RISK MANAGEMENT AND INVESTMENTS
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"THE LEGISLATIVE FRAMEWORK FOR
THE MANAGEMENT
OF RISKS IN THE FINANCIAL SECTOR"

Presented by
LUCILLE MAIR
Mair and Company
at the
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I wish to thank the organisers, the Caribbean Centre for Monetary Studies and the Caribbean Association of Industry and Commerce for inviting me to address this important seminar.

It's a pleasure to be here as it was last year when I spoke at the Pensions Seminar.

A most timely and useful Seminar almost on the eve of the implementation of the New Basel Capital Accord.

Our banks and insurance companies are now regionally active and there are moves afoot by our Government for uniformity in approaches to supervision of banks, insurance companies and other financial institutions.

The topic given to me is wide, hence my paper will treat mainly with banks, but will also address insurance companies since they make up a large part of our financial sector and their products and ownership are now crossing over with banks. *(Time is limited, so I can only touch on a few aspects of the topic.)* I have not dealt with mutual funds as there is no specific legislation governing them, except in so far as they are owned and operated by banks.

I will approach the topic from the perspective of whether the legislative framework is adequate for the management of risk and whether the regulator has the legal powers for effectively supervising financial institutions in that regard.

My focus is on the laws of Trinidad and Tobago, Barbados, Jamaica and Bahamas.

The legislation governing the regulation of banks in these countries are fairly similar in terms of licensing requirements, minimum capital requirements, statutory reserves, capital adequacy requirements, borrowing limits, restrictions on borrower groups, rules for inspection and supervision of banks.

The legislation referred to are

- Financial Institutions Act, 1993, (Trinidad and Tobago).
- Financial Institutions Act, 1996,(Barbados).
- Financial Institutions Act, 1992, as amended by the 1997 Act (Jamaica).
- Banks and Trust Companies Regulation Act, 2000 (Bahamas).

These countries have adopted most of the requirements and specifications set out by the Basel Committee on Banking Supervision in the 1988 Capital Adequacy Accord and all banks are required to meet the minimum ratio of 8% of total capital to risk-weighted assets.

The traditional risks which banks face are -

Credit Risks
Liquidity Risks
Market Risks
Interest Rate Risk
Earnings Risk
Solvency Risks
Currency or Exchange Risks,

and, there are a host of other risks which banks face including, political, legal and reputation risks.

The measurement of risk was first introduced for international banks in 1988 by the Basel Committee on Banking Supervision with a requirement that the minimum ratio of capital to risk-weighted assets should be 8% of total capital, a vital requirement in reducing the risk of bank insolvency.

The Basel Committee has since recognised that with the significant transformation of financial markets since 1998, the assessment of risk exposure by examining a single asset class, system or geographical location could be misleading and could leave the institution vulnerable to market, operational and credit risks.

A new Basel Accord has been developed and is to be introduced in 2004 for internationally active banks. It is intended to align capital adequacy assessment more closely with the key elements of banking risks and to provide incentives for banks to enhance their risk measurement and management capabilities.

Essentially, the new Accord will introduce the “three pillar” approach to banking supervision i.e minimum capital requirements, a supervisory review process of an institution’s capital adequacy, internal assessment processes and measures to foster market discipline through a transparent disclosure process.

It is not really appropriate to legislate for every specific risk measurement. However, the legislation of all 4 countries contain some provisions which address the need for management of risks and for the supervisory process governing same. All have provisions for onsite inspection and offsite supervision, but that is not sufficient. The Bahamas legislation has the most comprehensive provisions from the supervisory perspective. The First Schedule to the Bahamas Act specifically sets out the Inspector’s functions, which are, among other things, to ensure that banks have in place and use systems that accurately measure, monitor and control market and other risks. But, the shortcoming is that the legislation does not contain a corresponding obligation on banks to comply with same. The Inspector is also mandated to “set prudent and appropriate capital adequacy requirements not less than those established in the Basel Capital Accord and its amendments” and to “cooperate with supervisors in other jurisdictions to the extent necessary for the purposes of cross border supervision consistent with the requirements of the Basel Accord of 1988.” These provisions are flexible enough for Bahamas to meet the new Basel Capital Accord. However, an amendment to its legislation is required if there is to be an obligation on banks to comply with the requirements set by the Inspector.

The Trinidad and Tobago Financial Institutions (Prudential Criteria) Regulations, 1994, provide specific criteria for measuring credit risk and some aspects of operational risk, but not market risks. In order to comply with the new Basel Capital Accord which requires the measurement of credit risk operational risk and market risk in determining capital levels, an amendment will be required to the Financial Institutions Act, 1993 or the Regulations.

The Jamaica legislation gives the Minister power to make Regulations to deal, among other matters, with the obligation of licensee to provide for doubtful loans and other asset based risks, and, criteria as regards the minimum solvency standards to be maintained by licensees and as regards the measurement of the capital bases of licensees. It is possible that regulations could be tailored within this enabling provision to treat with the new Capital Accord requirements.

Similarly, the Barbados legislation gives the Minister power to make Regulations which deal with capital adequacy requirements and the measurement of credit risk. Presumably measurement of other risks are applied based on general supervisory norms that minimum solvency requirements be maintained.

The provisions of the Bahamas legislation regarding the Inspector's functions are clear and direct and should be adopted by other countries, (subject of course to adaptation to local characteristics). But there must be a reciprocal requirement for compliance by licensees. (It is always preferable for the supervisor to have clear powers, and not have to face challenges by licensees regarding extent of authority.)

Banks frequently carry on part of their business through subsidiaries and affiliates. Banks may also belong to a group headed by a holding company and in such cases the activities of the holding company and subsidiaries are important to the supervisor since the bank may be exposed to "upstream" and "downstream" risks arising from its owners or from parallel entities within the group.

Consolidated supervision seeks to evaluate the strength of an entire group, taking into account all the risks which can affect a bank, whether or not they are carried in the books of the bank or with affiliates and irrespective of the legal entities or countries in which they are conducted. It is important, therefore, that supervisors have the power and authority to monitor banks on a consolidated basis.

How do our legislation treat with this aspect?

The Trinidad and Tobago banking legislation gives the Central Bank power to request from an affiliate information pertaining to a transaction investment or shareholding between the licensee and an affiliate. The Central Bank has no power of examination or supervision of the affiliate unless it also is a licensee.

The Barbados Central Bank has power to inspect books of holding parent or affiliate companies that are located in Barbados and to call for information on such companies from the related licensee; but it has no power of physical inspection of those affiliates.

The Jamaican legislation gives the Supervisory Department power to examine the books, records, statements and other relevant documents of a holding company and to demand information of a holding company where a licensee is a subsidiary of the holding company.

The Bahamas, because it is the home of many branches of international banks, has detailed provisions for inspection by a foreign supervisory authority for the purpose of consolidated supervision and to determine among other things, whether the bank or trust company has adequate risk management systems and complies with capital adequacy and risk diversification requirements. The Inspector of Banks, however, does not have power to examine local holding companies or affiliates of local banks.(This seems to be an oversight in the drafting of the legislation).

Of concern also are risks from gradual erosion of traditional barriers between different types of financial institutions - banks, insurance companies and securities companies.

Insurers take on significant risks. These could encompass, cross-investment, cross distribution, provision of integrated services and of course cross-sector risk transfers. There are sufficient common elements with banks (e.g risks inherent in the underlying assets or liabilities) which could be measured in determining capital adequacy levels.

In the Caribbean region, supervision of insurance companies is not as fully developed and comprehensive as supervision of banks. Assessing risks in an insurance company is a very complex issue. The person who has a handle on that aspect is usually the actuary, who uses a variety of powerful tools to model risks. But the actuary does not have an obligation under existing law to assess and rate the solvency of insurance companies.

With our banks and insurance companies coming closer together, the question to be asked is whether the existing legislative framework for the management of risks in the broader financial sector is adequate.

The insurance Legislation of Trinidad and Tobago, Jamaica, Barbados, St. Lucia do not contain either specific or indirect provisions which give the supervisors power to ensure that the insurance companies apply specified weights to risk to determine minimum capital adequacy levels.

Under our insurance legislation in Trinidad and Tobago, the supervisor has little authority to probe into the holding company or affiliate which is exerting influence over the insurance company or to ensure that appropriate measures are put in place to mitigate risks which stem from such relationship. This position is the same in Jamaica and Barbados. I have not examined the Bahamas Insurance Act and am unable to comment on it.

It is clear that the limitations faced in all the jurisdictions is the lack of convergence of the supervisory interface with respect to cross-sector risk. The supervisor should have the power to require that the pool of capital is adequate to support all these activities.

This leads to the issue whether there is need for an integrated supervisory approach or whether supervision should remain around specialist agencies for banking, securities and insurance sectors. One argument for an integrated approach is the economies of scale in a small developing country and another is where the financial sector is dominated by banks with a smaller role for capital markets. Trinidad and Tobago has announced that it is moving towards integrated supervision and has already started the preparatory stages of such integration. Grenada is in the process of integrating the supervision of all financial institutions under a single unit. Jamaica is on the eve of introducing a new Insurance Act to facilitate the more effective monitoring of insurance companies, impose solvency standards and address proper risk management by insurance companies. It is not integrating supervision with banks.

What is of immense importance is the need for information sharing and co-operation among regulatory authorities, both domestic and international, to ensure that group oversight and risk assessment are achieved. Only Bahamas and Jamaica have provisions which facilitate this complete sharing of information.

Even if the legislative framework for the management of risks is adequate, the supervisor has to ensure that the financial institution has in place effective internal controls to manage risks, an efficient management information system and properly trained personnel with analytical skills who can apply risk modelling techniques. But measuring and defining risk is one step in the process of controlling risk and it is the role of the management to identify and solve the problem.

The Trinidad and Tobago Companies Act now places full responsibility on the board of directors for the oversight of its company. It is incumbent upon the board of directors to have proper procedures and policies in place to identify risks and deal with them and to ensure that senior management is capable of managing and taking risks. They must also understand the type of risks to which their institution is exposed.

Correspondingly, supervisors must have the capability to assess financial safety and soundness of financial institutions and power to address unsafe and unsound practices. But supervisors should not be dictating how an institution should be run.

The prudential criteria requirements stipulated in the banking legislation in Trinidad and Tobago, Jamaica, Barbados and Bahamas address to some extent, the issue of unsafe and unsound practices, but some amendments are needed to give more effective powers. Also, the procedures for enforcement tend to be somewhat cumbersome and drawn out in some legislation (especially in Barbados) and should be amended to make it easier for supervisors to be effective.

The insurance legislation in most of the islands will need amending to introduce prudential requirements to ensure that capital is aligned more closely to risk and to give the supervisor the required powers to ensure compliance with capital requirements and to foster safety and soundness in the financial system.

An adequate legislative framework with the supervisor having the necessary regulatory powers, fortifies the supervisory review process. There is no doubt that regulatory driven reforms will ensure that financial organisations consider new risk management technologies and tools to mitigate and control their exposure to a wide range of risks.

If our financial institutions are to gain in stature and enter into the international financial arena, they will be required to comply with the new Basel Capital Accord and address the correlation between market, credit and operational risk. The “three pillars” are meant to be mutually reinforcing, contributing to a higher level of safety and soundness in the financial sector, with the combination of bank management, supervision and market discipline, a goal that all supervisors share.

Our supervisors will no doubt be agitating to have a comprehensive approach to supervision of our financial institutions and to have our banks meet these new requirements of capital adequacy. The governments must play their part in having appropriate legislation in place.