

Speech to the Caribbean Association of Indigenous Banks

Delivered by;

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Trends in Regulation and Implications for the Regions' Banking System

Mr. chairman, distinguished guests, I would first like to congratulate CAIB for continuing this series of conferences as I believe that indigenous banks play a very important role in the development of the region. They can identify with the priorities of economic development in the region. We sink or swim together. My address will be on the third imperative in your title - the role that regulation plays in ensuring the stability of commercial banks and of the system, changes in global regulatory perspectives in recent times, and the importance of regulatory changes for the Caribbean banking systems. I was also asked to leave you with some thoughts on Basel II.

The removal of many barriers to the movement of funds on a global scale, the setting up of branches of international banks across the globe and the increased openness to volatility which can result has led to a greater interest in the regulation of the financial system. In the case of banks, the Bank for International Settlements (the BIS) embarked on a programme requiring intensified risk management for banks. The International Monetary Fund (IMF), intensified the use of the Financial Sector Assessment Programmes (FSAPs), which pay much attention to issues of risk management in the wider financial sector sense, the FATF concerned itself with anti-money laundering and the FSF with global financial stability. Some of these have focused more on emerging markets than on developed markets, but all include developing markets such as ours and they have all been supplemented by an increasing consciousness of

corporate governance, arising principally in the US but affecting the entire corporate world, particularly the corporate world of the public company.

This has led to the development of an array of rules, guidelines, techniques and approaches designed to prevent, if possible, and certainly to reduce the impact on the global financial system and on geographical or business- connected systems, of inadequate risk management in any part of the financial system. This development is logical, as it was international organizations who have pushed the merits of and the inevitability of globalization. However, the wider the extent of globalization, evidenced by cross border ownership structures, flows and cross border obligations, the greater the potential for a mishap in one jurisdiction leading to difficulties for others and for a domino effect occurring.

These new financial regulations, coming as they have in fast succession in the past 10 years, present challenges both for regulators in terms of ensuring adequate oversight and for the regulated entities in terms of compliance. It is therefore important for financial institutions to appreciate why they are being asked to comply.

The most important reason is the stability of one's own institution and in the long run its profitability and avoidance of crisis but also the stability of the financial system, whether national, regional or international, depending on the scope and reach of institutions. But because one can be affected by the negligence of others, your own care and oversight are not enough, hence it becomes a matter of global system responsibility.

While some emerging markets are not very international, there is increasingly little flexibility in making special cases for emerging markets or for indigenous banks, on the grounds that "it doesn't apply here", particularly if we are seeking recognition internationally, either as a financial group or as jurisdiction marketing itself to international business. Also, even though a few modifications may be made for domestic situations, and cases may be argued as to why

certain rules are not necessary here, it is important that the key aspects of the standards remain international, and that consistent definitions are used across countries if countries in one jurisdiction are to feel comfortable doing business in another, without doing their own detailed due diligence on the level of compliance in each jurisdiction in which they intend to do business. To do otherwise may hamper the chances of our own banks making inroads into international markets, and indeed banks in the region who have goals of greater intra regional and extra regional expansion have understood this and have responded appropriately.

Also, not only must we have these criteria in place, we must be seen to have them in place. It takes little for some poorly informed report coming out of the major cities to damage the region. We cannot afford to let that happen. If the price we pay is constant vigilance and oversight then it is worthwhile. The lesson we learnt is that whether deserved or undeserved, damage reduction from negative press is costly and prolonged. Transparency and compliance helps to overcome undeserved comments.

The financial sector has also grown in size and complexity and new institutions, products and services have evolved to meet the changing demands of customers. We in the region have not been isolated from the trend, as our institutions have been required to evolve to keep pace with an increasingly demanding and sophisticated customer that wants access to the products and services seen in the international markets. Financial innovations have changed the risk profile of the industry. In the past a primary issue of security was rarely the subject of derivative issues at any stage in its life. Then, the obligations of the parties and the risks were clear. Today the level of financial innovation has rendered the location of risk less straightforward. In addition, non-bank financial institutions can develop these derivatives, and transfer risk to other parties other than the originators. It is important therefore for non-banks also to be subject to some level of regulation.

The importance of heightened regulation cannot be underestimated given two other separate developments which have made the financial industry more risk prone on the one hand and increased the consequences of failure on the other. One is the integration of financial services in the fields of securities, banking and insurance. The other is the increase in the number and scale of mergers and acquisitions world wide with attendant calamitous potential repercussions should these mega banks fail.

The integration of services leads to greater opportunities but may open up the possibility of regulatory arbitrage, where an entity can be governed by lighter requirements but engage in secondary activity in another field where, were it his primary activity, it would have had to assume heavier capital or other requirements. Also, in integrated environment, what is added here is not only the risk to the banking, securities or insurance sector individually, but the simultaneous risk. It is for this reason that in some jurisdictions, particularly those which permit integration of these activities, they are being placed under a single regulator. In the Caribbean, we have several arrangements and it is not clear which is the optimum. The verdict is still out. However, what is clear is that there needs to be some level of collaboration by regulators across the industries in each national environment. This has happened in the region among regulators in subsectors before it has happened by regulators within the same national boundaries; though it is beginning to be corrected of late.

Side by side with these regulatory developments and their attendant obligations, are banking systems where small banks coexist alongside branches of large international banks which operate within guidelines set by the host supervisor. As a result, part of regulatory development has also involved home-host collaboration at the regulatory level. Indeed, not surprisingly, in an environment of mergers and acquisitions, the home supervisor seems to be increasing in scope, as the incidence of consolidated supervision increases.

Because of the increasing complexity of banking and the higher level of financial innovation in the banking system and the increasingly global transactions, the perception of risk has changed considerably and with it the measurement and assessment of risk. In addition off balance sheet risks, a factor which has been influenced not only by financial innovation but by the increase in funds under management – a spurious distinction - have brought new dimensions to risk assessment. Indeed the introduction of Basel II is partly the result of these developments.

Basel II calls for the establishment of key financial structures, changes in the culture of risk management, refinement of risk measurement techniques, improvements in our disclosure and governance frameworks and an overall upgrade in the management of our institutions.

Simply put, Basel II is based on the notion of three mutually reinforcing pillars.

The first pillar offers a range of methodologies to quantify three of the major risk categories faced by banks: credit, operational and market - operational risk, being the newly recognized risk requiring a capital charge.

Pillar I offers a menu of approaches, ranging from simple to complex calculations and models for calculating capital for the three major risk areas in banking. These range from the Standardised Approach, which is heavily reliant on the use of credit rating agencies, (and I am pleased to note that we now have a regional rating agency in our midst) to the Internal Risk Based models (foundation IRB and Advanced IRB), which rely on the institutions' internal models to derive the credit risk parameters.

Pillar II, known as the supervisory pillar, provides guidance on the bank's and supervisor's responsibilities with respect to risk management and financial stability and directly empowers

supervisors with the authority to make capital and intervention to promote safety and soundness.

The second pillar is governed by four principles and requires banks to develop a rigorous internal economic capital model and assessment process.

Principles three and four, call for banks to operate above the minimum level of capital and for supervisors to intervene early and may necessitate some improvements to the legislative frameworks.

The final pillar focuses on disclosure and engages the market in the overall supervisory process and could allow for a small well managed institution to better access the market and actively compete against the more established brands.

Additionally the accord is flexible with respect to the timing and method of disclosure, so it is not expected to undue burdens on institutions. Although there is no immediate specific pressure from the International Financial Institutions such as the IMF and World Bank to adopt the accord, there is a general market pressure to avoid being classified as second class.

In a global survey of mid-tier banks by the Economist Economic Unit (2004) the potential benefits for institutions adopting Basel II were identified as :

- Better risk management;
- Better pricing of products and allocation of capital to reflect the risk;
- Better access to funding;
- Greater transparency;
- Improved efficiency;
- Better competitive positioning; and
- Reduced volatility of earning and high overall profitability.

To implement Basel II, Caribbean banks will be required to identify all potential risks and create a risk management culture at all levels of the institution including business strategies and their associated risks. Internal capital assessment models where these are developed will allow banks to better tie management decisions more explicitly to risk.

The disclosure of risks exposures and measurement methodologies will also allow customers, investors and other clients to make more informed decision about banks and will also improve the institution's competitive edge.

Also improved pricing and management of risk, together with lower cost of funds should result in efficiency gains and smoothing of earning volatility. It is also anticipated that over-time the payback on the significant infrastructure requirements for Basel II development will lead to higher profits.

The single major challenge to the implementation of Basel II globally is the cost of the implementation, particularly for smaller institutions.

Institutions seeking to use the advanced approaches will be faced with a significant challenge with regard to the availability, collection and storage of data. Institutions need to have data that cover preferably a business cycle or at the bare minimum 3-5 years of good data for operational risk and 5-7 years for credit risk.

Already Central Banks, through the work of the Caribbean Group of Bank Supervisors are already carrying the cost of the substantial infrastructure requirements.

Another key issue will be that of attracting, retaining and retooling staff, as well as the cost of training associated with a significant change in technology and culture.

In Barbados we expect to implement the market risk amendment in 2007 and by 2009 we expect banks to move to one of the simpler approaches – either the standardized or the foundations IRB, and by 2012 those banks which are transitioning to advanced IRB should be doing so.

Closing Remarks

Despite the challenges and the costs there are significant gains to be made from adopting a proactive approach towards the introduction of the new standards. They will improve the balance sheets of banks and reduce loan write-offs and loan provisioning and reduce exposure to bank crisis. Having said that, we can choose the timing and the model we choose in conjunction with your regulator. These benefits alone will place us in a better position to compete globally and alongside large banks and should help to attract investment to our region. Basel II, though challenging, is therefore an opportunity for banks to prepare for the global market. In concert with the time frame set with your regulator, I encourage you to commit to its implementation lest we be considered second-class banks.

I thank you.