The role of the Trinidad and Tobago Securities and Exchange Commission in reducing Systemic Risk and formulating Macro Prudential Policy for the Securities Industry

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Abstract

Financial regulators globally have made the containment of systemic risk within their jurisdictions together with overlays of macro prudential policies a major objective of their regulatory mandates. The Trinidad and Tobago Securities and Exchange Commission (TTSEC) recently had its regulatory powers expanded through amendments to the Securities Act, 2012.[2] This paper discusses operational aspects of the role that the TTSEC must perform to ensure the reduction of systemic risk within the local capital markets. Within this discussion will be an examination of the mutual fund industry of Trinidad and Tobago, which falls under the regulatory purview of the TTSEC. The paper focuses the trends within the industry, its contribution to the development of the local capital markets and its potential risks. It also discusses the reasons why the TTSEC regulates the industry and outlines the procedures used to regulate the mutual fund industry. Systemic risks are best mitigated against through the use of a holistic macro prudential perspective.

Keywords: Systemic risk, Macro Prudential Policy and Regulation.

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[2] The amendments for the Securities Act, 2012 were assented to by the President on September 10, 2014.

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Introduction

The Trinidad and Tobago Securities and Exchange Commission (TTSEC), is responsible for the regulation of the securities industry. The Central Bank of Trinidad and Tobago (CBTT) is the regulator with responsibility for Banking, Finance, Insurance and Credit Unions. The TTSEC has signed an MOU with the CBTT to work together to regulate and develop the capital markets.

The importance of the Financial Sector can be measured by its contribution to annual Gross Domestic Production (GDP) which is about 14% to 18% and is the second largest contributing sector after the Energy Sector (38% to 45 %) share of annual GDP. This sector is regulated by two (2) institutions: the Central Bank of Trinidad & Tobago ("CBTT") and the Trinidad & Tobago Securities and Exchange Commission ("TTSEC") both of which utilizes tools to identify, monitor, mitigate and manage systemic risk to ensure transparent, fair and efficient markets. The TTSEC must complement the work of the CBTT, which has responsibilities for monetary policies.

In the Securities Industry, all regulatory frameworks were built upon a disclosure based model. Disclosure based models allowed market actors to design their products through innovations, apply for registration and distribution while the Regulator fostered investors' confidence in the capital market by enforcing the legal framework for securities. Financial Products and Institutions were judged individually along micro prudential policies to manage risks. However, during and after the financial crisis of 2008/09 when the financial sector was looked at holistically to ensure growth, financial stability, and prudent monetary policies, there were inherent risks due to the movement of money.

After the financial crisis, three (3) major issues for Security Regulators were to develop a comprehensive holistic regulatory framework, address macro prudential policies concerns and mitigate against systemic risks. These regulators must ensure greater transparency, find a balance between unrestrained financial innovation and over regulation, increase resources to monitor market development and identify emerging risks.

Under disclosure-based regulation, the issuer (Company) is required by the regulatory framework to make full disclosure of its affairs to the investor. After which, it is up to the investor to take responsibility for his own investment decisions. The regulator would leave it up to the investing public to decide on whether it wishes to invest in such a company in an open market (Harrison, 2000). However, the Regulator has the responsibility to ensure fair and transparent markets.

As noted in Wong (2010), disclosure-based regulation suffers from two significant failings[3]. First, it lacks coherence in that shareholder rights are presently too weak to compensate for the hands-off regulatory approach. Second, Wong argues that disclosure has been deployed excessively as a regulatory tool, resulting in inundation and poor quality of information as well as other unintended outcomes. Moreover, he states that disclosure has been ineffectively used to address issues that are better tackled through substantive regulation (Wong, 2010).

Locally securities regulation began with the passage of the Securities Industry Act, 1995 which proclaimed the establishment of the TTSEC. The current legislation, the Securities Act of 2012

[3] Wong's references are made primarily in connection with the U.S. securities framework.

(SA 2012), is seen as the disclosure-based regulatory framework with a macro prudential overlay that is more in line with current trends in global securities regulation.

There have been a number of key changes that have been enacted with the passage of the SA 2012.

- Section 6 (e) now allows the TTSEC to conduct inspections, reviews and examinations of self-regulatory organizations, broker-dealers, registered representatives, underwriters, issuers and investment advisers.
- Section 6 (l) now allows the TTSEC to *"assess, measure and evaluate risk exposure in the securities industry"*.
- Section 7 (l) of the SA 2012 states that one of the functions of the TTSEC is to *"monitor the risk exposure of registrants and self-regulatory organizations and take measures to protect the interest of investors, clients, members and the securities industry"*.
- Section 70 (1) "a reporting issuer knowingly or recklessly makes a misrepresentation ….commits an offense and is liable on conviction on indictment to a fine of one million dollars and to imprisonment of three year.
- Section 90, allows the TTSEC's Chief Executive Officer to make interventions into " unsafe or unsound practices" which would "be a risk of loss, or damage to a registrant or self –regulatory organization, its investors or the general public".
- Section 91 & 92 deals with market manipulations as an offense.

As a consequence, one of the main mandates of the TTSEC has become the monitoring of risk exposures and ultimately the reduction of systemic risk. The reduction of systemic risk in

financial jurisdictions has become a major focal point in the development of any securities regulatory framework, primarily due to the events that followed the Global Financial Crisis of the late 2008/09 and the pursuant global recession. As a consequence, financial regulators have progressively shifted their approach from purely a micro prudential approach towards adding macro prudential regulation in order to achieve their common objective of reducing systemic risk in their respective financial jurisdictions.

The concept of Systemic risk, like most economic concepts, has been problematic to precisely define as noted in Hendricks et al (2006). They identified one definition as *"the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy[4]"* (Hendricks, Kambhu, & Mosser, 2006, p. 2). However, while Hendricks et al state that this definition could be considered broad enough to permit differing views,[5] they also note that there are those who argue that damage to the real economy is not sufficient grounds to classify an episode as systemic.

The key characteristic of systemic risk is the movement from one stable (positive) equilibrium to another stable (negative) equilibrium for the economy and the financial system. Thus, proponents of this view would argue that research on systemic risk should focus on *"the potential causes and propagation mechanisms for the 'phase transition' to a new but much less desirable equilibrium as well as the 'reinforcing feedbacks' that tend to keep the economy and*

[4] This was derived from a 2001 Group of Ten report entitled, *"Consolidation in the Financial Sector."* It is available at: www.bis.org/publ/gten05.html.

[5] Hendricks et al state that these views relate to *"whether certain recent episodes within the financial system constituted true systemic risk or only threatened to become systemic by having a significant adverse impact on the real economy."*

financial system trapped in that equilibrium" (Hendricks, Kambhu, & Mosser, 2006). Despite this dissonance, there is common agreement on the need to reduce systemic risk within the financial system as evidenced by the IOSCO Principles. In 2010 IOSCO outlined 38 Principles of securities regulation, which are based upon three main objectives of securities regulation: (1) protecting investors; (2) ensuring that markets are fair, efficient and transparent; and (3) reducing systemic risk (International Organization of Securities Commissions (IOSCO), 2010).

A key aspect of the systemic risk debate is the issue of systemically important financial institutions (or SIFIs). A firm is considered to be systemically important if its failure would have *"economically significant spillover effects which, if left unchecked, could destabilize the financial system and have a negative impact on the real economy"* (Thomson, 2009, p. 1). More recently, the turbulent economic environment during the Global Financial Crisis led to several bank runs in the U.S. which forced the closure and/or takeover of established institutions such as Washington Mutual, Wachovia and more famously, Bear Stearns. Goldman Sachs was a recipient of US $10 billion in preferred stock investment as part of the Troubled Asset Relief Program that was implemented by the U.S. Treasury. Essentially, these are organisations that are considered "too big to fail." and in spite of large bail outs by the Federal government, that intervention has not produced the economic relief to the economy or the poorer and most affected segment of the population.

The remainder of this paper is divided as follows. First, it compares macro prudential regulation with micro prudential regulation. Then it briefly discusses establishing an operational regulatory

framework and its importance. The paper then provides background on the IOSCO Principles as well as the history of securities regulation in Trinidad and Tobago. It discusses the role of the TTSEC in reducing systemic risk through the use of the IOSCO Principles and macro prudential policy. More specifically, it examines the mutual fund industry of Trinidad and Tobago in terms of trends happening within the industry, its contribution to the development of the local capital markets and its potential risks.

Macro Prudential Regulation versus Micro Prudential Regulation

The term macro prudential can trace its origins to the "Bank for International Settlements" when it was used in the late 1970s[6] to denote *"a systemic or system-wide orientation of regulatory and supervisory frameworks and the link to the macro economy"* (Borio, 2009). There are three fundamental features that distinguish the macro prudential from the micro prudential approach to regulation and supervision. Borio (2003). These features are related to objectives, focus and the characterisation of risk as seen in Table 1.

[6] Clement (2010) noted that records suggest that its first appearance dates back to June 1979 at a meeting of the Cooke Committee, the forerunner of the present Basel Committee on Banking Supervision.

<u>Table 1 - The macro prudential and micro prudential perspectives compared</u>

Fundamental Features	Macro prudential	Micro prudential
Proximate objective	Limit financial system-wide distress	Limit distress of individual institutions.
Ultimate objective	Avoid output (GDP) costs	Consumer (investor/depositor) protection
Characterisation of risk	Seen as dependent on collective behaviour ("endogenous")	Seen as independent of individual agents' behaviour ("exogenous")
Correlations and common exposures across institutions	Important	Irrelevant
Calibration of prudential controls	In terms of system-wide risk; top-down	In terms of risks of individual institutions; bottom-up.

Source: Borio (2003)

The proximate objective of a macro prudential approach is *"to limit the risk of episodes of system-wide financial distress so as to contain their cost for the macro economy"* (Borio, The future of financial regulation, 2009, p. 2). The proximate objective of a micro prudential approach contrasts with the former in that its proximate objective is to *"limit the risk of failure of individual institutions, regardless of their impact on the overall economy"* (Borio, 2009). While the micro prudential approach is best rationalised in terms of consumer (depositor or investor) protection.

The second distinguishing feature concerns the focus of each approach. The focus of the macro prudential approach is the financial system as a whole. Borio (2009) used the analogy of the financial system as a portfolio of securities, where each security represented a financial institution. He stated that the focus of a macro prudential approach would be only the losses

sustained on the overall portfolio. However, the micro prudential approach would be focused on the individual institution. The micro prudential approach would *"care equally about losses on each individual security"* (Borio, 2009, p. 3). Borio further noted that the degree of diversification or risk concentration in the overall system was crucial from a macro prudential perspective. What mattered was the common exposures across financial institutions, not so much those within the portfolios of individual institutions, which represents the main concern of the micro prudential approach.

The final distinguishing feature is the treatment of aggregate risk under each approach. The macro prudential approach treats aggregate risk as dependent on the collective behaviour of institutions as endogenous. This is because, collectively, institutions can affect the prices of financial assets, and the quantities transacted (e.g. borrowed and lent). This can affect the strength of the economy itself. This has powerful feedback effects on the soundness of the institutions. In contrast, the micro prudential perspective treats aggregate risk as exogenous. Individual institutions have insular views towards risk. Just as it is believed that individual institutions will generally have little impact on market prices or the economy, it is also believed that asset prices, market/credit conditions and economic activity are unaffected by their decisions. The sharp contrast between the approaches is reflected in the fundamental disagreement over the validity of the micro prudential dictum: "for the financial system to be sound it is *necessary* and *sufficient* that each individual institution is sound".

The macro prudential approach is best thought of as consisting of two dimensions, which have different implications for the calibration of prudential tools. The first concerns how risk is

distributed in the financial system *at a given point in time.* The second dimension concerns how aggregate risk evolves over time, referred to as the "time dimension". The key issue in the cross-sectional dimension is the existence of common (correlated) exposures, as a result of institutions being directly exposed to the same or similar asset classes or because of indirect exposures associated with linkages[7] among them. Clement (2010) states that this required the calibration of prudential tools with respect to the systemic significance of individual institutions, i.e. their contribution to overall risk. He cited the example of institutions whose failure would be more disruptive for the system as a whole being subject to tighter standards (Clement, 2010, p. 64).

In terms of the time dimension, the key issue is how system-wide risk can be amplified by interactions within the financial system as well as between the financial system and the real economy. Borio (2009) states that the mutually reinforcing process between falling risk perceptions, rising risk tolerance, weakening financing constraints, rising leverage, higher market liquidity, booming asset prices and expenditures during expansions feeds into itself. This potentially leads to the overextension of balance sheets. This process operates more abruptly in reverse as financial strains emerge, financial distress becomes amplified. Thus, he posits that the main policy question should be how to dampen the inherent procyclicality of the financial system.

The development of the regulatory framework to manage systemic risk.

[7] Borio cites the example of counterparty relationships.

Historically, the securities industry in Trinidad and Tobago first emanated from a Government-led thrust to localize the foreign owned commercial interests within the economy in the early 1970s. Regulatory matters at that time would have been handled by the "Capital Issues Committee" and the "Call Exchange". The Committee was established under the Ministry of Finance and the Call Exchange was set up under the umbrella of the Central Bank of Trinidad and Tobago (Trinidad and Tobago Stock Exchange, 2013).

Currently, the Trinidad and Tobago Securities and Exchange Commission is the regulator for the securities industry. TTSEC has supervisory responsibility for The Trinidad and Tobago Stock Exchange and the Trinidad and Tobago Central Depositary Limited, which are two Self-Regulatory Organisations operating within the local securities industry. In addition, TTSEC has responsibility for the registration, monitoring and surveillance of market actors comprising of broker-dealers, registered representatives, investment advisers, underwriters and registrants of collective investment schemes.

Regulation of the securities industry first began with the passage of the Securities Industry Act of 1981. This was the catalyst for the creation of the Trinidad and Tobago Stock Exchange (Trinidad and Tobago Stock Exchange, 2013). The Trinidad and Tobago Stock Exchange is a Self-Regulatory Organization with a mandate to control its own affairs and, prior to 1997, the regulation of the local capital markets. However, to maintain separation of powers, the TTSEC was established with the proclamation of the Securities Industry Act in 1997 with its purpose being *"…to promote transparency and integrity in the capital market…in order to protect*

investors and foster the orderly growth and development of the market." (Trinidad and Tobago Securities and Exchange Commission, 2013).

The Securities Act 2012[8] (SA 2012, the Act) established the TTSEC as a body corporate that regulates the securities market and outlined its powers and functions[9]. The SA 2012 gives the Commission the power to enforce policies and procedures to ensure the efficient operations of the market and mitigate against systemic risk.

Some core policies covered in the Act are as follows but not limited to:

1. Section 51: The requirement for all persons who wish to carry on the business of broker-dealers, investment advisers or underwriters to be registered with the commission
2. Section 62: The requirement for all securities distributed or listed with any self-regulatory organization[10] to be registered with the Commission.
3. Section 63-67" Requirements for reporting issuers[11] to submit annual reports and financial statements, material change statements and interim financial statements. These statements must be filed and delivered via a specific process.

In addition to the mandate outlined in the Act, the TTSEC ensures compliance with Anti Money Laundering and Combating the Financing of Terrorism (AML/CFT) legislation which includes the Proceeds of Crime Act (POCA) and The Financial Obligations Regulations (FORs)[12].

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[8] Previously the Securities Industry Act 1995 (SIA 1995, 1981).
[9] As noted in Sections 5-8 of the SA 2012.
[10] Section 4 of the SA 2012- Self Regulatory Organization is a clearing agency, securities exchange, association of market actors registered or required to be registered under the act, any agency that sets standards for or monitors the conduct of its members.
[11] As defined under Section 4 of the SA 2012.
[12] Section 6 (i) of the SA 2012

As part of the legal framework, the TTSEC releases guidelines, Section 146 SA 2012, to the market which provide specifically the various protocols that should be observed in the market in different situations. The guidelines also outline standards of behaviour expected of registrants as they conduct their business. Some Examples of these are:

i. Guidelines on Anti-Money Laundering & Combating The Financing of Terrorism
ii. Repurchase Agreements Guidelines
iii. Collective Investment Scheme Guidelines
iv. Promotion Presentation Standards for Collective Investment Schemes

Potential Risk Areas of the Securities Industry

1. The Size and Composition of the Securities Industry as at September 2014

When computing the size of the local securities industry (297.35 billion), the values of four distinct components are taken into account, which include:

i. the stock market capitalisation of the local equity markets; (109.06 billion)
ii. the value of debt instruments issued (which are inclusive of loan notes, bonds, commercial paper and Treasury Bills); (85.84 billion)
iii. Securitized Instruments[13];(56.59 billion) and
iv. Net Funds under management of the mutual fund industry. (45.86 billion)

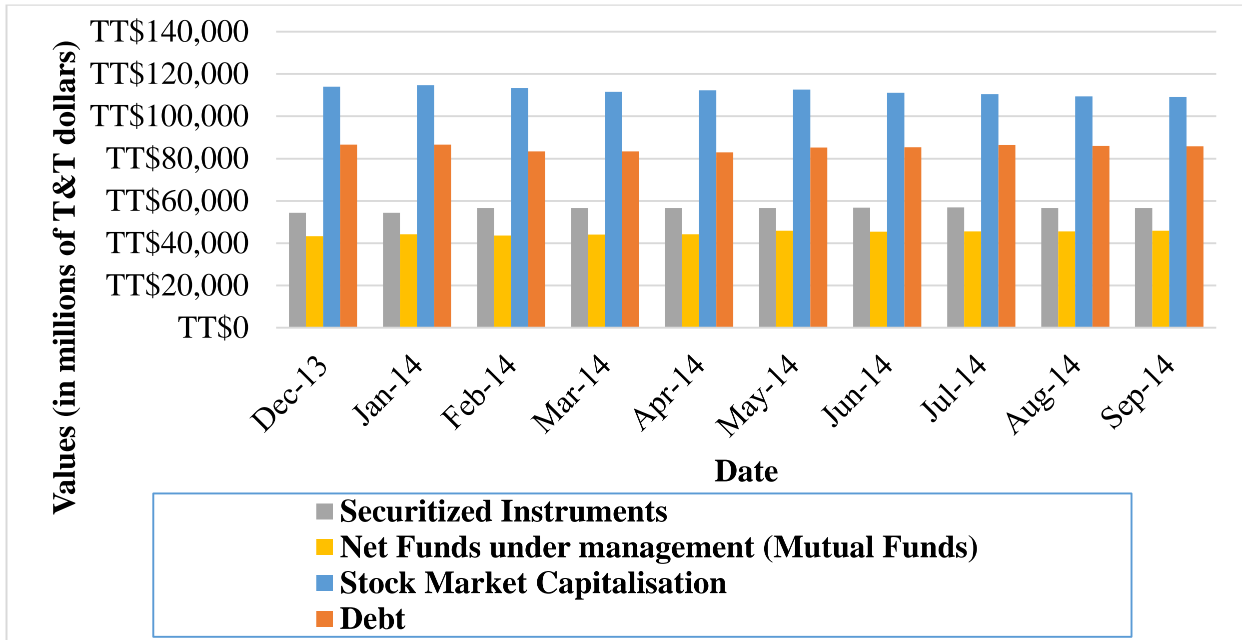
[13] In the local capital markets, these are mainly Certificates of Participation that have plain vanilla bonds as their underlying asset.

The securities industry (from December 31, 2013 to September 30, 2014) has seen declines in two of its major components: equities and debt instruments (see Figure 1 and Table 1). Market capitalisation of the local equity market declined by TT $4.94 billion (or 4.33%) while the value of debt instruments registered by the TTSEC declined by TT $691.40 million (or 0.80%) during this period. On the other hand, the value of securitised instruments that were registered during this period increased by TT $2.16 billion (3.96%) and net funds under management by mutual funds rose by TT $2.59 billion (5.99%). However, these were insufficient to offset the major declines in equities and debt instruments; which resulted in a decline of TT $881.60 million in the securities industry during the subject period.

Table 2 - Estimated Size of the Components of the Securities Industry of Trinidad and Tobago (December 2013 – September 2014)

Date	Stock Market Capitalisation	Debt	Securitized Instruments	Net Funds under management (Mutual Funds)	Total
December 2013	114,000.94	86,531.40	54,434.14	43,269.40	298,235.88
January 2014	114,673.59	86,531.40	54,434.14	44,276.04	299,915.18
February 14	113,349.22	83,436.05	56,569.72	43,564.67	296,919.66
March 2014	111,495.44	83,436.05	56,569.72	44,028.69	295,529.89
April 2014	112,303.30	82,936.65	56,569.72	44,212.45	296,022.11
May 2014	112,554.04	85,199.63	56,569.72	45,880.79	300,204.18
June 2014	111,094.33	85,384.63	56,733.76	45,401.29	298,614.01
July 2014	110,548.16	86,392.46	56,928.51	45,543.71	299,412.84
August 2014	109,503.44	86,025.45	56,592.05	45,671.16	297,792.10
September 2014	109,062.06	85,840.00	56,592.05	45,860.17	297,354.28

Figure 1 - Estimated Size of the Components of the Securities Industry of Trinidad and Tobago

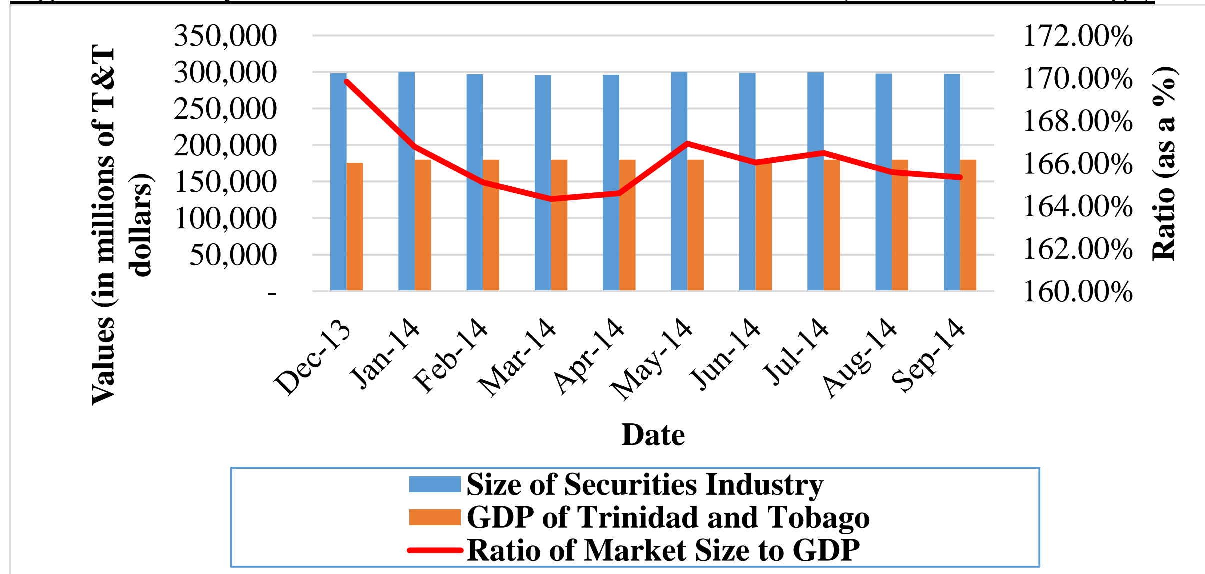


The importance of the securities industry to the real economy of Trinidad and Tobago can be seen through comparisons of estimated market size and the value of the country's Gross Domestic Product. As seen in Figure 2 and Table 2, the ratio of securities industry market size to Gross Domestic Product was about 165% as at September 30, 2014.

Table 3 – Comparisons: Securities Market Size and G.D.P. (Trinidad and Tobago)

Date	Market Size	G.D.P.	Ratio of Market Size to GDP (%)
December 2013	298,235.88	175,608.50	169.83
January 2014	299,915.18	179,842.00	166.77
February 2014	296,919.66	179,842.00	165.10
March 2014	295,529.89	179,842.00	164.33
April 2014	296,022.11	179,842.00	164.60
May 2014	300,204.18	179,842.00	166.93
June 2014	298,614.01	179,842.00	166.04
July 2014	299,412.84	179,842.00	166.49
August 2014	297,792.10	179,842.00	165.59
September 2014	297,354.28	179,842.00	165.34

Figure 2 – Comparisons: Securities Market Size and G.D.P. (Trinidad and Tobago)



2. Systemically Important Financial Institutions (SIFIs)

There are a number of SIFIs in the local financial sector:

- Unit Trust Corporation (UTC)
- National Insurance Board (NIB)
- Home Mortgage Bank (HMB)
- Trinidad and Tobago Mortgage Company Limited (TTMF)
- Agricultural Development Bank (ADB)

i. There are some major market markers holding substantially large investment portfolios. Failure of such an organisation would most likely have a negative impact on the local financial system and real economy.

ii. The National Insurance Board (NIB) receives monthly funds and is a repository of funds and so have a responsibility to invest the funds to meet future commitments. Higher returns would involve higher risks.

iii. The TTMF and HMB are part of government housing loans to low income families, monthly income of below TT $ 8,000.00 per month at 2 % interest. There is a high risk of non-performing loans.

3. The Mutual Fund Industry of Trinidad and Tobago

The Importance of the Mutual Fund Industry

The mutual fund industry has been a major vehicle used for the mobilisation of a country's financial resources. It can provide a way for millions of small investors to participate in the securities markets and to save for their futures. Mutual fund investment in the equity markets can provide a stable source of capital for firms seeking capital. Mutual funds can be more attractive to investors than investment in individual stocks because they offer the benefits of diversification and professional management. (Fink, 1998).

The History of the local Mutual Fund Industry

The establishment of the Trinidad and Tobago Unit Trust Corporation in 1982 signalled the creation of the local mutual fund industry. The Corporation represented the culmination of an important public policy initiative, which was to enhance the mobilization and allocation of domestic financial resources and to ensure that citizens of the country participated in the income and capital growth of the country (Edwards, 2012).

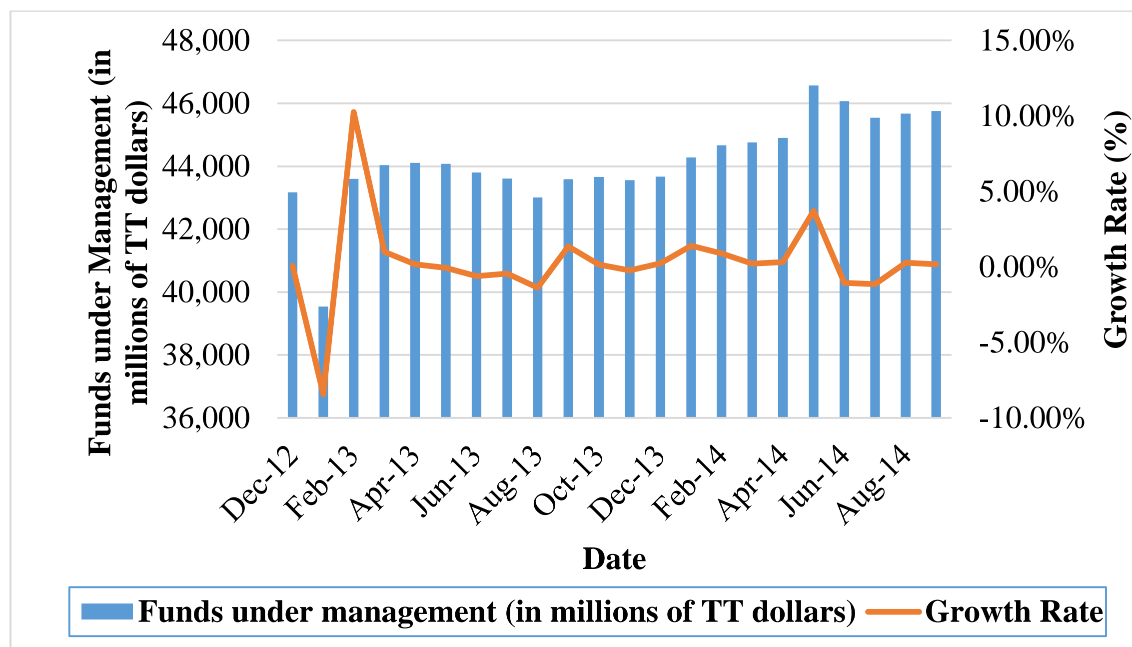
The mutual fund industry grew at a phenomenal rate over the period 2000 - 2004 years, during which time its growth was faster than that of bank deposits. The results of a survey study[14] commissioned by the TTSEC showed that assets under management (Funds under management) in domestic mutual funds grew by approximately 500% between 2000 and 2004, increasing from

[14] In 2005, the Trinidad and Tobago Securities and Exchange Commission ("the TTSEC") and the Central Bank of Trinidad and Tobago ("the CBTT") sponsored a survey and analysis of the mutual funds industry. The study was designed to assess and evaluate the structure and functioning of the industry with a view to providing a background for its proper regulation. The study addressed not only those products that are generally called mutual funds, but also a number of other Collective Investment Scheme products whereby an individual investor contributes payments towards a pool of investments that is managed by a professional investment manager on behalf of the whole group.

TTD $5 Billion in December 2000 to TTD $27 Billion by the end December 31, 2004. By comparison, the worldwide industry growth rate was 35% over the same period (Trinidad and Tobago Securities and Exchange Commission, 2008).

The mutual fund industry in Trinidad and Tobago is currently comprised of sixty registered mutual funds being offered by 14 registered providers. As seen in Figure 3 below, funds under management for the industry have steadily risen in 2014 from TT $43.67 billion as at December 31, 2014 to TT $45.75 billion as at September 30, 2014. Additionally, funds under management grew by approximately 5.98% during the period December 31, 2012 to September 30, 2014.

Figure 3 - Overview of Trinidad and Tobago's Mutual Fund Industry (2014)[15]



Source: Trinidad and Tobago Securities and Exchange Commission's Collective Investment Scheme Monitor

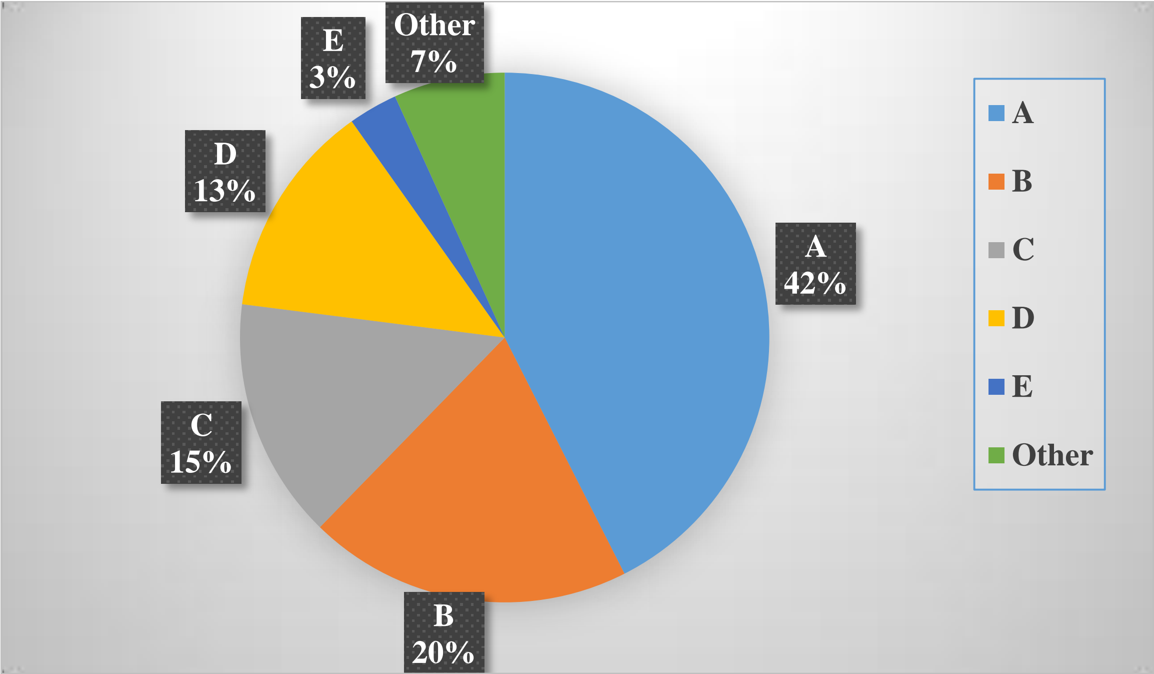
[15] Growth rate for December 2012 was calculated using funds under management as at November 30, 2012; which was TT $43,148.46 million.

Table 4 - Overview of Trinidad and Tobago's Mutual Fund Industry (2014)

Month	Funds under management (in millions of TT dollars)	Growth Rate (%)
December 2012	43,173.62	0.06
January 2013	39,535.77	(8.43)
February 2013	43,596.88	10.27
March 2013	44,033.82	1.00
April 2013	44,109.12	0.17
May 2013	44,080.3	(0.07)
June 2013	43,806.5	(0.62)
July 2013	43,607.82	(0.45)
August 2013	43,004.17	(1.38)
September 2013	43,588.74	1.36
October 2013	43,657.18	0.16
November 2013	43,560.21	(0.22)
December 2013	43,666.98	0.25
January 2014	44,276.04	1.39
February 2014	44,667.38	0.88
March 2014	44,763.12	0.21
April 2014	44,902.18	0.31
May 2014	46,566.07	3.71
June 2014	46,069.25	(1.07)
July 2014	45,543.71	(1.14)
August 2014	45,671.16	0.28
September 2014	45,753.65	0.18

The top five (5) issuers within the mutual fund industry currently accounts for 93% of total funds under management in the industry as at September 30, 2014. The Trinidad and Tobago Unit Trust Corporation (UTC) is the current market share leader despite the fact that it only has five mutual fund offerings available to the investing public.

Figure 4 - Market Share Percentage of Top 5 Issuers in the Mutual Fund Industry (as at September 30, 2014)



Source: The Trinidad and Tobago Securities and Exchange Commission

Table 5-Funds under Management (FUM)

Organisations	FUM (in millions of TT dollars)
Issuer A	19,455.68
Issuer B	9,047.37
Issuer C	6,731.04
Issuer D	6,031.58
Issuer E	1,377.98
Other	3,110.02

Issuers have organized themselves into the Mutual Fund Association of Trinidad and Tobago [16](MFATT).

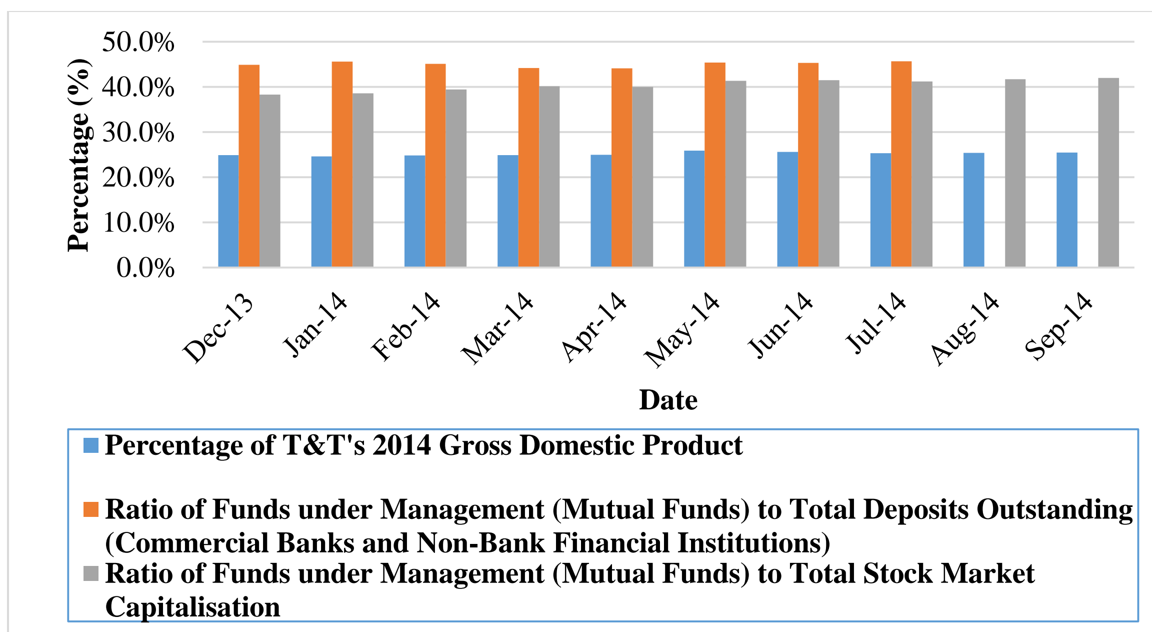
Why regulate the Mutual Fund Industry?

1. Funds under Management (FUM): It is important to note the systemic importance of the mutual fund industry to the financial system and real economy of Trinidad and Tobago as it represents a significant portion of each system. Indeed, with commercial deposit rates at historic lows, it has become the main investment vehicle through which local households in Trinidad and Tobago invest their savings. As seen in **Figure 5**, total funds under management for the mutual fund industry in September 2014 is estimated to be 25.44% of the Gross Domestic Product[17] (GDP) of Trinidad and Tobago for 2014. The ratio of total funds under management to total stock market capitalisation on the Trinidad and Tobago Stock Exchange (TTSE) was approximately 40% during the period, December 2013 to September 2014.

Figure 5 –Systemic Importance of the Mutual Fund Industry in Trinidad and Tobago

[16] See Appendices C, MFATT objectives

[17] Source: The Review of the Economy 2014, Ministry of Finance and the Economy.



Source: Author's calculations based on mutual fund industry data and data from the Ministry of Finance and the Economy, Trinidad and Tobago and the Central Bank of Trinidad and Tobago.

Table 6: FUM compared to GDP as at September 2014

Date	Funds under Management (Mutual Funds) (in millions of TT dollars)	Total Deposits Outstanding (in millions of TT dollars)	Stock Market Capitalisation (in millions of TT dollars)	GDP (2014) (in millions of TT dollars)
Dec 13	43,666.98	97,254.50	114,000.94	175,608.50
Jan 14	44,276.04	97,097.30	114,673.59	179,842.00
Feb 14	44,667.38	98,991.40	113,349.22	179,842.00
Mar 14	44,763.12	101,335.00	111,495.44	179,842.00
Apr 14	44,902.18	101,735.00	112,303.30	179,842.00
May 14	46,566.07	102,531.00	112,554.04	179,842.00
Jun 14	46,069.25	101,653.00	111,094.33	179,842.00
Jul 14	45,543.71	99,662.10	110,548.16	179,842.00
Aug 14	45,671.16	N/A	109,503.44	179,842.00
Sept 14	45,753.65	N/A	109,062.06	179,842.00

2. Complexity of Players: The size of the top five issuers arguably show that the potential risks that these corporations pose to the mutual fund industry and the wider financial system in the event of bankruptcy by one or more of these organisations. Indeed, it can be argued that failure of one may trigger bank runs which would result in financial contagion.

3. Prudential Regulation: As such, there is a need for the TTSEC to ensure that mutual fund providers follow international best practices so as to avoid negative shocks to the financial systems. One of the main tools available to the TTSEC for regulating the industry is the Collective Investment Schemes Guidelines. The areas addressed in the Collective Investment Scheme Guidelines include, inter alia:

i. Continuous Reporting with a view to bringing ***all*** mutual fund managers and trustees under similar continuous reporting requirements that are already observed by other issuers of securities in this market, and providing for special reporting requirements, such as a portfolio/ asset allocation schedule;

ii. Nomenclature rules with a view to ensuring that mutual fund names do not mislead as regards their investment strategies;

iii. Prospectus disclosure with a view to ensuring that adequate disclosure of both general risks and those associated with a mutual fund's specific investment objectives/strategies are communicated to existing and potential investors and that such investors have adequate and ready access to Fund Prospectuses on the internet, at branches of mutual fund managers' offices and other easily accessible public places;

iv. Performance measurement and advertising, and comparisons of mutual fund performance with a view to ensuring that misleading performance claims are not being communicated to existing and potential investors;

v. Fund governance with a view to ensuring adequate separation of functions that are designed for the protection of the interests of investors (Trinidad and Tobago Securities and Exchange Commission, 2008, pp. 4 - 5).

As part of its continuous reporting requirements, the Guidelines provides the TTSEC with the authority to collect data from the mutual fund providers, which is sent to the TTSEC in a monthly report. The monthly report should contain information on a number of key indicators such as funds under management; sales and redemptions by each fund that is offered by the provider.

The Way Forward – The mitigation and management of systemic risk and the need for Financial Crisis Management

Listed below are some of the action items the TTSEC is engaged with:

1. Continued collaboration with the CBTT as a fellow regulator to offer support to develop and implement macro prudential polices. There currently exists a MOU for cooperation between the two entities.
2. Continued dialogue and interaction with market actors as partners in developing the capital markets.

3. The TTSEC has a disclosure-based supervisory approach towards regulation but is including other approaches such as risk based capital requirements. The TTSEC is engaged in the creation and operationalization of a risk-based capital adequacy framework for its market registrants. In 2013, the TTSEC also established a Compliance and Inspections Division, which is mandated to conduct onsite inspections of market registrants. The TTSEC will identify potential problem areas so as to head off potential crises that may arise from market registrants who may have overextended their risk exposures; thereby becoming legitimate threats to the stability of the securities industry and the wider financial system.

4. The TTSEC is also involved in the National Financial Crisis Management Plan (NFCMP) Taskforce[18], which focuses on the systemic risks that emanate from Systemically Important Financial Institutions (SIFIs).

5. The TTSEC has adopted the Principles of Securities Regulation, as issued by the International Organization of Securities Commissions (IOSCO).

6. The TTSEC has developed a new strategic plan 2014 -2017 with the goals of improving the operational efficiency and effectiveness, developing a positive corporate image and fostering the development of the securities industry.

This shift towards macro prudential policy planning allows the TTSEC to take into consideration the various factors that could present as systemic risks within the local securities industry. This

[18] In addition to the TTSEC, the Group is comprised of members from the Ministry of Finance and the Economy of Trinidad and Tobago, the Central Bank of Trinidad and Tobago and the Deposit Insurance Corporation of Trinidad and Tobago.

is also in keeping with global trends in securities regulation. The SA 2012 will provide the TTSEC with a strong foundation for the mitigation of systemic risk, the containment of financial contagion and the fostering of greater investor confidence in the local securities markets.

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Appendices

A. The IOSCO Principles

The International Organization of Securities Commissions (IOSCO) published its seminal work, "Objectives and Principles of Securities Regulation" (hereby referred to as the IOSCO Principles) in May 2003 and later updated in June 2010. The 2010 report outlines 38 Principles of securities regulation, which are based upon three main objectives of securities regulation: (1) protecting investors; (2) ensuring that markets are fair, efficient and transparent; and (3) reducing systemic risk (International Organization of Securities Commissions (IOSCO), 2010, p. 3).

The 38 principles were categorised under nine broad categories: (1) Principles Relating to the Regulator; (2) Principles for Self-Regulation; (3) Principles for the Enforcement of Securities Regulation; (4) Principles for Cooperation in Regulation; (5) Principles for Issuers; (6) Principles for Auditors, Credit Rating Agencies, and other information providers; (7) Principles for Collective Investment Schemes; (8) Principles for Market Intermediaries and (9) Principles for Secondary Markets. There were eight new principles that were added based on the lessons learned from the 2008 financial crisis and the subsequent changes that were made in the regulatory environment. Their proper implementation is arguably critical to the creation and maintenance of a sound global regulatory system.

B. Key Definitions for the Mutual Fund Industry

A mutual fund or collective investment scheme is defined as *"an issuer that was established for the principal purpose of investing property of any description, including money, provided by its security holders; and the securities of which entitle the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate*

interest in the whole or in a part of the net assets of the issuer" (Trinidad and Tobago Securities and Exchange Commission, 2008, pp. 10 - 11). Mutual funds are either Open-Ended or Closed-Ended. The former are mutual funds which continually create new units or redeem issued units on demand. The unit holders buy units of the fund may redeem them on a continuous basis at the prevailing Net Asset Value (NAV). These units can be purchased and redeemed through the asset management company which announces offer and redemption prices daily. Closed-Ended funds are funds which are listed on an exchange such that there are a fixed number of units outstanding so that investors must purchase units from other investors via a market.

There are seven categories of mutual funds, which include an Equity Scheme, a Balanced Scheme, an Asset Allocation Fund, a Fund of Fund Scheme, a Money Market Scheme, an Income Scheme and an Aggressive Fixed Income Scheme:

i. An Equity Scheme is a fund that invests in equities more commonly known as stocks. The objective of an equity fund is long-term growth through capital appreciation, although dividends and capital gain realized are also sources of revenue.
ii. The Balanced Scheme provides investors with a single mutual fund that invests in both stocks and debt instruments. This is aimed at providing investors a balance of growth through investment in stocks and of income from investments in debt instruments.
iii. An Asset Allocation Fund may invest its assets in any type of securities at any time in order to diversify its assets across multiple types of securities and investment styles available in the market.

iv. Funds of Funds are those funds, which invest in other mutual funds. These funds operate a diverse portfolio of equity, balanced, fixed income and money market funds (both open and closed ended).

v. A Money Market Scheme is among the safest and most stable of all the different types of mutual funds. These funds invest in short term debt instruments such as Treasury Bills and bank deposits.

vi. An Income Scheme focuses on providing investors with a steady stream of fixed income. They invest in short term and long term debt instruments like government securities like T-bills.

vii. The aim of an Aggressive Fixed Income Scheme is to generate high return by investing in fixed income securities while taking exposure in medium to lower quality of assets also (The Mutual Fund Association of Trinidad and Tobago, 2013).

C. MFATT primary objective

MFATT primary objective

is to promote and profile the mutual industry through the achievement of eleven specific tasks:

i. Promoting professionalism and exemplary practice among members in the ethical conduct of the mutual fund business;

ii. Raising the profile of the mutual fund industry to make Trinidad and Tobago the prime location as a domicile for mutual funds and the preferred choice as a location for the administration of mutual fund services. This includes heightening the profile of this industry in local, regional and international spheres;

iii. Providing a forum for members to discuss issues or matters relating to the mutual fund industry;

iv. Representing members collectively in discussions with, or assist any member to make any representation or recommendation to, any government, government representative or supervisory authority which is concerned with the Mutual Fund Industry;

v. Promoting the education of the investing public on investments and on the Mutual Fund Industry;

vi. Improving professionalism and standards of research and fund management expertise in Trinidad & Tobago;

vii. Providing an information resource for the Mutual Fund Industry. Through the development of Industry Policy, Guidance Papers, Technical Briefings and the work of the Association's committees, the Association will assist in defining practice in complex areas such as compliance, valuation, accounting and presentation of performance. The partnership between its administration, legal and audit members ensure that all interests are addressed in the formulation of these Guidance Papers. In doing so, the Association provides a valuable service in generating and disseminating information in an effective and complete way;

viii. Setting performance reporting standards;

ix. Collecting and disseminating industry data statistics;

x. Supporting the development of those working in the Mutual Fund Industry. Through training programmes, conferences and industry specific seminars provided by the Association, the Association will actively support the professional development and escalation of expertise of those working within the Industry; and

Providing an avenue for public comment on the Industry – suggestions, feedback, comments (The Mutual Fund Association of Trinidad and Tobago, 2013)