Strengthening the Regional Financial Stability Architecture and Building Capacity in the Caribbean

BY

Dave Seerattan

Presented at the Joint CCMF/CARTAC Conference on
FINANCIAL STABILITY, INTERCONNECTEDNESS AND RISK ASSESSMENT IN THE CARIBBEAN

The Hyatt Regency Conference Centre
Port of Spain
Trinidad and Tobago
19-20th March 2015

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. Possible enhancements to the regional financial stability architecture
6. Summary

Defining financial stability architecture

- The regional 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 regional financial stability
- The regional financial stability architecture should involve
  - Institutions - regional committee(s) or new institution(s) with a specific mandate for regional financial stability
  - Monitoring and reporting systems - RFSR
  - Decision making frameworks – executive protocols for intervention at the regional level (common resolution framework)
  - 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 executive action which require use of public funds
- This regional structure would be built on the domestic architecture of member countries which would need to be buttressed by:
  - The increased harmonisation of laws
  - Implementation of consolidated supervision
  - Creation of institution-specific supervisory colleges
  - The development of MOUs to facilitate information sharing among regulators;
  - The institutionalisation of a governance framework to monitor cross-border entities in normal times and to address problems when institutions are under stress; and
  - The development of common resolution frameworks

Structure of the Financial System in the Caribbean

- Key features of the Caribbean financial landscape
  - The presence of large and entrenched conglomerates and financial groups
  - Increasing regional financial integration and the intensification of cross-border financial activity
  - Regional financial markets are still relatively thin and underdeveloped
  - The commercial banking sector dominates
  - Diversity in regulatory and supervisory systems in the Caribbean
- This complex, concentrated and interconnected system coupled with markets that are still relatively underdeveloped and legislative and regulatory system which are not homogenous complicates the task of designing suitable financial stability structures at the national and regional levels
- The development of the regional architecture is now critical since the CL Financial crisis and other crises around the world thought everyone 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

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 models of financial stability architecture has evolved (Nier, Osinski, Jacome and Madrid, 2011) with different models differentiated by factors such as:
  - The degree of integration of the central bank and other supervisory agencies
  - Ownership of the macro-prudential 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 - There are three basic types the *fully integrated, "twin peaks"* and *no integration* regulatory models
  - An IMF survey in 2011 indicated that most emerging and developing countries use a partially integrated
  - 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

- 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

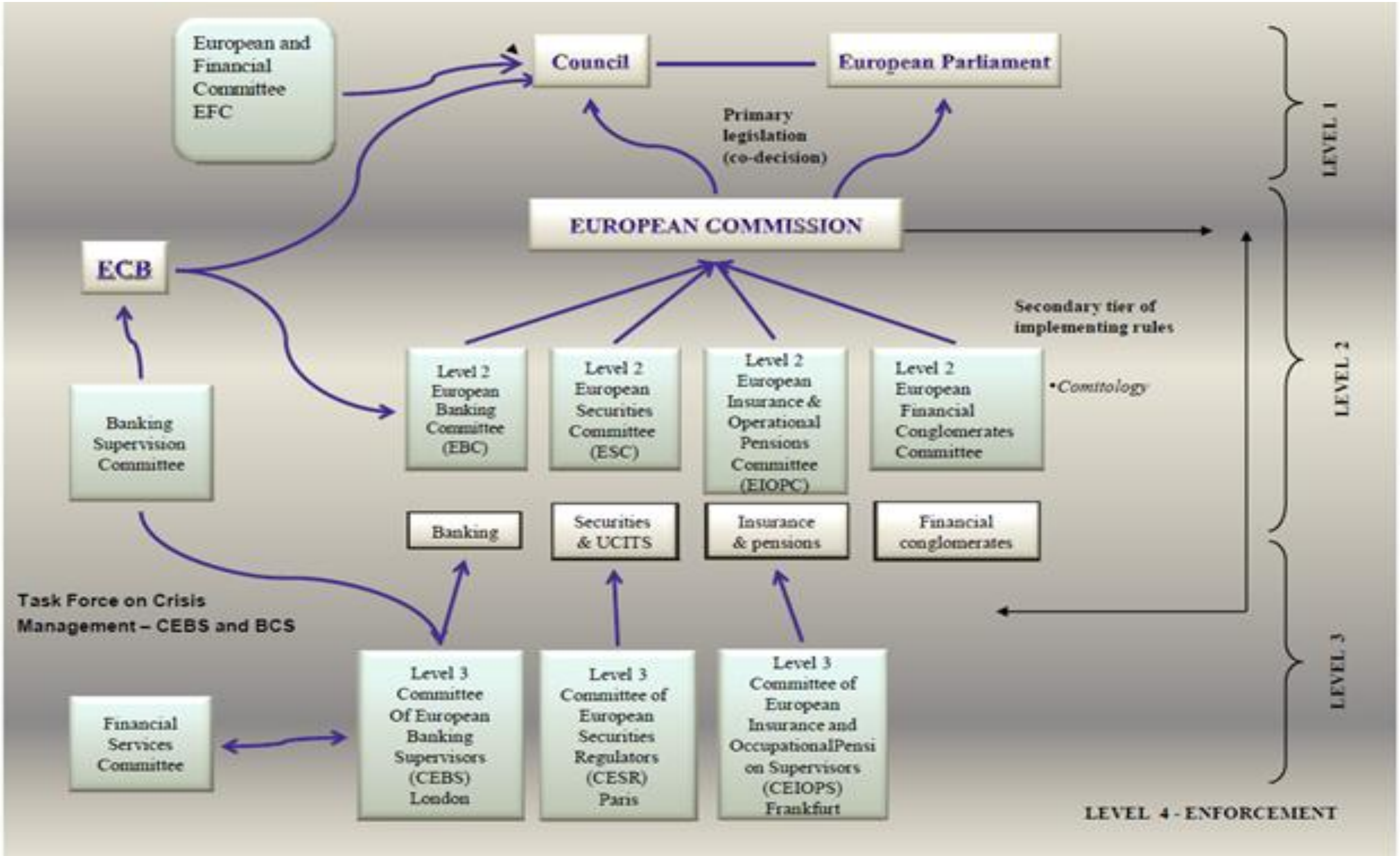
- Accountability for their macro-prudential role done mostly through the publication of FSRs but can also involve testimony before the parliament and the publishing of information on its decision making process but generally only in cases where the financial stability mandate is codified in statute

Models for the development of financial stability architecture

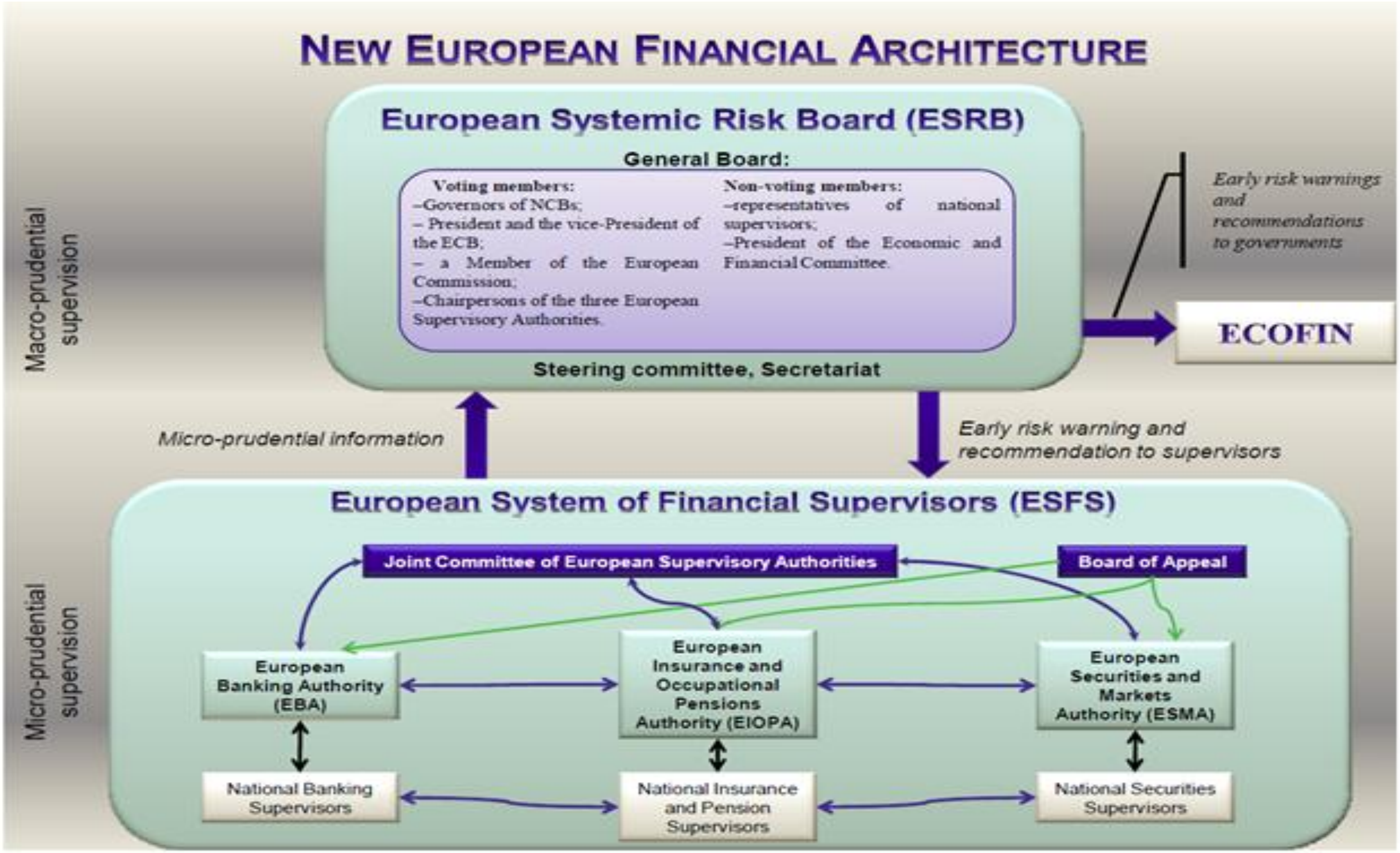
Table 1. Stylized Models for Macroprudential Policy

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)

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 meant that coordination problems could pose significant challenges
- Model 1 had more accountability built in since it reported to the European Commission and Parliament but more susceptible to political factors 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 was 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

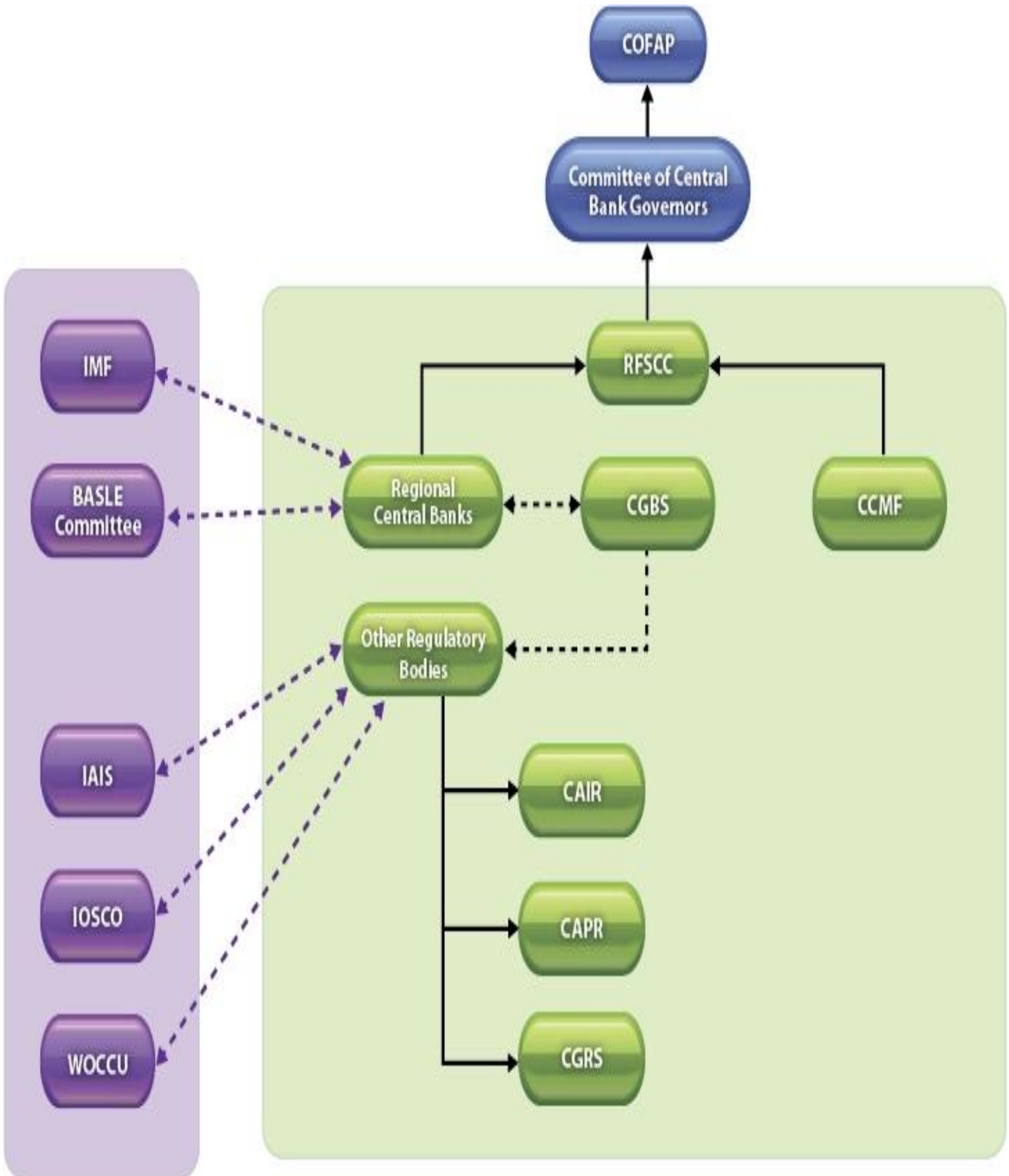
Advantages

- The CARICOM Group of Central Bank Governors is a natural regional forum which could serve as the basis for a wider regional committee that could sit at the apex of the CFSA – *Similar to the ESRB*
- The existence of regional regulatory associations (CGBS, CAIR and CGSR) which can help to promote consensus on regional financial stability issues
- Improvements in the national financial stability architectures in the region
  - The creation of dedicated financial stability units
  - Improved institutional capacity trough training and data development
  - The formation of national financial stability committees
  - The setting up of regional supervisory colleges
  - MOUs to facilitate information sharing between different jurisdictions
  - 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
  - IADB funded project on financial risk assessment in the Caribbean
  - IMF Caribbean regional financial project focusing on financial interconnectedness
- Long standing efforts to develop the regulatory and supervisory systems
  - Update financial legislation
  - Strengthen regulatory and supervisory frameworks
  - Increased harmonisation of laws
  - The implementation of consolidated supervision

Possible Caribbean financial stability Architecture

- The governance framework for cross-border regulation and supervision should be headed by the committee of CARICOM central bank governors who would
  - Receive periodic reports, including the regional financial stability report
  - Advise the Council of Finance and Planning generally on systemic regional risks
  - Devolve into sub-committees of relevant governors (SCOG) to form in association with the relevant supervisory authorities a regional crisis management group (RCMG) if there are cross-border implications
  - The RCMG, under the *chairmanship of the governor of the home country* of the problem institution, will coordinate the actions necessary to resolve the situation
- Additional regional financial stability architecture governance elements:
  - A cross-border coordinator (CBC) who will serve as the Liaison between the relevant sub-committee of governors (SCOG)
  - A domestic standing group (DSG) in each jurisdiction responsible for managing crisis
- The CBC assumes operational responsibility include:
  - Ensuring the sharing of information among the relevant jurisdictions without delay
  - Assessing the systemic nature of any problem and its cross-border implications
  - Ensuring all relevant parties are informed of the assessment process its outcome
  - Coordinating the public communication process and ensuring that public communications are shared among stakeholders before release to the public
  - Updating and distributing contact list details of relevant parties when a problem emerges
  - Responding to enquiries from other supervisors/parties at a cross border level

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 have to be included at the level of the committee of central bank governors in a broader oversight committee
- COFAP may 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