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THE LAW AND THE CENTRAL BANK: ISSUES AND IMPLICATIONS FOR BANKING SUPERVISION IN TRINIDAD AND TOBAGO

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ABSTRACT

The paper argues that the approach to financial legislative reform in Trinidad and Tobago has been reactive and dilatory and suggests that this was a major factor in the financial disruptions experienced during the 1980s. The paper further proposes a limited agenda of reforms and renovation of financial legislation that would enhance the efficiency of financial supervision. Among these are included the need for more general and specific powers for the regulatory authority and the need to standardise accounting practices in regulated institutions.

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INTRODUCTION

Unlike the central banks in developed countries, many of which tended to evolve out of the experience of domestic crises, those established in the Caribbean came as part and parcel of the process of political independence. It is quite ironic, therefore, that in one of the earliest critiques of central banking in the region Thomas was compelled to note the following:

> "More than any other sphere of the administration of public policy, central banking in the region has been dominated by foreign expertise. Not only have the laws been framed by these experts, but their administration during the earlier years has been in all cases left to foreign experts."

While the role of foreign expertise in subsequent changes and additions to the banking law has been less overt, the legislative process has been no less dependent, relying heavily on the models and precedents of older and more developed jurisdictions. This approach undoubtedly has its value and its validity. But, whether relatedly or not, there appears

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to have emerged in the field of Caribbean law making an acquiescence in the role of the perennial latecomer. There is the tendency to accept as inevitable the existence of a sometimes considerable time lag between legislative developments in the developed countries and those in the region.

This paper looks briefly at some aspects of financial legislation and financial legislating in Trinidad and Tobago with particular reference to the impact on the regulatory function of the Central Bank. It concludes by proposing a minimum agenda for the reform of the financial regulatory structure in Trinidad and Tobago.

The Legal Framework

The legislative basis of monetary, financial and exchange policy, and for the regulation and supervision of financial activity in Trinidad and Tobago, is set out in four separate pieces of legislation, the Central Bank Act (1964), the Banking Act (1964), the Exchange Control Act (1970) and the Financial Institutions (Non-Banking) Act (1979). The Central Bank Act may justifiably be regarded as the centerpiece of the legislative framework for it is this which defines the fundamental objectives and scope of actions of the Bank. Some of these objectives find specific and detailed expression in the the other three pieces of legislation.

The Central Bank Act embraces a broad developmental objective and endows the Bank with the orthodox tools of monetary policy. These include the power to fix and vary reserve requirements, and use of the

rediscount rate and selective credit controls. The Act also empowers the Bank to engage in open market operations and sets out the limits of government borrowing both by way of advances and through the sale of securities to the Bank.

The Banking Act was enacted in 1964 as a companion piece to the Central Bank Act, its stated purpose being to make provision for the licensing of commercial banks and for regulating the business of banking. It established requirements for the issue of a banker's licence, including minimum capital requirements, and provided for the office of the Inspector of Banks. The Inspector is responsible for making recommendations to the Bank and to the Minister of Finance on the issue of bankers' licences and for monitoring compliance with banking law. He was given wide powers of access to all bank records and documents and could demand information from bank officials.

The Financial Institutions (Non-Banking) Act is analagous in intent and similar in many of its provisions to the Banking Act although it was enacted under dramatically different circumstances, and some fifteen years later (Table 1). It provides for the licensing of non-bank finanical institutions and brings their activities within the regulatory purview of the Central Bank and the Inspector of Banks.

The Exchange Control Act was enacted in 1970 and proclaimed in 1971 as part of official efforts to secure greater national control of national resources and to ensure that domestic savings were used in the development interests of the country. The Act, inter alia, prohibits and otherwise regulates dealing in gold and foreign currencies, imposes a

TABLE 1

SUMMARY OF MAIN STATUTORY REQUIREMENTS OF COMMERCIAL BANKS AND NON-BANK FINANCIAL INSTITUTIONS

	COMMERCIAL BANKS	NON-BANK FINANCIAL INSTITUTIONS
Minimum paid-up capital ($)	300,000	800,000
Annual Licence Fee ($)	500	5,000
Restrictions on:		
Maturity of deposit liabilities	-	1 year (minimum)
Maturity of loans	-	1 year (minimum)
Maximum Secured Credit (percent of loan portfolio)		
Loans to a Single Borrower	-	10
Maximum unsecured Credit (percent of paid-up capital and reserve fund)		
Loans to Directors	5	5
Loans to Associated and Affiliated Companies	5	5
Loans to Officers or Employees	5	5
Loans to a Single Borrower	10	10
Reserve and Liquidity Requirements		
Cash Reserve Ratio (percent of deposits)	12	5
Secondary Reserve Ratio (percent of deposits	5	-
Additions to Reserve Fund (percent of net profit)	10	10

TABLE 1 (cont'd)

SUMMARY OF MAIN STATUTORY REQUIREMENTS OF COMMERCIAL BANKS AND NON-BANK FINANCIAL INSTITUTIONS

	COMMERCIAL BANKS	NON-BANK FINANCIAL INSTITUTIONS
Maximum Deposit Liabilities (as a multiple of paid-up capital and reserve fund)	20	20
Reporting Requirements		
Monthly Statement of Assets and Liabilities	yes	yes
Quarterly Statement of Loans and Advances	yes	yes
Yearly Statement of Earnings and Expenses	yes	yes

foreign currency surrender requirement and regulates payments to and securities transactions with non-residents. The Central Bank performs the administration of exchange controls under delegated authority of the Minister of Finance in whom formal authority is vested.

The Central Bank Act, as the cornerstone of the financial legislative structure, equips the Bank to perform the three basic functions of advisor to the government, regulator of the financial system and provider of banking and other services. By and large it is the Bank's function as advisor to the government and the importance of its role in monetary policy which tends to dominate its activities.

The relationship between central bank and government, and in particular the issue of central bank autonomy, has long been a source of fascination to central bankers. In Trinidad and Tobago the Bank's role in monetary policy is, under the law, explicity subordinated to political directive. While the relationship between the Bank and government has been largely non-conflictive, the Ministry of Finance has on at least one occasion and as recently as December 1987, invoked his authority to 'issue to the Bank such written directives of a general nature as may be necessary to give effect to the monetary and fiscal policies of the Government.' But, as we shall suggest, the issue of Central Bank autonomy is not without relevance to the Bank's other functions such as the regulation of the financial system.

Issues in Regulation and Supervision

Trinidad and Tobago's experience of financial crisis in the mid-1980s formed part of a global pattern of financial disruptions which

at various stages threatened the stock markets, large international creditor banks, and heavily indebted developing countries. The global experience seem to suggest that incidents of bank or non-bank failure have a distinct syndrome. For example, the financial crisis which ravaged the financial system of Thailand in the first half of the the 1980s has been attributed by Johnson mainly to the inadequacy of the legal, regulatory and supervisory framework. However, Johnson outlines a checklist of other contributory factors which strikes a note of resounding familiarity with anyone acquainted with financial disruptions in other countries. These include management weaknesses and inadequate internal controls, an overconcentration of lending to a few large-scale and interrelated enterprises and industries, and the extension of credit and guarantees to businesses in which directors and shareholders were heavily involved.

Farrell (1987) similarly identifies the absence of regulation, managerial inexperience, poor lending and control practices and concentration in lending as the key causative factors in Trinidad and Tobago's non-bank crisis of the mid-1980s. In each case the crisis was precipated by an economic downturn which sharply undercut asset values, leaving underlying weaknesses starkly exposed. Parallels are readily discernible in the Savings and Loan (S&L) crisis currently afflicting the U.S., which suggests that the level of financial development is not necessarily a useful discriminant for purposes of distinguishing between healthy and potentially vulnerable financial systems.

The similarities in the circumstances of bank failures worldwide are observable both across countries and over time. Financial

disruptions are therefore liable to be of a recurring nature where risk factors are allowed to persist or where the evolution and development of the financial system render inadequate or obsolete the safeguards which previously were sufficient to ensure stability. There is thus a degree of built-in obsolescence in the regulatory framework which dictates a need for continuous review and analysis of the existing structure and, where necessary, prompt and decisive implementation of appropriate reforms.

Relatively little recognition is given to the role that macroeconomic policies sometimes play in financial disruptions. In the case of Trinidad and Tobago this factor is recognised implicitly (Farrell 1989). Clearly, however, the fault lines which developed in the non-bank sector and the more liberal attitudes to risk taking in the prelude to the crisis were the unintended consequences of the inordinately high monetary expansion which resulted from the monetization of windfall oil revenues, and were validated by the largely passive stance of monetary policy. Between 1973 and 1983 the annual growth of the narrow money supply averaged 28 per cent, but monetary policy remained essentially inactive for most of this period, and intervened not at all between 1974 and 1980. The observation on the role of policy is significant in the context of current developments in world oil markets and their possible implications for the Trinidad and Tobago economy.

But whatever the role of policy, financial disruptions invariably tend to focus blame on the regulatory/supervisory framework. The non-bank crisis in Trinidad and Tobago immediately called into question the capacity and competence of the regulatory authority. But

although there were limitations in regulatory capacity, the major and more decisive weaknesses were readily seen to be the inadequacies of the legislation itself.

This issue of the adequacy of the legislative framework raises questions, firstly, about the substantive provisions of the law. At this stage suffice it to say that during the gestation of the non-bank crisis in Trinidad and Tobago there were simply no prudential controls on non-bank operations. In addition there was virtually complete freedom of entry into the market, which resulted in a fivefold increase in the number of finance companies from three (3) to fifteen (15) between 1973 and 1983 and a doubling of the number of trust and mortgage finance companies from four (4) to eight (8) over the same period.

A more interesting explanation is suggested by Gardner who sees bank failures and banking difficulties as often arising from periods of laissez faire. Once failure has occurred there is invariably a signficiant supervisory response which restores stability but also creates a quasi-monopolistic situation for the surviving institutions through tougher licensing requirements. Later, inefficiencies develop and the cycle of deterioration is restarted. The propensity for regulatory reform to be reactive and remedial rather than pre-emptive in orientation is well supported empirically. In the US the S&L crisis prompted passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), but only after the FSLIC (Federal Savings and Loan Insurance Corporation) had been completely wiped out and losses had risen to over $100 billion.

The approach to financial supervision in Trinidad and Tobago can justifiably be termed reactive, notwithstanding that a regulatory framework managed to be erected sometime before the collapse occurred in the non-bank sector. The fact that collapse was not averted however, was due precisely to what might be described as the regulatory lag, of which three aspects can be identified. These may be termed the recognition lag, the decision/implementation lag and the response lag. It is difficult to know how long it would have taken for the authorities to recognise impending danger. It is equally difficult to believe, however, that officials in the Central Bank and Ministry of Finance would not have developed, certainly by the mid-1970s, an acute sensitivity to the problem in view of the sheer conspicuousness and rapid growth of non-bank activity in the economy, and in light of the highly publicised secondary banking crisis which had shaken the UK financial system in 1973-75.

This notwithstanding, it is now a matter of record that the Financial Institutions (Non-Banking) Act was passed and assented to in 1979, but did not take effect until mid-1981 due to the failure to publish the necessary regulations (the decision/implementation lag). In the interim the problems of the independent finance companies festered and grew worse. Once the Act was in force the Central Bank employed the device of conditional licences to allow a period of transition for companies already in breach of the new Act to move towards compliance (the response lag). But for many of the companies the rot was too far advanced.

The eventual implementation of the Financial Institutions (Non-Banking) Act in 1981 for the first time allowed the Central Bank

access to hard data on the financial condition of non-bank institutions. However, before the Bank could act on the information it was overtaken by events in the form of the collapse of International Trust Limited in 1983. This proved to be the catalyst for the demise of several other precariously placed institutions. At this stage the Central Bank, recognising the danger to the financial system as a whole, instituted a financial support mechanism for the problem institutions at the same time as a system of deposit insurance began to be structured. By the time arrangements were in place to effect the managed closure of the problem institutions the cost of financial support, and excluding payments under deposit insurance, had mounted to approximately $148 million. This might be viewed as the cost of the late arrival of the deposit insurance system in 1986, instead of in 1981 together with the implementation of the Non-Banking Act.

The delays in enacting and later in implementing the Financial Institutions (Non-Banking) Act have never been satisfactorily explained. But they serve to highlight a particular twist to the question of the independence and autonomy of central banks. Central banks are prisoners of their statutes and can act only within their enabling powers. Nevertheless, in the final analysis they are quite powerless to affect either the substance, or the timing and speed of implementation of financial legislation, except by virtue of the respect which might be accorded their views in these matters. But as has sometimes been made clear, the Executive is under no obligation whatever to accept the advice of the Central Bank. The Central Bank Act in Trinidad and Tobago gives the Bank no explicit role in the formulation of legislation relevant to the exercise of its functions, although this is not inconsistent with legislative norms either in the region or further afield.

An Agenda for Reform

The legislative basis of central banking in Trinidad and Tobago, and the regulatory/supervisory regime in particular, evince an obvious need for comprehensive review and renovation. The need stems partly from the obsolescence of some of the existing provisions and partly from the requirement for new provisions to meet new concerns. The existing legislation, for example, shows no concern for issues of control and ownership of financial institutions. But the emerging tendency towards financial conglomeration in Trinidad and Tobago and the special dangers that accompany this trend clearly need to be catered for. But though the list of needed reforms is long only a few are discussed here, partly because of their direct and immediate bearing on the efficacy of financial supervision.

The first priority of reform would appear to be the need for consolidation and harmonisation of the banking and non-bank law, both as a matter of operating convenience and as a way of improving the degree of coherence between the two. The incremental fashion in which the regulatory framework developed has inevitably resulted in disparities between the earlier banking law and the more recent non-banking law. Although these disparities were not large, they generally reflect a greater stringency in the more recent legislation. However narrowing the differences in prudential standards could significantly reduce the burden of monitoring and inspection, and would appear to be easily possible in the case of provisions relating to the terms and cost of licensing, restrictions on persons eligible to serve as managers of financial institutions and restrictions on the holding of real property, among others.

The second major area of deficiency lies in the area of the Central Bank's powers of regulation and supervision. Provisions for the regulation of commercial banks are outlined in some detail in the Central Bank Act and include the power to:

(i) set or vary the Bank rate;

(ii) determine minimum cash reserve ratios as a percentage of deposits, with the provision that the rate cannot be less than 5 per cent;

(iii) limit the volume and availability of credit, in consultation and with the approval of the Minister;

(iv) fix maximum foreign currency working balances of the commercial banks;

(v) prescribe the local assets ratio;

(vi) compel the provision of data by commercial banks for the purpose of monitoring compliance with the law.

But while these powers are quite specific there is no corrresponding power of sanction except the threat, under Section 9 of the Banking Act and Section 11 of the Non-Banking Act, of revocation of licence by the Minister for contraventions of the law. This, however, is subject to prior notice, a right of reply and a right of appeal to the Court. In any event revocation is an extreme sanction presumably to be invoked in only the gravest of circumstances and is therefore of little practical value for ensuring day to day compliance with regulatory provisions.

The Banking and Non-Banking Acts themselves set out monetary penalties for some contraventions of the law, but these are typically small and in some cases, such as failure to supply periodical data to the Central Bank, penalties are non-existent (Table 2). Where penalties are specified they are exerciseable only through the medium of the courts.

TABLE 2

PENALTIES FOR NONCOMPLIANCE WITH THE STATUTORY REQUIREMENTS OF BANKING AND NON-BANKING FINANCIAL INSTITUTIONS ACTS

OFFENCES	BANKING ACT	NFI ACT
Undertaking business of a financial nature without a licence	Imprisonment for two years and a fine of $15,000	Imprisonment for two (2) years for company directors or/and a fine of $10,000. The company is also liable to a fine of $50,000.
Unauthorised use of the title 'Bank'	Imprisonment for (12) twelve months and a fine of $3,000.	-
Failure to comply with regulations on approval of managerial personnel	A fine of $3,000 or imprisonment for one year (for the person)	A fine of $2,000 or/and imprisonment for one year (for the person). A fine of $10,000 for the financial institution
Failure to comply with regulations with regard to activities of the institution	A fine of $3,000	A fine of $2,000 or imprisonment for a maximum term of 1 year.
Failure to comply with requirements of Inspector of Banks	A fine of $3,000 or imprisonment for 1 year	A fine of $1,000 or imprisonment for 1 year
Disclosure of information[1] on the operations of any financial institution to unauthorised persons	A fine of $3,000 and imprisonment for twelve months	A fine of $1,000 or/and twelve months imprisonment
Failure to comply with the submission of periodical statements to the Central Bank	-	-
Failing to publish an audited balance sheet	A fine of $1,500	A fine of $1,000

1 This relates to persons engaged in the bank inspection function.

TABLE 2 (cont'd)

PENALTIES FOR NONCOMPLIANCE WITH THE STATUTORY REQUIREMENTS OF BANKING AND NON-BANKING FINANCIAL INSTITUTIONS ACTS

OFFENCES	BANKING ACT	NFI ACT
Failure by a Manager to supply within the specified time a Ministerial request for information relating to the financial position of the institution in Trinidad and Tobago	A fine of $1,500	A fine of $1,000
Furnishing of false or misleading information under compliance with any requirement under the Act	-	A fine not exceeding $1,000 and/or imprisonment for twelve months

The fact that they have never been imposed only serve to illustrate the impracticality of this approach which conceivably could pose a more severe threat to the stability of the financial system than the infractions which they seek to punish. As a practical matter therefore, the Bank is virtually toothless with regard to its powers of enforcement.

In other jurisdictions the need to provide the authorities with specific powers of enforcement has long been recognized. In the United States for example the federal banking agencies can not only levy fines for contraventions of specific statutory provisions, but are also equipped with the power to issue cease-and-desist orders against violations of regulations or unsound banking practices. The authorities can go as far as to suspend or remove directors, officers and other individuals for wrongful conduct. Not only are similar provisions missing from the banking statutes of Trinidad and Tobago, but this has been compounded by a conspicuous failure or inability to prosecute under criminal law persons whose deliberate and reckless violation of banking prudence has resulted in the outright failure of financial institutions.

The supervisory arrangements are subject to similar limitations. The terms of reference of the Inspector of Banks are limited to making recommendations to the Central Bank and the Ministry of Finance with respect to the issue of licences, ascertaining and reporting on the financial condition of regulated institutions and monitoring compliance with the banking and non-banking legislation. The Inspector has no power of enforcement or sanction and his supervisory authority is closely delimited. The inability of the Inspector to compel compliance is not in itself problematic since, notwithstanding the fact that he is

appointed independently by the President, he is for all practical purposes an agent of, and reports to the Central Bank. The crux of the problem lies in the Bank's own powerlessness and only by extension that of the Inspector.

These fundamental deficiencies in the enabling powers of the Central Bank are only part of the problem. At the operational level bank supervisors confront the problem of the fungibility of accounting standards and practices within the limits of 'generally accepted accounted principles'. In practice, individual banks and other financial institutions adhere to widely varying conventions and standards of, for example, loan classification and provision. Thus a non-performing loan in one institution could easily be classified as 'performing' in another. Policies and practices may also differ with respect to the accrual of interest on non-performing loans, seriously impairing the ability of the Inspector to assess the true condition of financial institutions or, at the very least, complicating the task.

The growing resort to off-balance sheet financing (OBF) techniques has introduced an additional element of ambiguity to the task of bank supervision. In one of its more popular manifestations the OBF technique involves the transfer of assets or liabilities from one company to another, the transferee in most cases being a newly established creature of the company making the transfer. The acceptability and accounting legitimacy of this technique is illustrated by the fact that it was employed by the regulatory authorities themselves in structuring a solution to the Workers' Bank crisis in Trinidad and Tobago. However, to the extent that the associated risks are not fully and clearly

transferred they remain a contingent liability of the transferor with implications for, among other things, the determination of capital adequacy in relation to risk. The absence of uniform accounting standards for purposes of bank supervision and the inability of the regulatory authorities to compel them constitute some of the most glaring inadequacies of bank regulation and supervision in Trinidad and Tobago.

CONCLUSION

The financial disruptions that have affected Trinidad and Tobago in the 1980s owe a great deal to the tardiness and the reactive nature of regulation and supervision. This factor has also worked to increase the costs of financial disruptions when they have occurred. Priorities for reform include the need to unify the financial legislation, improve the general and specific powers of the regulatory authority and standardise accounting practices in regulated institutions.