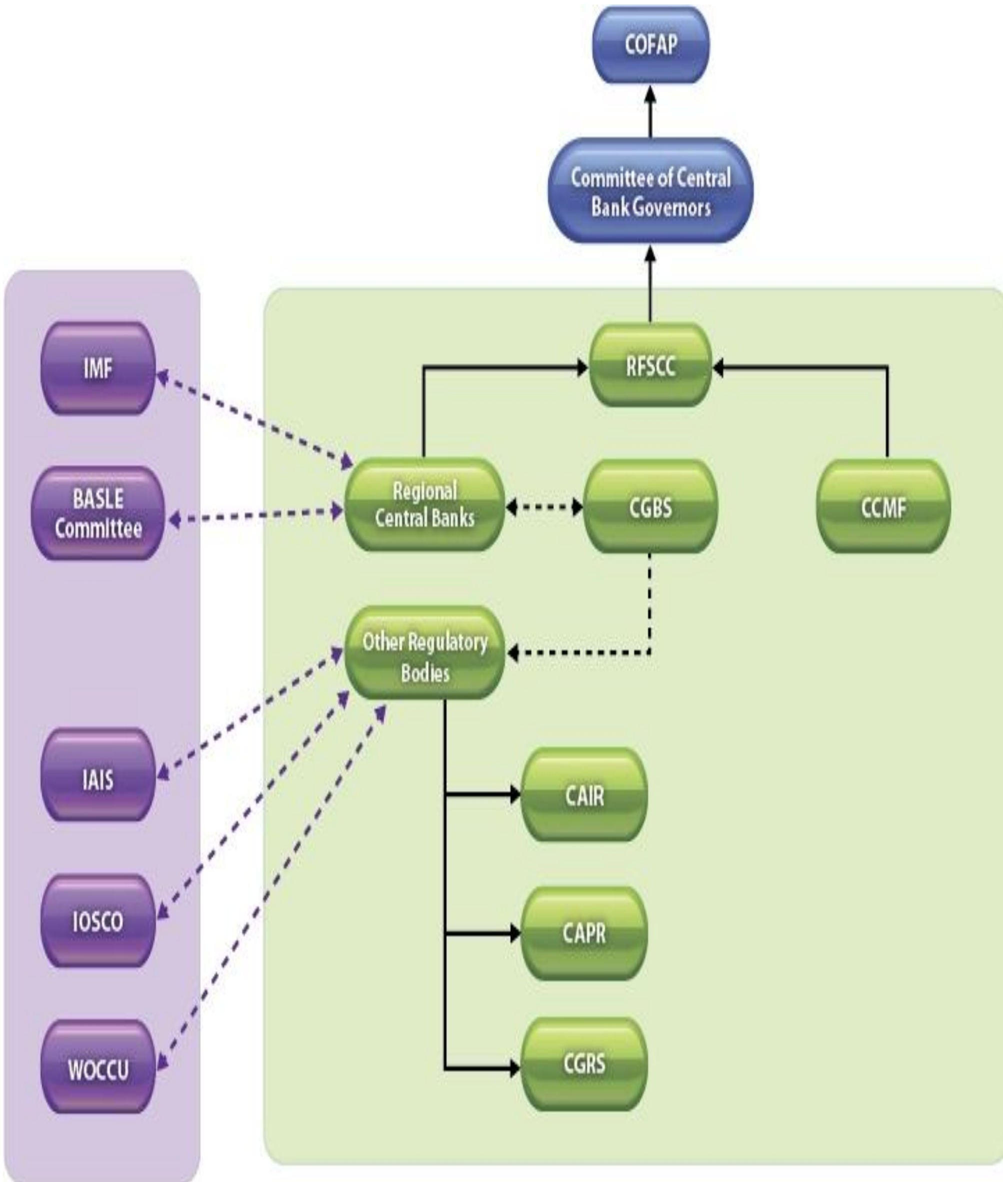
- The CARICOM Group of Central Bank Governors was a natural regional forum which could be used to lead the development of the CFSA and could serve as the basis for a wider regional committee which includes other financial regulatory agencies to sit at the apex of the CFSA charged with managing and resolving regional financial stability problems
- The existence of regional regulatory associations (CGBS, CAIR and CGSR) which can help to promote consensus on regional financial stability issues
- The improvements in the national financial stability architecture in member countries through the creation of dedicated financial stability units, improvements in the institutional capacity trough training and data development, the formation of national financial stability committees, setting up of regional supervisory colleges, MOUs to facilitate information sharing between different jurisdictions and the publication of financial stability reports (FSRs)
- IADB, the IMF and CARTAC has been instrumental in providing financial resources and expertise to drive this process
- Long standing efforts in the region to update financial legislation, strengthen regulatory and supervisory frameworks through increased harmonisation of laws and the implementation of consolidated supervision

Initiatives to address gaps in the CFSA

Two projects - common goals

- IADB funded project on financial risk assessment in the Caribbean
- IMF Caribbean regional financial project focusing on financial interconnectedness
  - A set of financial stability indicators at the national and regional levels and the production of the first RFSR
  - To develop improved methodologies for measuring and assessing the regional risks exposures especially those posed by financial conglomerates operating within the region
  - Help develop expertise and networks of regional central bankers and regulators to better assess and deal with vulnerabilities
  - The development of a financial interconnectedness map to flush out potential contagion risks
  - Proposals to develop the architecture for regional financial stability monitoring, reporting and policy response
- A draft RFSR has been prepared and is being amended in line with recommendations from participating central banks – the only other exercise of its kind other than the ECB's Financial Stability Review
- Data templates needed to prepare financial interconnectedness maps have been developed, tested and rolled out in participating jurisdictions – will provide much needed information on regional risk exposures and contagion risks
- Proposals for the development of a comprehensive CFSA is being developed

Possible Caribbean financial stability Architecture



- Makes use of existing institutional features so don't have to deal with the cost of new institutional arrangements
- Problems with institutional capacity and funding in non-central bank agencies - funding model based on fees from regulated entities
- Regulators of NBFIs that are not central banks may disagree with not being included at the level of the committee of central bank governors and should be in a broader oversight committee which includes CB governors to coordinate policy on regional financial stability
- COFAP is not the best forum to be at the apex of the architecture – problems with convening meetings, too broad a forum and the range of issues being discussed could compromise the focus on financial stability
- Better to have a committee of MOF from impacted jurisdictions closely aligned to the schedule of the governors meeting

Implications from the European experience, trends in financial stability architecture and Caribbean realities for the development of the CFSA

- Not codifying the CFSA in statute, particularly the oversight committee, and eschewing the use of a more hierarchical structure (which in theory should help enforcement) for the CFSA may be a useful strategic approach to achieve consensus to kick start the creation of the CFSA
- Current efforts to improve national systems would redound to the benefit of the CFSA since the regional architecture is only as good as its national component parts
- Efforts at consolidation of regulation would help the development of the CFSA since fewer players would make the achievement of consensus and decision making easier and lower coordination costs – use of the CBs as super regulators will make more efficient use of scarce expertise and financial resources for financial stability in a region where adequate funding for financial stability initiatives is the biggest problem
- Identification of dedicated funding for the resolution of crises and burden sharing is a key area in which agreement must be reached
- Current initiatives to develop the regional capacity to monitor, report and implement policies to contain regional risk exposures must be supported on a continuous basis to backstop the CFSA

END

- ✓ Thank You