Department of Management Studies, UWI, Mona

Working Paper

Financial regulation and the CSME

Jenifer Daley and Shirley-Ann Eaton[1]
November 2005

Abstract

In 1973, CARICOM Heads of Government agreed that in order to survive, it was necessary for CARICOM member states to strive for integration. The decision to establish the CARICOM Single Market and Economy (CSME) with effect from 1 January 2005, makes this paper particularly apposite. The paper seeks to address, from a public policy perspective, questions surrounding the influences on the capacity of regulators and supervisors to regulate financial markets as well as their ability to identify and measure potentially problematic risks in order to safeguard the financial environment. In particular, the paper seeks to highlight the implications for individual territory independence and behaviour. The paper proposes a template of a model regulator to address critical success issues for effective regulation within the CSME. In doing so, consideration will be given to the practical developments that have taken place up to now as well as to the legal and institutional implications of these proposals internationally.

This brief analysis aims to provide a concise, yet rigorous, examination of the issues underlying Chapter 3 of the Revised Treaty of Chaguaramas, pertaining to financial integration. The examination focuses on the most significant changes that are expected to result in financial regulation and the implications for policy making and financial stability. This non-mathematical discourse relies on recent publications on the related issues and integrates the theoretical contributions from various academic debates. As part of the process, the paper will address, from a public policy perspective, the urgency for CARICOM regulators to proactively identify and measure potentially problematic risks in order to safeguard the financial environment in a liberalized, 'regionalised' and single economy context.

[1] The views expressed are those of the authors and do not necessarily represent those of the University of the West Indies or the Department of Management Studies.

1 BACKGROUND AND INTRODUCTION

Globalisation has forced economies to become more interdependent. This interdependence has been evident in the formal organization through legal treaties establishing, for example, the Caribbean Common Market (CARICOM), the European Union (EU), the Central American Common Market (CACM), the North American Free Trade Association (NAFTA), and, more recently, the CARICOM Single Market and Economy (CSME). The effects of this increased interdependence facilitate the strengthening of economic ties among members and mandate government policy that takes into account implications beyond geographical borders. Increasing globalisation has also been accompanied by a record number of bank failures and other incidences of financial instability in many developing as well as developed countries during the decades of the 1980s and 1990s. These outcomes were primarily the result of structural changes within banking systems and financial markets in the face of unprecedented financial innovation and liberalisation in the 1980s. Today, the issue of financial instability and bank failures continue to engage much of public policy debates in countries all over the world.

As increased attention is being directed to improved operational performance within financial markets through restructuring following periods of distress and crisis, efforts are being intensified to operationalise the single market programme for the Caribbean region. This single market is intended to remove barriers to competition and to encourage factor mobility in financial and related services within the regional financial markets. These measures should enhance the efficiency in the allocation of resources, particularly as the mobility of capital increases. For the member states of (CSME), harmonization is a key tool to support the various policies and legislative activities relating to the integration of the internal market environment, consumer protection, information technologies, and competitiveness. In order to facilitate the exercise of the rights provided for in the CSME, provisions have been made for the adoption of appropriate measures for '… the establishment of market intelligence and information systems in the Community' as well as '… harmonised legal and administrative requirements for the operation of … [financial] entities' (Revised Treaty of Chaguaramas, Article 44). Undoubtedly, financial integration and harmonization bear several potentialities for CARICOM member states. In order to optimize the potential benefits and minimize the effects of the challenges, priority attention must be directed at securing the appropriate institutional structural foundation to support the integration process. This would engender strong and robust financial markets that are critical for economic development. Financial markets must therefore be properly managed to control the factors that influence growth in an increasingly globalised world to and ensure that growth proceeds in an orderly manner.

1.1 Research scope and methodology

In the Caribbean, commercial banks alone comprise on average more than sixty per cent of total financial sector assets.[2] Any financial sector policy must therefore have the stability and development of the banking sector as one of its primary goals. In this regard, it is instructive to examine what is the appropriate structure for financial regulation that will assist in the creation of well-developed and efficient markets and stable financial systems within and across CARICOM member states. Some of the fundamental questions arising from this are: What is the objective of 'harmonisation' of financial regulation as it has been conceived by policy makers and how is it expected to function in a practical sense bearing in mind the diversity among member states? Is harmonization of financial regulation enough to secure a safe and sound regional financial environment? The hypothesis is explored that a single regional coordinating regulator (though not necessarily uniform rules) is a necessary precondition for an appropriate financial regulatory framework within the CSME to secure financial stability.

This paper seeks to identify and highlight the challenges facing international financial regulation today, particularly as envisioned in a context of harmonisation across Caribbean states. In addition, the paper

[2] In fact, Haynes (2003) states that banks places the figure at between fifty-one and seventy-two per cent.

will, using the template of a model regulator, identify exactly what the key regulatory tasks in an integrated financial market might be and thereby develop proposals as to how they might best be performed. In doing so, consideration will be given to the practical developments that have taken place to date, noting the legal and institutional implications of these proposals. Specifically, output from the research aims to contribute to the debate as to what should be the optimal objectives for financial regulation within the CSME as well as contribute to the definition of a broad policy framework for financial regulators and supervisors across CSME member states.

This study employs a thematic examination of a series of questions and issues: What is the rationale for financial regulation? How will the recommendations of the Revised Treaty in relation to financial regulation be given effect in a practical sense? What are the implications for financial stability? What is the recommended regulatory response? In addressing these questions, some of the other key questions/issues investigated are: What is the role of regulators in the prevention of financial system instability? What are the implications of the divergence among CARICOM member states? Comparative analyses are undertaken to help to identify the specific underlying issues and peculiarities and to attribute causal relationships, where necessary.[3] It will also involve a review of extant and proposed legislation including the governing Revised Treaty of Chaguaramas.

The paper proceeds as follows: Section 2 gives a brief summary of the relevant literature on integration and regulation. In Section 3 is an outline of the data sources, while section 4 analyses the issues as it relates to financial integration, financial regulation and financial stability. Section 5 presents a comparative analysis and recommendation as the optimal regulatory structure for the CSME. Conclusions and policy recommendations are summarised in Section 6 in the form of policy initiatives to be pursued and policy questions to be addressed in measures aimed at effective financial regulation within the CSME.

2 LITERATURE REVIEW

2.1 Financial integration

Theory indicates that countries may gain from tighter economic integration. Definitions of financial integration in the literature fall somewhere on a continuum depending on the author's primary focus on functions, institutions or instruments. For example, two alternative measures of integration presented by Llewellyn focus more on instruments:

> … the extent to which arbitrage capital flows induce equilibrating movements in the spot exchange rate (1980:1) and
>
> … the extent to which interest rates in different financial centres move in parallel (1980:2)

Llewellyn (1980) notes that the degree of financial integration that has been achieved between countries is due, in large part, to increased international capital flows.
Noting some of the debated drawbacks of globalisation, Benn and Hall (2000) make reference to the notion of 'strategic' integration echoed in some quarters. In this context, integration would take place in a piece-meal manner with those sectors that are considered more capable of competing in globalised markets being strategically integrated in the first instance.

[3] It should be noted here at the outset that this analysis does not address the suitability of, or deficiencies inherent to, integration *per se*, nor does it address the problems relating to the implementation of a single market and economy. Rather, the analysis seeks to highlight the effect of financial integration and harmonisation of financial laws on the function, structure and stability of financial regulation. This paper is guided by the view that the financial industry within any economy must be understood in terms of the quantitative as well as the qualitative factors that influence performance and, ultimately, stability.

This papers adopts the definition of Galindo et al. who define financial integration as:

> … the process through which a country's financial markets become more closely integrated with those in other countries or with those in the rest of the world. It implies the elimination of barriers for foreign financial institutions from some (or all) countries to operate or offer cross-border financial services in others. This may imply linking banking, equity and other types of financial markets (2002:101)

In addition, Galindo et al. (2002) highlight the main alternative routes to financial integration: formal financial integration agreement between countries or *de facto* integration occurring on a country by country basis through the adoption of international standards. Galindo et al. (2002) note the complementary nature of both approaches at both the country and regional levels.

Fostered by the accelerated pace in globalisation, many countries have found it beneficial to integrate economically in one or more ways – and others, politically as well – in order to strengthen their bargaining power in trade negotiations and to allow them to become more adaptable to changing economic situations within the international environment. Among the benefits to the financial sector that may be secured by integration is greater diversification within and across financial spaces resulting in investment risk reduction, increased competition and lower transactions costs. This will promote greater efficiency, a reduction in margins and a more efficient payments and settlement system as the benefits of technology are exploited. Other benefits include: secure access to larger markets, lowering of trade costs for members, increased foreign direct investment (FDI), the establishment of a framework for regional cooperation. economies of scale and scope, and a mitigation of the 'brain drain' (often a casualty of developing economies) due to increased opportunities within the integrated region.

Financial integration has significant implications for financial regulation as well as for the conduct of monetary policy in the wider context. Llewellyn notes that:

> The extent of financial integration has a major bearing upon both the effectiveness of monetary policy in any one country and the extent to which individual countries are able to pursue a monetary policy strategy independently of that of countries. Increasingly, monetary policy has had to be framed within the constraints imposed by a high degree of financial integration in the world economy (1980:1).

In general, efficiency in financial markets should be enhanced through integration facilitated by increased capital mobility. The result will be increased access to lower cost capital, convergence in asset prices in the different member states, increased financing for investment, and increased diversification and consequential reduction in risks. It is clear that the integration of Caribbean economies has the potential to assist in the strengthening of domestic financial systems by encouraging sound regulation and supervision, greater transparency, and more efficient and robust institutions, markets, and infrastructure. Integration and its attendant results may also influence financial stability through facilitating better-informed investment and lending decisions and by its impact on market integrity and contagion. Furthermore, Galindo et al. (2002) note additional advantages in terms of reducing regulatory forbearance (within a context of a supranational regulator that is insulated from influential local interests) as well as avoiding regulatory arbitrage. At the firm level, advantages will be evident in better quality loan portfolios since it is expected that credit risk is inversely related to the number of clients.

Notwithstanding the potential benefits particularly as it relates to increased capital mobility, theory indicates that there are downside risks, the extent of which is dependent on a country's ability to adjust to the shocks. In the first place, unrestricted capital movements can lead to lending booms and cause

banking crises. This is particularly critical in the Caribbean region since these small, open economies are highly susceptible to financial volatility. The impact of these deleterious credit effects is, ultimately, financial system instability. Surges in capital flows resulting from liberalisation may also lead to the 'twin crises' (bank and currency crises) – as in the case of East Asia in 1997 or Mexico in 1994 – unless reversals are adequately managed (see, for example, Kaminsky and Reinhart, 1997). Notably, shorter-term capital flows, while also contributing less to economic development, carry the most risk as they tend to be more volatile, are subject to more speculative/confidence reversals and have a closer interaction with the financial markets. This was evidenced in Argentina and Mexico over the period 1990 to 1996 (see, for example, World Bank, 1998).

The recent experiences in Mexico, Jamaica and South East Asia have been costly both in economic and socio-economic terms. In Jamaica, for example, the cost of the banking crises of the 1990s was estimated at forty *per cent* of Gross Domestic Product (GDP). As such, integration must be premised on the establishment of a suitable institutional framework. In fact, Galindo et al. go further. They state that:

> Ideally, financial institutions in all countries participating in an integration arrangement should adhere to similar financial regulations. Such harmonisation ….can attract foreign players … [and] can improve the stability of the financial system (2002:104).

Historically, financial integration in the Caribbean has come mainly in the form of the establishment of foreign banks from developed countries operating concurrently in several countries in the region.

2.1.1 Caribbean integration in context

In a study conducted jointly with the Caribbean Centre for Monetary Studies (CCMS), the World Bank (1998) strongly supports a call for Caribbean economic integration as a prerequisite for financial sector development. Integration of economic and, possibly, political systems, will constrain the Caribbean Community to seek to find creative ways of optimising the benefits of, *inter alia,* revolutions in technology, liberalisation of financial markets, and globalisation. The recent thrust towards an integrated Caribbean Community is by no means novel. The first major attempt towards Caribbean unity in the twentieth century was manifested via the short-lived West Indies Federation in 1958. Subsequent thrusts towards Caribbean integration were propelled by the efforts of politicians, statesmen and businessmen who were of the view that a paradigm shift was necessary since a fragmented Caribbean 'could not find its way in the world' (Hall, 2000:11). It is noteworthy that despite the failure of the initial efforts at integration and the hiatus before the second major phase, the major motivating force for strength in unity was not abated by the shift in focus. Hall notes that:

> … the philosophical outlook of the founding fathers and the early leaders of the Community was shaped by a different environment and a different experience. In their time, the overwhelming consideration was the question of sovereignty, in both political and economic terms. … The development of the Community is now seen as requiring a more liberalised trade regime where protectionist measures are abolished and where the thrust of the activities of the Community is more driven by the need for a secure place in the changed global economy (2000:5).

Notwithstanding, the common thread in the thought process was that, despite their differences, unity was a necessity for the Caribbean economies to ensure survival. Of the three most important studies conducted to examine the prospects for the Caribbean Community in the new millennium, it was the measures outlined in the West Indian Commission of 1992 that formed the basis for what have now become pillars of the CARICOM Single Market and Economy.[4]

[4] The other two important studies are The Group of Experts Caribbean Report (1981) and the Bourne Commission Report (1988).

Since one of the primary reasons underlying the notion of integration is founded upon considerations of financial sector development (and therefore financial stability), there is therefore an inextricable link between economic integration and financial regulation.[5]

2.2 Financial Regulation

The rationale for regulation has been intensely debated and is well established. Bank regulation and supervision involves the employment of techniques and resources to protect the interests of depositors, and the preservation of financial stability (Hall, 1993). There is a distinction between regulation and supervision and, as proffered by Llewellyn (1986), bank regulation is:

> A body of specific rules or agreed behaviour, either imposed by government or other external agency or self-imposed by explicit or implicit agreement within the industry that limits (governs) the activities and business operations of financial institutions,

whereas supervision is:

> … the process of monitoring that institutions are conducting their business either in accordance with regulations or more generally, in a prudent manner (1986:9).

The regulation of banks may be effected *via* a country's central bank or by any other agency authorised to enforce regulatory standards and act as a supervisor, such as a banking commission. In some countries, these regulatory bodies possess legal independence from the polity. The functions of regulation may be classified by regulatory activity into: a set of preventative strategies and policies employed for bank safety and soundness reasons that are designed to limit risk-taking by banks, and a protective dimension that focuses on activities such as deposit insurance that offers protection to depositors in the event of failure of banks. Theoretically, there is no standard system for structuring the regulation and supervision of banks. Six main forms of regulation, utilised individually or in any combination, that determine the ethos of regulation in most countries, are summarised in Table 1.[6]

Table 1 Forms and Areas of Regulation

[5] Brownbridge and Kirkpatrick (2000), for example, record substantial empirical evidence to demonstrate the crucial role played by the development of financial markets and institutions in economic growth and development.

[6] In this paper, normative theories of banking regulation are not considered: no attempt is made to debate the best type of regulation whether private or public, an agent of the government or independent, the form the regulatory agency should take, whether the regulatory body should possess discretionary or non-discretionary power, or what approach the regulatory activity should take (Mishkin (2000) argues in favour of the less rigid 'supervisory approach,' relative to the rules-based 'regulatory approach').

FORMS OF REGULATION	**Environmental**	**Legal**	**Self-Imposed**	**Moral suasion**	**Self-regulation**	**External Agency**
	Financial firms are constrained by broad monetary policy	Statutes constrain the business activity, for example distinctions between banking and insurance	Imposed by choice of individual firms or by the industry to restrict their range of activities or range of businesses	Regulation emerges through the general authority of the central bank	An agency of the banking industry is given formal and legal authority to regulate the business of the industry	An 'independent' body is given authority to regulate and monitor the business activity of the industry.
AREAS OF REGULATION	**Geographical**	**Functional**	**Ownership**	**Pricing**	**Entry/ Establishment**	**Business Operations**
	There may be, for example, restrictions on inter-state banking as in the US.	Prescribes permitted activities for different firms such as banking or insurance	Details restrictions on amalgamations, for example between different types of business activities to limit conflicts of interest and concentrations of power.	Restricts the setting of interest rates and charges	Governs licensing and possibly the establishment of foreign firms. Usually controlled via minimum capital requirements and required management qualification	Govern the overall conduct of the business, for example, in relation to capital and liquidity requirements.

Source: Llewellyn (1986).

The economic and financial literature widely supports the view that regulation and supervision play a significant role in the efficiency and stability of the financial system (see, for example, Gavin and Hausmann, 1996; Goodhart et al., 1998; Caprio et al., 1998). Because the assumptions of perfect competition - many willing buyers and sellers and perfect information about the goods or services involved in each transaction – do not always hold, regulation is imposed to eliminate or, at least, mitigate, information asymmetries, moral hazard and adverse selection. Any undue advantage that one party to the transaction has over the other can lead to market failure, as can an inadequate number of sellers or a complex product. Generally speaking, financial regulators are relied on to provide authorisation of market participants; surveillance and supervision to ensure adherence to regulatory codes; enforcement of the punitive measures for non-compliance; timely and relevant adjustments to regulations; and the provision of information to enhance market transparency (see, e.g., Nicholls and Seerattan, 2004).

Financial regulators and supervisors are particularly concerned, ultimately, with regulatory capital and its underlying risks. High on the priority list are concerns regarding, for example, solvency, liquidity and capital adequacy.

The dynamic nature of the financial services sector presents a challenge to regulators and policy makers worldwide. Of particular note is the need for policy formulators and regulators to bear in mind the interrelationships at work within the financial system, and between the financial system and the wider economic systems. A review of the literature has indicated that regulator constraints and incentives have played a role in influencing the occurrence and, possibly, the extent of bank failures. Miller notes that:

> … relatively severe epistemological and political factors inhibit policymakers' ability to devise appropriate responses to the danger of banking crises. Even though we can often understand what happened in retrospect, taking the necessary concrete actions to prevent a crisis from occurring *ex ante* is much more difficult (1998:282).

Poor, inadequate, or otherwise ineffective regulation has frequently been proposed as one of the main factors why banks fail. This highlights the significance of the symbiotic relationship between financial regulation and financial stability.

3 DATA

This study utilised secondary data primarily in the form of legislative rules and codes of individual CARICOM member states as well as legislation specific to the CSME. Specifically, the study relied on the provisions of the Revised Treaty of Chaguaramas and a Draft Financial Services Agreement (FSA) that has been prepared to guide the harmonisation of the regulation and delivery of financial services across CSME member states. Recent legislative amendments giving effect to the provisions in the revised Chaguaramas treaty have also been utilised.

4 ANALYSING THE ISSUES

4.1 Financial Regulation and Integration - Core competences for achieving financial stability through effective regulation

The need for an appropriate institutional structure is a recurring theme in the debates and discussions about Caribbean integration. This is because policy makers acknowledge that while the potential benefits of integration are being stressed, these goals are meaningless if considered in isolation. The potential gains in terms of efficiency in resource allocation and deepening of financial markets, for example, for CARICOM states will be stillborn if due consideration is not given to the wider institutional structure and the regulatory environment within which market participants operate. This theme draws attention to the nature and character of the regulatory and supervisory environment within which banks and other financial entities operate and the entities themselves.[7] Indeed, one of the main reasons that has been suggested for the recent banking crisis in Jamaica is the lack of an adequate regulatory framework to support initiatives to relax regulations imposed on banks (see, for example, Daley, 2002). In recognition of the potential for regulations to secure the conditions for preventing certain events that led to the recent crisis, new provisions have been introduced and existing statutes governing the operation of banks and other financial entities in Jamaica have been amended. In focusing on the consequences of the existence of institutions, this paper supports the view that the presence of institutions in society reduces the level of uncertainty by 'establishing a stable structure to human interaction' (North, 1990:6). What, then, are the preconditions for this institutional regulatory structure that would foster a stable, secure and efficient financial system? In supporting the view that there is a greater need for regulation in developing economies than elsewhere, Goodhart *et al*. (1998) note that:

> Externally imposed rules and ratios should be relatively *more important* … since less reliance can be placed on internal mechanisms (1998:104).

These considerations are especially important because the precise mechanisms through which regulation is effected is critical to the level of success achieved; identifying those mechanisms for the CSME is the main aim of this study.

Linked to the question of adequate or effective regulation is the question of government involvement and political influence in the regulatory process, which is reflected in regulatory forbearance. The frequency and severity of this problem is generally greater in developing countries, where the impact of powerful private interests is stronger, and where there is a threat of legal repercussions on the actions of regulators with respect to intervention in, or closure of, problem banks (Goldstein and Turner, 1996). With this in mind, there is therefore a need to implement measures in these countries that can effectively reduce

[7] It should be noted that while the stability of the financial sector is being stressed as critical to economic development, this study focuses primarily on banks because of their dominance in the financial sectors across CARICOM.

regulatory forbearance. In noting the peculiarities of regulation for developing countries, Goodhart *et al*. (1998) highlight that there is considerable potential advantage in simple and straightforward regulations. Amongst the new initiatives that are being taken by regulators and supervisors that may be useful in this respect, are structured and quantitative assessments of the financial performance of banks. These include the use of risk assessment systems, and 'early warning' systems to generate timely warning, and rules-based regulation and supervision such as 'prompt corrective action' (PCA) schemes to initiate warranted action by supervisors. Davies and McManus (1991) find that reducing regulatory forbearance may be more effective when efforts are supported by restrictions on risk-taking by banks.

The argument that is proposed is that an important prerequisite for effective regulation is a reporting environment founded upon robust regulatory safeguards. (Moskow in Caprio) Regulation should be goal-oriented and seek to accomplish those goals efficiently. It is incumbent on regional policy makers to respond in like manner to the dynamism evidenced in financial markets and to establish the appropriate platform for securing financial stability. In other words, regulation should evolve as technology improves and the structure of the financial markets change.

There is also a critical need for sufficient mechanisms for enforcing prudential requirements and for improving the intelligence of regulators generally. Since the 1980s, bank regulators and supervisors have had to adjust to more sophisticated supervisory methodologies for monitoring and assessing banks in a potentially riskier and more complex, competitive, and volatile market environment. Certainly, the approach and conduct of supervision will vary in terms of its extent, scope and frequency, as well as in the effectiveness of its monitoring surveillance available in any particular country. This is particularly critical in developing countries where 'the regulatory capacities are weaker and information is poorer' (Stiglitz, 1999:1514). Generally, internationally accepted standards are usually considered to be more effective at promoting sound domestic financial systems and international financial stability, since these standards are considered to be more objective and relatively free of national biases (White, 1996). Consequently, it is expected that the adaptation, adoption and successful implementation of international standards and provisions such as those proposed by the BCBS (frequently referred to as Basle I and Basle II) will yield both national and regional benefits.[8] Within these principles are provisions that address many of the factors to which financial system instability in developing countries has been adduced: insufficient levels of capital to support risk-weighted assets, high levels of non-performing loans, poor corporate governance, poor liquidity management and poor risk management within financial firms.

In addition, the use of an appropriate 'early warning' system to complement 'traditional' regulation would significantly enhance the effectiveness of regulators' surveillance through systematic assessment within a formalised framework on an on-going basis. It would facilitate the effective identification of weak or potentially weak entities, the prioritisation of examinations between 'weaker' and 'stronger' entities, and the initiation of timely remedial action. In addition, integration requires a clear outline for the financial markets infrastructure as it relates to the establishment of an efficient payments and settlement system, which is also critical to a well functioning regulatory framework as this will increase efficiency, decrease transactions costs, and increased reliability and transparency will reduce risks.

In addition to potential boom-bust cycles, it is possible that market failures in one part of the region or in other regions can have contagion effects on individual states or the region as a whole, particularly where institutional support is weak. Although it may be argued that the operationalisation of integration activities is determined by the availability of adequate funding, policy makers will need to acknowledge that the strategic planning and timing of the implementation of the various integration activities is of

[8] It can be questioned whether the optimal regulatory framework for developing countries is equivalent to that for more developed countries. This study supports the view of Goldstein and Turner (1996), Stiglitz (1999) and others who propose that the regulatory framework for developing countries may need to show marked differences because the risks are greater. The issue of 'adaptation' is therefore a very important one.

utmost importance as is the need to proceed carefully with integration activities. This is because weaknesses in a local financial system or in macroeconomic policies may be exacerbated and may affect other economies. Regulation provisions and practices should be such that the effects of any such contagion are eliminated, or at the very least, mitigated. The World Bank notes that:

> Since the capacity to implement such [regulatory] policies and their effectiveness may not be perfect, this approach must be pragmatic and take account of developing countries' specific conditions (1998:150).

In other words, policy makers need to be cognisant that the relative importance of different standards and practices to individual economies will depend on the individual country's financial structure and other domestic circumstances. Implementation must fit into a country's overall strategy for economic and financial sector development, taking account of its stage of development, level of institutional capacity, and other domestic factors.[9]

As regards the protective dimension to regulation, attention should be devoted to the potential implications for deposit insurance and the related portability of risks within the context of a fixed rate deposit insurance scheme. Considerable scope exists for shifting the incentive structure facing bank owners and managers, as well as depositors, so that excessive risk-taking is penalised. Whilst it is in the interest of stability to establish protection in the form of deposit insurance, the scheme must be so designed that the extent of coverage, administration of the fund, and the moral hazard it induces (manifested in the pricing of the premia) are effectively managed so as to reduce the frequency or extent of bank failures.

4.2 Additional Policy Prescriptions for optimal regulatory performance

The Caribbean region by its very size and nature – small, thin, under-developed markets – is inherently fragile and susceptible to shocks and financial volatility. This paper supports the view that legal reform *per se* is insufficient to secure or restore the stability of a financial system. The World Bank supports this view and highlights the importance of macroeconomic stability to financial stability:

> In trying to ensure a safe and sound banking system, it is a fundamental error to rely on regulation and supervision alone. If the banking system is structurally vulnerable and if the economic environment is highly volatile, no amount of regulation and supervision can prevent banking problems. Minimizing macroeconomic volatility through sound fiscal and monetary policies, is the basis for a sound financial sector. It is no coincidence that the economies that have achieved macroeconomic stability also have the healthiest banking systems (1998:20).

What is needed, then, is a whole concatenation of policies, tools, and techniques that are applied with sustained purposefulness. Central to these structural prescriptions noted above is the imperative for CARICOM financial policy makers to further commit to address accounting and other rules that directly and indirectly influence financial regulation and supervision. Of course, further enhancement is required in the form of continual reassessment and modification and by enforcing punitive measures for non-compliance.

4.2.1 Financial regulation, financial stability and disclosure

[9] This line of thinking implies the rejection of the idea of the wholesale adoption of (regulatory) policies and practices for use in less developed countries, for example. This is in sympathy with North's non-transferability of rules across societies due to the influence of history and informal constraints (e.g. attitudes, norms, culture), *inter alia*, on outcomes (see North, 1990).

First, there is a definite need for greater transparency and enhancement of the disclosure of key financial information to facilitate more informed decision-making, and to assist regulators in carrying out their responsibilities. The importance of timely and accurate information within individual financial entities as well as a fully developed culture of transparency and accountability cannot be overstressed. In recent years, much more importance has been placed on enhancing the relevance, reliability, comparability and understanding of information disclosed by banks and other financial entities throughout the region (World Bank, 1998; BoJ, 1998). Furthermore, continuing deregulation, increasing globalisation and the accompanying cross-border and multi-currency financial transactions, and the international transfer of capital have played an important role in catalysing the need for international financial standards to harmonise accounting practice and improve transparency. In this regard, there has been increased emphasis on the role of accounting and accountants as important prerequisites for effective regulation and efforts aimed at financial stability. This is because increased disclosure requirements cannot by themselves secure the desired results, particularly where firms have incentives to distort reported figures. Moreover, the provision of information that is readily interpretable and comparable across geographical boundaries through the process of international accounting standardisation, is likely to have positive repercussions on international capital flows, inward investment (both at a country level and a regional level) as well as the activities of the equities markets.

The Basle Committee on Banking Supervision (BCBS) underscores the importance of accounting and accountants to the regulatory process in a report to G7 Finance Ministers:

> Banking supervisors have an interest in the quality of accounting standards and their effective implementation, as a means of providing a basis for relevant and reliable measures of assets, liabilities, equity and income, as well as capital adequacy, and enhancing market discipline through transparent financial reporting. They want to ensure that the accounting standards used by banks both support and facilitate supervisors' objective of fostering safe and sound banking systems (2000:6).[10]

Considerations of financial regulation and financial stability are not only highly dependent on effective disclosure but are also inextricably linked to considerations regarding risk management, market discipline and enforcement.

4.2.2 Financial regulation, financial stability and risk management

There is a bias towards the call for more effective risk management in financial firms that is doubtlessly due to the high correlation evidenced between financial firms and excessive risk taking. The cultivation and maintenance of a culture of risk management within banks is seen by many as a strategy for both improving internal risk management as well as ensuring a more adequate recognition of the position and place of corporate governance, not only in the intermediation process but also, in the regulatory process.

4.2.3 Financial regulation, financial stability and Market discipline

There is a presumption that standardisation of information and improved transparency through increased disclosures will assist in ensuring market discipline and therefore promote financial stability. The strengthening of market discipline has long been considered as an avenue to safe and sound banking systems. Additionally, in the light of the recent collapses of Enron and WorldCom, for example, there is also a critical need for improvements in corporate governance, as firms seek to strengthen and preserve investor confidence and enhance stability.

As noted above, the implementation of standards *per se* is not sufficient to ensure financial stability;

[10] See also, Daley (2002).

standards are not an end in themselves but a means for promoting sound financial systems and sustained economic growth.[11] Successful implementation of standards also involves a process of interpretation, application, assessment, and enforcement.

4.2.4 Financial regulation, financial stability and Enforcement

Recent corporate collapses highlight the need for effective enforcement. Rigorous prudential operation requirements are meaningless if not implemented and consistently enforced. It is critical, therefore, that economies have in place an effective legal framework and infrastructure for enforcement. This concept bears heavily on the role and structure of regional financial regulation consequent on the CSME. This paper proposes the need for a single coordinating regional regulator with legally authorised oversight, administrative and monitoring powers (see below for full discussion).

Efforts at standardisation must be accelerated if the benefits of integration are to be optimised. In this regard, the challenge is for regional policy makers to be able to respond to the various demands, while balancing the issues of sequencing and timing on a national as well as regional basis. In their review of the Caribbean financial sector the World Bank noted that:

> While financial sector reforms would ideally be conducted on a regional basis as a first step towards establishing global links with international financial markets, experience has shown that it is difficult to implement reforms simultaneously. For this reason, countries should begin a process of harmonisation through reciprocal liberalisation of tax, legal, capital, and other regulations, while standardising financial sector regulators and their enforcement (1998:45).

Having established the major regulatory requirements necessary to realise financial stability, we now turn to examine the extent to which these pre-conditions have been satisfied and the implications of the developments that have taken place so far.

4.3 Financial Regulation within the CSME

Prudential regulations and supervision have a significant role to play in the stability of any financial system. It will be recalled that one of the primary reasons proffered for the market failures from the experiences of several developing countries spanning a wide geographical area was that of inadequate or lax regulation and supervision of financial entities.[12] More specifically, the market failures of the past may be attributed to intense competition in an over-banked environment that resulted in product innovation *ultra vires* the provisions of the governing legislation. Furthermore, regulators have been blamed for exercising undue forbearance in the light of unambiguous breaches of the law.

With the constantly changing financial marketplace, particularly over the past three decades, financial regulators in the Caribbean (and the world over) are faced with an increasing challenge to regulate in an increasingly risky environment where the nature and types of products have increased in variety and complexity. Of course, regulatory rules and policies in developing countries are usually an adaptation of rules and policies developed in more advanced societies and policy formulation has been, in many cases, a response to the current urgent need.

All members of the CSME subscribe to the Revised Treaty of Chaguaramas (RTC) – the governing treaty establishing the Caribbean community. In the third chapter of the RTC provision is made for '… the right of establishment, the right to provide services and the right to move capital in the Community' (Article 30(1)). Article 38 further provides for the 'Removal of Restrictions on Banking, Insurance and

[11] See also FSF – http://www.fsforum.org/Standards/WhatAre.html

[12] Jamaica in the mid-1990s, countries in East Asia in 1997/8, Mexico in 1994/5, Uganda in 1997/8.

Other Financial Services' and states that:

> The Member States shall remove discriminatory restrictions on banking, insurance and other financial services (Article 38(1))

A Draft Financial Services Agreement (FSA) prepared by the CARICOM Secretariat serves to guide the 'development and application of harmonised regional standards in the financial services sector … .' The intention is to facilitate intraregional operations and improve the delivery of financial services within the Caribbean Community (Draft FSA, 2004). The Preamble to the draft FSA acknowledges 'that the development and application of harmonised regional standards in the financial services sector are essential for the efficient operation of the CARICOM Single Market and Economy' and 'the formulation and application of internationally accepted standards and best practices on a regional basis would enhance' the sector's international competitiveness.

Members States of CARICOM have their own constituted home-country financial services supervisory and regulatory authorities. Many countries have begun a process of redefining the regulatory framework towards meeting international standards and there is similarity in approaches to the supervision of banks, insurance companies and other financial entities. Legislation governing the regulation of banks reflects congruence in licensing requirements, minimum capital requirements, statutory reserves, capital adequacy requirements, borrowing limits, restrictions on borrower groups, the identification and measurement of risks, and rules for the inspection and supervision of banks.

However, despite many common characteristics, it is clear that there is diversity in the region, particularly in terms of the degree of development and sophistication of the financial markets (see Table 1 and Table 2). To note a simple example, in Trinidad and Tobago, it is illegal to trade in a security without physical possession; in Jamaica, the Central Securities Depository (CSD) facilitates the trading in securities without ever gaining physical possession. There are also implications of differences in fiscal and macroeconomic policy, inflation and exchange rate path. These differences among CARICOM member states, resulting primarily from size, stage of development of the economy, quality of macroeconomic management and the institutional and regulatory framework, imply some level of difficulty to the pre-conditions necessary for effective regulation, consistence in the implementation of methodologies, the convergence or standardisation of cross-border regulation, and also give rise to several important legal and economic implications as regards the drive towards integration. Where the divergence in the characteristics of the various financial sectors is indicative of significant risk perceptions, this could thwart financial sector development and devalue the potential benefits of integration. At the same time, the Draft FSA speaks to measures that will "ensure parity among member states in the provision and delivery of [financial] services" (Article 44:1). It is instructive to question, how this parity will be secured in a practical sense given the divergence among member states coupled with the fact that the transmission mechanism is imperfect.

.

Table *2* CSME member states compared

Influences on Capital mobility	Bahamas, The	Barbados	Belize	Guyana	Jamaica	OECS*	Suriname	Trinidad & Tobago
population (millions -2003)	0.32	0.27	0.26	0.77	2.6		0.44	1.3
GDP (US$bn – 2003)	5.3	Na	na	0.74	8.1		na	10.5
Avg. ann. % Growth per capita GDP 2003	Na	3.2	na	-1.2	1.4	Na	na	12.4
Total Debt %GDP (2003)	Na	27.5	na	195.2	66.2	Na	na	26.2
Exchange rate regime[+]	F	F	F	FL	MF	F		MF**
Dollarisation - fx deposits fx loans								
interest rates (2002) real deposit lending	 4.6 4.3 6.0	 6.3 2.7 8.5	 12.1 6.3 14.8	 11.4 4.5 16.3	 9.3 8.6 18.5	 Na 	 -6.2 9.0 22.2	 19.3 4.8 12.5
Functioning capital market	N	N	N	Y	Y	N	N	Y
Secondary market	N	N	N	N	Y	N	N	N
Active Equity market	N	Y	N	N	Y	N	N	Y
capitalisation US$bn – 2003	-	1.8	-	-	5.8	-	-	6.5

Source: World Bank; Inter-American Development Bank.
* The OECS comprises Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts & Nevis, St. Lucia, St. Vincent & the Grenadines
[+] F- fixed, FL – floating, MF – managed float.
** Exchange rates in these countries have effectively been fixed. Exchange controls are in force in Barbados.
na – not available

Table 3 Financial regulation and supervision within CARICOM

Characteristics of Financial Regulation	Bahamas, The	Barbados	Belize	Guyana	Jamaica	OECS	Suriname	Trinidad & Tobago
Risk-based capital		Y			Y	Y		Y
Prudent loan loss provisioning (>90 days non-accural. Consistent classification)		Y			Y	Y		Y
Reserve requirements for non-banks v. banks					≠	≠		≠
Independence of regulator/supervisor		N			N	Y?		N
separate regulator banks/non-banks								
Adoption of Basle I		Y			Y*	Y		Y
Adoption of IFRS[§]		Y			Y	Y		Y
adoption of FATF recommendations re money laundering								
Information-sharing among supervisors					Y^	-		Y
Deposit insurance explicit fixed rate - risk-based Co-insurance		 Y Y N N			 Y Y N N	 N		 Y Y N N

Source: Anecdotal evidence

[§] International Financial Reporting Standards

International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) are among twelve standards identified by the Financial Stability Forum (FSF) as critical for securing sound financial systems.[13] The BCBS, the International Organisation of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) support the spirit of the IFRS and similar efforts to harmonise international reporting standards to enhance interpretation and comparability and, as noted by the BCBS, could strengthen the link between public reporting and prudential requirements.[14] Jamaica's adoption of IFRS as of 1 July 2002 signified Jamaica's acknowledgement of the role of robust and effective accounting and disclosure standards and practices in effective financial regulation and supervision and the country's integration into mainstream accounting practice on par with world standards. Within CARICOM, Barbados, the Dominican Republic, Haiti, and Trinidad and Tobago have also adopted IFRS as the national accounting standards. Certainly, the CSME should augur for full convergence with IFRS (as well as other international standards) among member states that must recognise them as prerequisites for integrating into the world economy. Already, all member states have adopted international standards on money laundering into national law.

5 An appropriate regulatory model for the CSME

For integration to achieve the desired outcomes, it is imperative for regulation to be effective in securing stability. Regulatory policies and practices as it relates to the CSME must be developed in the context of integration, international market developments and broad monetary policy. Undoubtedly, the lack of standardization regarding financial regulatory policy, implementation, enforcement and comprehensiveness across CARICOM member states bears real and potential impact for stability. Careful examination of individual countries is needed in order to determine what are the most appropriate as well as the most practical solutions for both the country and the region at large. Within this context, there is increasing pressure for regulators, not only to develop adequate and appropriate reforms to keep abreast of developments within the financial markets, but also to enforce these reforms free from political interference. Hanohan (1997) notes that:

> Weak enforcement due to political interference is the Achilles' heel of any regulatory system (1997: 21).

The interactions within the marketplace and any resulting risks created as a result of the dissolution of geographical boundaries due to integration must be carefully managed. The ability to enforce reforms in a consistent and unbiased manner may require increasing levels of regulator independence and autonomy. This is particularly important within a context where integration is being propelled devoid of a framework of political unity. Consideration must therefore be given to the formulation, structure and administration of surveillance and enforcement of regulatory rules and codes. In what ways will these considerations be influenced by politics, legal practice and the variation among CARICOM member states in legal systems, financial structure, cultural business practices and governance arrangements? Will there be a single regional regulatory agency? Will the local regulators and supervisors have the responsibility for individual territories only? Where would the responsibility lie for regional coordination? The answers to these questions suggest either the adaptation of an existing regulatory model or the development of a model specific to the CSME. Historically, foreign banks have been a dominant feature of the Caribbean landscape and financial services linked to trade and investment flows have been facilitated by these institutions at both ends of the deals. North America and Europe remains the major markets for Caribbean goods and services and have in place institutional frameworks for banking supervision and regulation which could serve to assist in determining the appropriate institutional structure for achieving the desired integration of financial services in the CSME.

Of course, failure to reach consensus on information standards, legal systems, and corporate governance will increase the difficulty of standardising regulatory codes and undermine the efficient operation of financial markets. This will create undue risks since regulation that enhances efficiency

[13] The IASB is an independent private sector body based in the UK aimed at promoting convergence of accounting principles worldwide.

[14] See, e.g., Jain (2002) http://www.pwcglobal.com/jm/images/pdf/IAS%20to%20be%20adopted%20in%20Jamaica.pdf

in one state may expose another to a greater level of risks due to peculiarities in the environment and the resulting differential impact of the provisions on different jurisdictions (see ECOFIN, 2000, for similar views expressed in relation to the EU; Alexander and Dhumale, 2000).

This paper strongly supports the need for a designated regional regulatory authority to negotiate and agree rules and protocols for common implementation and for enforcement: A discrete set of recommendations for individual local regulators is simply not enough. The difficulties associated with this line of thinking are obvious since it suggests serious consideration of the sensitive areas of political unity and common currency, to name a few, that would be necessary to 'iron out the kinks.' However, this line of thinking also highlights the urgency for the appropriate policy initiatives to support efforts at integration and capital market liberalisation. It is to these that attention is now focused.

5.1 Selecting the Appropriate Financial Regulatory Model

In examining the structure of regulatory agencies in several countries, Goodhart et al. note that:

> There is substantial variety of institutional structures for regulatory and supervisory institutions throughout the world (1998:183).

In determining the appropriate financial regulatory model we adopt a framework that is akin to the World Financial Authority posited by Eatwell and Taylor (1998). As noted earlier, the financial regulatory models developed in the United States (US) and the European Union (EU) are useful guides.

5.1.1 The United States Federal Reserve System

The institutional regulatory structure in the US is quite complex due to the existence of both federal and state agencies responsible for banking regulation and supervision. The Federal Reserve System consists of the US Federal Reserve Bank (the Central Bank – the Fed) and twelve regional Federal Reserve Banks located in major cities throughout the United States (Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, San Francisco). The Fed is an independent body which is self-funding and makes decisions autonomously of the executive or legislative arms of the State, although it is subject to Congressional oversight. The activities of the Fed are subject are subject to periodic reviews by Congress and its responsibilities may be altered by statute. The Fed must work within the framework of the overall economic and financial policy objectives of the government. The Fed, which was created by the Federal Reserve Act of 1913, has supervisory and regulatory authority over a wide range of financial entities in addition to conducting the nation's monetary policy and providing financial services to the US government, the public, and home and foreign financial institutions. The supervisory authority of the Federal Reserve involves the monitoring, inspecting and examining of banking organisations to assess their condition and compliance with relevant laws and regulations. It can take action in the event of non-compliance or problems. Under its regulatory function it can issue specific regulations and guidelines governing the operations, activities, and acquisitions of banking organisations.

The seven-member Board of Governors of the Central Bank is nominated by the President and confirmed by the Senate. Governors are appointed for a single term of fourteen years; the term cannot be reduced on the grounds of policy preferences. The length of the term employed with staggered appointments is intended to assist in insulating the Board and the Reserve System as a whole, from day-to-day political pressures. The Board of Governors of the Central Bank, located in Washington, D.C. has centralized and supervisory influence over the Reserve Banks, with the individual Reserve Banks carrying out narrow control over their day-to-day operations under the management of a president, who is the chief executive officer, and a board of directors. Notably, under the US Federal Reserve System, directors of federal districts do not simultaneously serve as members of the Board of Governors of the Federal Reserve Bank.

Under the US Federal Reserve System, the primary supervisor of a domestic banking entity is determined by the type of entity as well as on the basis of the governmental authority that granted its

charter. The Fed is responsible for supervising and regulating certain segments of the banking industry, namely, bank holding companies, diversified financial holding companies, foreign banks with U.S. operations, state-chartered banks that are members of the Federal Reserve System (state member banks), foreign branches of member banks, U.S state-licensed branches, agencies, and representative offices of foreign banks, nonbanking activities of foreign banks, as well as edge and agreement corporations through which U.S. banking organisations may conduct international banking business. It shares supervisory and regulatory responsibilities for domestic banking operations with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) at the federal level. It also shares supervisory and regulatory responsibilities with the banking departments of the various states.

The Federal Financial Institutions Examinations Council (FFIEC), established in 1978, facilitates consistency in the examination and supervision of banking organisations. It is comprised of the chairpersons of the FDIC and the National Credit Union Administration, the comptroller of the currency, the director of the OTS, and a governor of the Federal Reserve Board. The FFIEC prescribes uniform federal principles and standards for the examination of deposit-taking entities and promotes coordination of bank supervision of federal and state regulatory activities.

While it is acknowledged that surveillance and enforcement are critical to the effectiveness of regulation and supervision, it is also acknowledged that comprehensive surveillance requires significant outlay in resources. It is evident that the US system of regulation and supervision is complex with many different levels of regulation and supervision. The resource intensive process seems unlikely, therefore, to be suitable in most developing countries. Although there is no precise information on costs, certainly we can intuitively assert that this system is costly to establish, implement and administer. Establishing such a system for use within the small, developing member states of the CSME in the short to medium term would be prohibitive.

5.1.2 The Eurosystem

Financial integration in the European Union (EU) has proceeded gradually through a coordinated process of legislation among member states. In documenting the history, role and functions of the European Central Bank (ECB), Scheller (2004) provides an overview of EU financial integration. Policymaking towards the creation of an integrated financial services sector in the EU commenced in 1973. This initiative assumed greater impetus in June 1998 and in May 1999 a five-year Financial Services Action Plan (FSAP) was published by the European Commission. This FSAP was endorsed by the European Council of ministers in 2000. The FSAP contains forty two measures to fill gaps and remove any barriers and to provide a legal and regulatory environment that supports the integration of financial markets across the EU. The ECB and the national central banks (NCBs) of member states constitute the European System of Central Banks (ESCB).[15] The Eurosystem is comprised of the ECB and NCBs of member states that have adopted the Euro as legal tender. The ECB was established under the EC Treaty as a specialised, independent organisation and has a legal personality of its own. Each NCB of the Eurosystem has legal personality within its respective national law, but is an integral part of the Eurosystem.

Financial regulation in the EU is based on a principle of 'unity in diversity.' This has facilitated an orderly and pragmatic integration process while protecting the individual public policy interests of the various member states. The institutional framework for banking supervision established by the legislation of the European Community rests on the principles of home country control, mutual recognition, minimum harmonization of basic concepts, and cooperation among the competent authorities. The principle of home country control places the supervision of a bank in the competent authority of the member state where it is licensed. A licensed financial institution can provide local branch or cross-border banking services throughout the EU on the basis of an EU-wide mutual recognition of bank licensing and supervisory practices. Community legislation provides for minimum harmonization of basic concepts pertaining to the definition of a bank, criteria for bank licensing and common standards of prudential supervision and accounting principles. Supervisory responsibility is carried out at the national level in keeping with the institutional arrangements

[15] It should be noted that, unlike the ECB or the NCBs, the ESCB has no legal personality.

specific to each member state, that is, in some member states their central banks are responsible for banking supervision and in others, separate bodies perform banking supervision and cooperate with their respective central banks.

The European Central Bank (ECB) which was established on 1 June 1998 is responsible for monitoring the cyclical and structural developments in the EU banking sector and in other financial sectors. Assessment of the possible vulnerabilities in the financial sector and its resilience to potential shocks is carried out in collaboration with the EU national central banks and supervisory agencies. The ECB is given regulatory powers and can adopt 'Regulations' and 'Decisions' that are binding on the member states and that have a direct effect (though not legally binding) on third parties other than the NCBs of the Eurosystem. ECB Regulations are adopted by the Governing Council but the Governing Council may delegate its authority to adopt Regulations to the Executive Board. In addition, the ECB is authorised to issues guidelines, instructions, and internal decisions. Guidelines and instructions are part of Community law and are therefore legally binding and judicially enforceable instruments enacted to ensure that decentralized operations are carried out consistently by the NCBs. They prevail over pre-existing and subsequent national legislation. Internal decisions are applicable to organizational, administrative or financial matters of the Eurosystem and are legally binding for all EU member states. A consultative Banking Supervision Committee, hosted and supported by the ECB and comprised of senior representatives of central banks and supervisory authorities of the member states, promotes cooperation among central banks and supervisory authorities. The Committee also assists the Eurosystem in carrying out its statutory tasks related to prudential supervision and ensuring the stability of the financial system.

Operational decision-making responsibilities within the ECB reside with the Executive Board. Six members of the Executive Board and the governors of all the NCBs from twelve euro area countries comprise the Governing Council of the ECB. A General Council is comprised of governors off all NCBs, whether in the euro area or not, in addition to the President and Vice President of the ECB. The Executive Board participates in the decision-making of the Governing Council with the same rights and responsibilities of the NCB Governors. Appointments to the Board are made by the Heads of State or Government, on a recommendation from the EU Council after consultation with the European Parliament and the Governing Council of the ECB. The members are appointed on a contractual full-time basis with the ECB and must be persons of recognised standing and professional experience in monetary and banking matters. The Board's major responsibilities include the implementation of monetary policy of the euro area in line with the guidelines and decisions laid down by the Governing Council, issuing the necessary instructions to the euro area NCBs, and managing the current business of the ECB.

The EU model of financial integration serves as an appropriate point of departure in the selection of the financial regulatory model for the CSME. However, caution must be exercised bearing in mind the differences in economic development between EU and CSME member states as well as the level of sophistication, thinness and inherent volatility of Caribbean financial markets.

5.1.3 Financial Regulation for the CSME

While it is impractical to test regulatory codes for their effect on each jurisdiction as a precondition for *consensus ad idem*, a practical compromise is possible. In such a case, ECOFIN (2000) recommends a two-stage regulatory process. The first stage would involve the selection and acceptance of general and basic universal tenets that are critical to the success of financial regulation. Practically speaking, these could refer to provisions such as those of the Basel Accord that are aimed at levelling the playing field by harmonising regulatory standards in international financial markets. The second stage, which presupposes the first, would involve the construction of flexible codes that can adapt to a changing environment as well as to the peculiar governance structures and commercial practices within each member state.[16] The cooperative mechanisms already in place, for example as evident in the adoption of IFRS and FATF recommendations, are important first steps – but just that: first steps. What is needed, further, is for the process to be guided at the regional level to secure proactive regulation that keeps abreast with or, ideally, ahead of, financial market developments within the CSME. Arising from this, a single regional financial regulator for the CSME is being

[16] ECOFIN proposals are couched in the existence of a central regional regulatory authority.

proposed for consideration by policy makers. Theoretically, a single regulator carries several advantages including: mitigating problems of competitive inequality, inconsistencies, overlaps and gaps and ensuring accountability of national regulators. A single regulator may also catalyse fiscal consolidation and structural reforms, both necessary for boosting investment prospects and facilitating the desired deepening of capital markets. Using the model of the World Financial Authority (Eatwell and Taylor, 1998), we address the key issues for effective regulation within the CSME: What are the key regulatory tasks to be performed by the regional regulator? What should be the legal foundation for the actions of the regional regulator? How are the tasks of the regulator to be performed?

5.1.3.1 Key Regulatory Tasks

Eatwell (xxxx) suggests that the single regulator would perform identical functions as any national regulator and seek to facilitate the regional development of policies that balance macroeconomic needs with those for financial stability. This paper suggests that these functions should include: rules of entry for market participants, the provision of aggregated regional information to enhance market transparency and data-sharing across countries, surveillance and monitoring to ensure adherence to regulatory rules and codes, enforcement of punitive measures for non-compliance and continual policy development to ensure relevance to market trends.[17]

5.1.3.2 Legal foundation for the actions of regional regulation

The activities necessary for effective regulation support the call for a single regional regulator to determine common rules and procedures. The acceptance and implantation of these rules and procedures must be legally binding on the member states. In other words, the regulator must be empowered with legal authority to issues guidance, directives and instructions to national authorities in the regional interest. While the move to internal risk management and less stringent rules is desirable, rules-based mechanisms are particularly critical in developing countries where 'the regulatory capacities are weaker and information is poorer' (Stiglitz, 1999:1514). Furthermore, problems with regulatory forbearance arising from political interference tend to be more common in small developing societies. The bias in these arguments is not to suggest a ceding of sovereignty but, rather, a recognition of the advantages of collaborative decision-making for regional development.

5.1.3.3 Conducting regulatory tasks

The spirit of the home country control principles utilised in the EU are applicable to the conduct of regulation in the CSME. In this context, primary responsibility for regulation within each member state will be retained at home. However, it is critical to regional financial integration that national goals are not in conflict with regional goals. As such, national regulators must operate within common regional guidelines. Eatwell provides a succinct summary of the issues:

> … the importance of the [regional regulator is] not to tell national authorities what to do, but to ensure that in a single [regional] financial market they behave in a coherent and complementary manner to manage the systemic risk to which, in a seamless market, they are all exposed. Effective [regional] regulation will necessarily be confederal, with different responsibilities at appropriate levels of the system. But there must be a coherent confederation with common principles and common values, resulting in (converging) national codes enforced by national authorities to attain common goals (p.11].

CSME policy makers seeking to secure a safe, sound, and efficient financial environment should ensure that high standards of regulatory codes are uniformly maintained so that those economies with high standards are not undermined by less stringent and riskier economies. As noted by Eatwell in a recent publication:

[17] The recent establishment of a regional credit bureau in the form of CariKris is welcome in this regard.

> … it is clear that criteria for authorisation should be at the same high level throughout the international market: ensuring that a business is financially viable, that it has suitable regulatory compliance procedures in place, and that the staff of the firm are fit and proper persons to conduct a financial services business. If, in a liberal international financial environment, high standards are not uniformly maintained then firms authorised in a less demanding jurisdiction can impose unwarranted risks on others, undermining high standards of authorisation elsewhere (p. 7).

Furthermore, while the spirit of the Draft FSA should be lauded, the concerns raised regarding timing of integration of the various member states and the attendant effects on harmonisation of provisions in the regulation and delivery of financial services remains a cause for real concern.

6 Concluding remarks

This paper has sought to identify and isolate the optimal regulatory structure and role of financial regulation within the context of integration of CARICOM member states. Although this study is still preliminary, there are far-reaching implications because it anticipates some of the real issues that have yet to be addressed.

Several analytical themes have been presented in this paper: first, the integration of CARICOM member states is a positive step towards improving the quality and efficiency of markets in an increasingly globalised world. The second theme is that integration under the CSME will mark significant changes in the context and operation of financial markets within the region. The third theme relates to potential increased volatility in financial systems resulting from the increased mobility of capital across member states. Planned harmonisation of product delivery and the regulatory framework is expected to influence the work of regulators, supervisors and other policy makers, in addition to real and perceived influences on financial stability. There is also strong support for consistency in regulation and supervision among the various financial entities to mitigate or eliminate regulatory arbitrage (World Bank, 1998; McCreevy, 2005). At the same time it is acknowledged that, in addition to financial regulation and supervision, a broad range of political, social, legal and institutional factors impinge on financial stability. This underscores the importance of the interaction of the provisions among the local environment of each member state in creating the optimal environment for financial stability. Certainly, these provisions take on added significance within the context of a single market and economy. Further, legal reforms to address out-dated provisions for bankruptcy and relating to the pledging and seizure of collateral could also enhance the regulatory process. Not only can laws governing bankruptcy act as a deterrent against default on debt and ultimately enhance stability, but they can also provide a way of salvaging a proportion of loans in case of failure.

Preliminary findings suggest some important questions for the policy makers within CARICOM. To some extent, these questions will intensify some of the recent pressure that has been brought to bear on governments and policy makers within the region in recent times. In reaching a consensus for optimising the benefits of integration, policy makers will have to weigh the potential consequences of various policy actions and any necessary redress effected. Efforts at harmonising regulatory norms will, of course, be influenced by financial sector efficiency and the presence of an environment that facilitates the mobilization of capital and a reduction of risks. Notably, no clear definition has as yet emerged to clarify exactly what is meant by 'harmonisation' as used in the context of the CSME. Certainly, this is one issue that would require clear and unambiguous resolution in order to guide the integration process. The Concise Oxford Dictionary (1997) suggests that it means to bring into, or to be in, agreement. Alternative actions suggested are 'agree,' 'cooperate' and 'coordinate.' Such coordination or cooperation implies the coexistence of the regulations of the different CARICOM member states, even where there is a potential for conflict or where there is a need for combined action (Chetcuti, 2001). Obviously, this sort of arrangement lacks binding force and does not promote the neutrality necessary to secure the benefits of integration as indicated. If this is indeed what is to be understood is required by Chapter 3 of the RTC, there is an implication for member states to enter reservations against items specified in the RTC; it is certainly implied in Article 43

(see Appendix).[18] If member states reserve the right to maintain restrictions, then the harmonisation that is desired supports a form of 'integration-lite' that could lead to market distortions and a possible loss of confidence by the market of the authorities' ability to commit and deliver as promised. This is not to deny flexibility or voluntary convergence, but it remains a significant issue that due to the nature of Caribbean economies – small, open, economies with macroeconomic imbalances and thin, underdeveloped markets – there is an apparent greater susceptibility to shocks. Depending on the nature of reservations entered, this could have adverse effects on the function of the markets in other regions and could produce adverse results.[19]

At the opposite end of the spectrum to harmonisation is standardisation. Defined in the reference, it suggests conformation to a standard, and alternative actions include 'equalize' or 'homogenize.' Taken as given, standardisation of financial regulation would imply full unification of regulatory codes within the Caribbean Community. In its most advanced stage, this suggests an extreme level of integration that would encompass the sensitive areas of monetary union and dispossession of sovereignty. Intuitively it can be appreciated that standardisation at such a level is impractical in the short (and possibly even longer) term if only because it lacks political acceptability since no government would readily cede national sovereignty.

While this paper has consistently argued for regulatory policies and codes that take account of the peculiarities of different economies, the foregoing analysis has clearly shown that there are some areas that may require a more 'rules-based' approach if the benefits of integration are to be optimised.
In other words, what is suggested here is a carefully constructed mix of harmonisation and standardisation pursued with sustained purposefulness and commitment to reaping regional as well as local benefits. This would allow for some decisions to be taken at the country level (such as those relating to implementation) rather than at the regional level (which could involve the broad standard-setting process), having cognisance of the peculiarities with the various economies. In this increasingly globalised world, these considerations must be influenced by broader efforts at harmonisation and standardisation of rules and codes within world financial markets (for example, IFRS and Basle principles).

6.1 Conclusions and policy recommendations

It is not the intent of this paper to outline a detailed and comprehensive prescription as the panacea to Caribbean integration. Instead, two broad sets of recommendations arising from the analyses are outlined below. This section outlines briefly a recommended set of policy initiatives to be pursued as a vital component of any measures aimed at financial stability. What is required of policy makers is that these be developed into a specific and coherent set of provisions and institutions through which the emerging regional policies may be implemented and maintained. In practical terms, this must involve the development of guidance for effective cooperation in cross-sectoral and cross-border regulation. Practical everyday operational rules and tools must be identified and coherently assured including, but not limited to, exchange of information and expertise and the design of regulation such as setting up common reporting formats and common training of personnel (McCreevy, 2005).

The prime issue is the development of institutional structures that support the ethos of international harmonisation and cooperation. To give the matter due consideration, policymakers must establish the appropriate linkages with, and secure an appropriate environment for, macroeconomic stability as a necessary precondition for a robust and efficient financial sector.

The second recommendation is inextricably linked to the first set. Essentially, the second recommendation is the set of some of the critical questions to be addressed by policy makers and regulators in their efforts at financial stability within a context of 'partial' economic integration.

[18] In his discussion of tax harmonisation in the EU, Chetcuti (2001) offers a continuum of definitions of harmonisation that may be adapted for implementation.
[19] EU member states subscribe to the OECD Codes of Liberalization and are allowed to enter reservations against items that they may be unable or unwilling to liberalize. Certainly, the EU is very dissimilar to CARICOM in size, nature, level of development and sophistication of markets. See National Institute of Economic & Social Research (1996) *The Single Market Review Series,* available at Internet.

Among the most incisive questions are: Do regulators support the efforts at integration and is this support evident in the approach to regulation? Do the various financial entities have the appropriate foundation on which to function within an integrated, regionalised environment? Has regulatory staff (and the staff of oversight bodies such as the stock exchanges) been educated in the requirements of the protocols and the spirit of the provisions and have they demonstrated buy-in and a commitment to be effective enforcers?

It should be noted that the results reported in this paper do not bear on the issue of the relative efficacy of integration vis-à-vis 'fragmentation.' Neither has it focused on the central bank's role as regulator. Rather, the paper has sought to examine the broad potential impact of the effect of integration on financial regulation and ultimately, financial stability. Vexed questions remain in terms of the state of readiness of the CARICOM member states for integration as well as the fact that a referendum has not been held to seek the views of the populace on some critical issues. In fact, the newly elected leader of the Opposition Jamaica Labour Party was recently reported to have issued new calls for plebiscites on various issues (*Daily Gleaner*, July 4, 2005). In the meantime, while it is understood that integration in the wider sense is a gradual process, it is suggested that for the benefits of integration to be optimised as intended, the provisions in the Revised Treaty must be considered as a unit. The issues which the relevant articles address are so inextricably linked that within this context, any piece-meal implementation of the requirements must be rejected, since that is likely to lead to sub-optimal results. Not only so, but it points to the need for what Mishkin calls 'getting regulation and supervision right' (2000:32). What is required is a specific and coherent set of provisions and institutions that will add value and through which the emerging regional policies may be implemented, complemented and maintained. This is an imperative to ensure that, as was done in the case of financial liberalisation in many developing countries, the cart is not put before the horse.

Appendix

Extracts from the Revised Treaty of Chaguaramas: Chapter 3

ARTICLE 42
Co-ordination of Foreign Exchange Policies and Exchange of Information
1. The Member States shall take such measures as are necessary to coordinate their foreign exchange policies in respect of the movement of capital between them and third States.
2. The Member States shall keep the competent authorities in other Member States informed of significant unusual movements of capital within their knowledge to and from third States.

ARTICLE 43
Restrictions to Safeguard Balance-of-Payments
1. In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member State may, consistently with its international obligations and subject to paragraph 5 of this Article, adopt or maintain restrictions to address such difficulties.
2. The restrictions which may be adopted or maintained pursuant to paragraph 1 of this Article may include quantitative restrictions on imports, restrictions on the right of establishment, restrictions on the right to provide services, restrictions on the right to move capital or on payments and transfers for transactions connected therewith. However, such restrictions:
(a) shall, subject to the provisions of this Treaty, not discriminate among Member States or against Member States in favour of third States;
(b) shall at all times seek to minimise damage to the commercial, economic or financial interests of any other Member State;
(c) shall not exceed those necessary to deal with the circumstances described in paragraph 1 of this Article; and
(d) shall be temporary but in any event not longer than a period of eighteen (18) months and be phased out progressively as the situation described in paragraph 1 improves.
3. In determining the incidence of such restrictions, the Member State concerned may accord priority to activities which are essential to its economic stability. Such restrictions shall not be adopted or maintained for the purpose of protecting a particular sector in contravention of the relevant provisions of this Treaty, due regard being paid in either case to any special factors which may be affecting the reserves of such Member State or its need for reserves.
4. Restrictions adopted or maintained pursuant to paragraph 1 of this Article, or any changes therein, shall be promptly notified within three (3) working days to COFAP and to COTED, and, in any event, the Member State concerned shall immediately consult with the competent Organ if and when requested.
5. COFAP shall establish procedures for periodic consultations including, where possible and desirable, prior consultations with the objective of making recommendations to the Member State concerned for the removal of the restrictions.
6. The consultations referred to in paragraph 5 of this Article shall:
(a) be designed to assist the Member State concerned to overcome its balance-of-payments and external financial difficulties;
(b) assess the balance-of-payments situation of the Member State concerned and the restrictions adopted or maintained under this Article, taking into account, inter alia:
(i) the nature and extent of the balance-of-payments and the external financial difficulties;
(ii) the external economic and trading environment of the Member State applying the restrictions; and
(iii) alternative corrective measures which may be available.
7. The consultations shall address the compliance of any restrictions with paragraph 2 of this Article and, in particular, the progressive phase-out of restrictions in accordance with paragraph 2(d).
8. In such consultations, all findings of statistical and other facts presented by the Committee of Central Bank Governors relating to foreign exchange, monetary reserves and balance-of-payments, shall be accepted and conclusions shall be based on the assessment by the Committee of the balance-of-payments and the external financial situation of the Member State concerned.

ARTICLE 44

Measures to Facilitate Establishment, Provision of Services and Movement of Capital

1. In order to facilitate the exercise of the rights provided for in this Chapter, COTED and COFAP shall, subject to the approval of the Conference, adopt appropriate measures for:

(a) the establishment of market intelligence and information systems in the Community;

(b) harmonised legal and administrative requirements for the operation of partnerships, companies, or other entities;

(c) abolition of exchange controls in the Community, and free convertibility of the currencies of the Member States;

(d) the establishment of an integrated capital market in the Community;

(e) convergence of macro-economic performance and policies through the coordination or harmonisation of monetary and fiscal policies, including, in particular, policies relating to interest rates, exchange rates, tax structures and national budgetary deficits;

(f) the establishment of economical and efficient land, sea and air transport services throughout the Community, and

(g) the establishment of efficient communication services.

2. COFAP and COTED shall establish a comprehensive set of rules in respect of the areas listed in paragraph 1 of this Article for approval by the Conference.

References

Basel Committee (1997) *Core Principles for effective banking supervision*, Available at Internet, URL: http://www.bis.org/publ/bcbsc102.pdf.

Basel Committee (2000) Review of international accounting standards, April, BIS: Switzerland

Caprio, G., Hunter, W. C., Kaufman, G. G., Leipziger, D. M. (eds.) (1998), *Preventing Banking Crises: Lessons from Recent Global Bank Failures*, The World Bank: Washington, D. C.

Caribbean International Broadcast Network and JIS (2005) Town Hall Meetings, May, June.

Chetcuti, J-P. (2001) 'The economic justification of tax harmonization in the EC,' available at Internet, URL:- http://www.chetcuticauchi.com/jpc/research/eu-tax-harmonisation-2.htm

Daley, J. A. (2002) 'Studies in bank failures: the case of Jamaica with cross-country analyses of the Mexican and Ugandan experiences,' *Unpublished PhD thesis*, Cardiff University, March.

Davies, S. M. and McManus, D. A. (1991) 'The effects of closure policies on bank risk-taking,' *Journal of Banking and Finance*, Vol. 15, pp. 917-938.

Eatwell, J. (xxxx) 'The Challenges Facing International Financial Regulation,' Queens College Cambridge

Eatwell, J. and Taylor, L. (1998) 'International capital markets and the future of economic policy.' A paper prepared for the Ford Foundation project *International Capital Markets and the Future of Economic Policy*. New York: Centre for Economic Policy Analysis, London:IPPR.

ECOFIN (European Union Economic and Finance Ministers) 2000. *Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets*, (Lamfalussy Committee), Brussels, 9 November

Financial Stability Forum (2001) *International standards and codes to strengthen financial systems*, Available at Internet, URL: http://www.fsforum.org/Standards/Repiscsfs.pdf.

Galindo, A., Micco, A. and Serra C. (2002) 'Financial Integration' in Beyond Borders. The New Regionalism in Latin America, Social Progress in Latin America Report, pp. 101-124

Gavin M. And Hausman, R. (1996) 'The Roots Banking Crises: The Macroeconomic Context', *Inter-American Development Bank Working Paper 318*.

Golding, B. (2005) 'Golding calls for Carib referndums on CCJ, CSME,' *Daily Gleaner*, 4 July , available at Internet, URL: http://www.jamaica-gleaner.com/gleaner/20050704/lead/

Goldstein, M. and Turner, P. (1996) 'Banking Crises in Emerging Economies: Origins and Policy Options,' *BIS Economic Papers*, No. 46, October.

Goodhart, C., Hartmann, P., Llewellyn, D., Rojas-Suárez, L., and Weisbrod, S. (1998) *Financial Regulation: why, how, and where now?*, Routledge: London.

Hall, K. O. (2000) Integrate or Perish. Perspectives of the Heads of Government of the Caribbean Community and Commonwealth Caribbean Countries 1963-2002, 2nd Ed., Ian Randle Publishers: Kingston.

Hall, M. J. B. (1993) *Banking Regulation and Supervision: A comparative study of the UK, USA and Japan*, Edward Elgar: England.

Hanohan, P. (1997) 'Banking System Failures in Developing and Transition Countries: Diagnosis and

Prediction,' *BIS Working Paper*, No. 39, Bank for International Settlements: Basel.

Haynes, C. (2003) The Emerging Regulatory and Supervisory Framework for Managing Risks in the Caribbean Banking Sector, Paper presented at Caribbean Centre for Monetary Studies Seminar, May.

International Accounting Standards Manual (2002)

Jain, A. (2002) *International accounting standards to be adopted in Jamaica – are you ready?*, Available at Internet, URL: http://www.pwcglobal.com/jm/images/pdf/IAS%20to%20be%20adopted%20in%20Jamaica.pdf

Kaminsky, G. L., and Reinhart, C. M. (1999) 'The Twin Crises: The Causes of Banking and Balance-of-Payments Problems,' *American Economic Review*, Vol. 89, No. 3, pp. 473-500.

Llewellyn, David T. (1980) International Financial Integration. The limits of sovereignty. Macmillan: London and Basingstoke

Llewellyn, D. T. (1986) *The Regulation and Supervision of Financial Institutions*, The Institute of Bankers: London.

McCreevy, C. (2005) 'Regulatory and supervisory challenges for financial integration,' *Lamfalussy London Summer Dinner*, London, 27 June.

Mishkin, F. S. (2000) 'Prudential Supervision: Why is it important and what are the issues?' *NBER Working Paper*, No. 7926, National Bureau of Economic Research: Cambridge, MA.

North, D. C. (1990) *Institutions, Institutional Change and Economic Performance*, Cambridge University Press: Cambridge.

Stiglitz, J. E. (1999) 'Reforming the Global Economic Architecture: Lessons from Recent Crises,' *The Journal of Finance*, Vol. 54, No. 4, pp. 1508-1521.

Wilson J.D. (1999), Theories of Tax Competition, *National Tax Journal*, June

World Bank (1998) 'Beyond Financial Crisis,' *Global Economic Prospects and the Developing Countries*, the World Bank:Washington.

✖