

**THE POLITICAL ECONOMY OF FINANCIAL REGULATION:
GLOBAL AND CARIBBEAN PERSPECTIVES**

Terrence W. Farrell

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Adlith

I joined the Central Bank of Trinidad and Tobago from a teaching and research position at UWI St Augustine in 1980 (October). As a lecturer in Monetary Economics at the university, I had heard of Adlith Brown who was at ISER in UWI Mona, but it was not until I was at the central bank that I actually met her. Adlith was the coordinator of the Regional Programme of Monetary Studies, forerunner of the CCMS, and it was her job to corral the central banks into funding and supporting the Programme. Petite and elegantly dressed with a round face and warm smile, Adlith certainly did not conform to the stereotype of the disheveled academic researcher. I can't recall exactly the year, but I do recall that the first RPMS meeting I attended was in Barbados and on my arrival at the hotel, I was invited by Adlith to have drink. I was a little surprised, but I soon discovered that she enjoyed a good rum especially of course, Jamaica's famous Appleton's.

I recall that she would sit patiently in the anteroom to the offices of the Governor and Deputy Governor in the Treasury building where the central bank was then located, awaiting an audience so she could press her case. She embodied how such partnerships are supposed to work. She made herself present to the central bankers in their hallowed halls, she was engaging, and she was persuasive, and she was undoubtedly responsible for sustaining the RPMS during the 1980s when structural adjustment and stabilization was abroad throughout the region. I think she was happy to have me, a former UWI academic, as an ally within the Trinidad and Tobago central bank, and we cooperated well together until her untimely death. I am happy to have known and collaborated with Adlith, and I am delighted to present this lecture in her memory at this Conference.

I am also honoured and privileged to follow the many distinguished Caribbean economists who have given this lecture at previous conferences such as Clive Thomas, Lloyd Best, Ewart Williams and Compton Bourne to name a few. I would like to acknowledge Professor C.Y. Thomas (affectionately "CY") who is, I understand, a special honoree of this year's conference. As students, we were privileged to have CY's books on Monetary and Financial Arrangements and on central banking, as well as of course his excellent work with Havelock Brewster on

economic integration which we could use to study our own economies and monetary systems from the perspective of citizens of the region. We owe a tremendous debt of gratitude to CY for his tremendous work and his insights which have shaped economic thought and policy in this region over many decades.

INTRODUCTION

If the financial meltdown were a three act play (in which we are still witnessing the third act), there would be many villains and a dearth of heroic figures. Blame aplenty there is to share around. Bank customers who should have known that those sub-prime mortgages were just too good to be true; the mortgage brokers who sold them those mortgages with inadequate documentation and knowing that customers were well short of normal prudential criteria for such borrowings; the banks who originated the mortgages and sold them on, the investment bankers who stripped those mortgages creating a range of 'mortgage-backed securities' from the cash flows and sold these on to other financial institutions; the credit-rating agencies, who rated those securities as investment grade; the insurance companies which created the credit default swaps to protect the investment banks; the hedge funds who recognised that these securities were mis-priced and profited from the eventual collapse; and let us not forget, the regulators who caused the problem in the first place and never saw it coming. Parallel comments can be made about the fall of CLICO and CIB, their sale of EFPA's and INCs, the cupidity of investors in those instruments, and the action or inaction of the regulators across the Caribbean region.

The financial meltdown has already been the subject of searching analyses by government officials, international financial institutions, academics and commentators as well as congressional hearings in the United States, and already several high-profile court cases. This audience is very familiar with these analyses, and it would be tedious and pointless to reprise these here. I have three broad comments on the meltdown and the response to it. First, the response to a crisis may lead to over-reaction and recrimination which could be deleterious over the medium and long runs. I think we are witnessing a great deal of this. Second, it is vitally important to ensure that we perceive clearly the different types of risks that different financial institutions assume and resist the temptation to lump all risk-taking institutions into one basket for the convenience of regulation. Third, it is also important to appreciate that market structures in developing countries are sufficiently different from those in developed countries so that the approaches to regulation need to be assessed on their own terms in developing countries. I have never been comfortable with the deference our officials seem to pay to what comes out of the international financial institutions and the apparently uncritical adoption of prescriptions designed for markets and situations which may be quite different from ours.

I would like to focus in this lecture the role and performance of the financial regulators in the debacle we have witnessed, the consequences of which the global economy is struggling to overcome. I will review the bases of financial regulation and the fundamental dilemma it poses for the regulator. I will discuss the political economy of financial regulation and the motivations attitudes and fears of regulators. My thesis is that the causes of regulatory failure are to be found in those motivations, fears and attitudes. I will discuss the CLICO/CL Financial crisis in the context of the global problem and the particular political economy of Caribbean financial regulation.

My Credentials

I would first like to address the question that may pop into the minds of some of you here and that is – By what authority does he dare to speak on the profound, nay, sacred mysteries of financial regulation and financial crisis management? I could try to answer by saying that I spent 15 years in central banking here in Trinidad and Tobago, and that I was in that time involved in the interventions and crises of that period. First, we had to address problems at certain non-bank intermediaries –Southern Finance, International Trust and others -- and then the Trinidad Cooperative Bank which led to the important amendment to the Central Bank Act and the introduction of section 44D. Then there was the intervention of the Workers Bank, the establishment of the Deposit Insurance Corporation, and finally the controversial intervention and merger of three local banks into the First Citizens Bank. There had been no major interventions before those which occurred between 1984 and 1993, and none since, until the recent intervention of CLICO Investment Bank and CLICO in 2009.

More important, I crossed over to the ‘dark side’ in 1998 when I joined a local insurance company which quickly became a regional insurance company with acquisitions in Jamaica, and the Netherlands Antilles. The target insurance business in Jamaica had become available from the financial crisis which hit Jamaica in the mid-1990s, and I was part of the Guardian Holdings team which negotiated with FINSAC for the assets to support the insurance liabilities we assumed. But my experience of insurance dates back to 1988 when I became chairman of the then partially state-owned Reinsurance Company (TRINRE). Since 2008 I have been a director of Republic Bank Limited. As a consultant in strategy and business development, I have worked for banks and mortgage finance institutions on their strategic plans. I have, as it were, both hunted with the hounds and run with the hares!

THE THEORY OF FINANCIAL REGULATION: WHY REGULATE?

I would like to begin by addressing the question “Why Regulate?” or in more formal terms, the theory of financial regulation. As with any other kind of regulation, the case for financial

regulation rests primarily on (1) externalities, that is, external economies and diseconomies, and (2) other sources of market failure. Financial intermediaries trade in risk. They may transform risk across time or space or they may transfer risk from one entity to another, or both. In some cases the pricing of risk transfer is explicit as in the case of the purchase of an insurance policy. In other cases, the risk transformation is not at all transparent to participants, as in the case of a depositor in a commercial bank.

Externalities arise because the failure of one financial institution may undermine confidence in the system as a whole and lead to its collapse. The risks which depositors (and shareholders) face may become evident only when the institution collapses. Information asymmetries are one source of market failure for financial institutions. These externalities are not discerned or appreciated by profit-maximising financial institutions or utility-maximising depositors or policyholders, but they constitute an important basis for regulatory oversight. Parenthetically, it is important to note that fraud, mis-selling and misfeasance are *not* per se bases for regulatory oversight. Fraud may be the trigger for a collapse of an institution, but it is not the business of the financial regulator to prevent fraud, but rather to ensure the financial institutions have corporate governance systems and practices that minimize fraud.

Over the course of a business cycle, financial markets will also experience expansion and contraction. In the contractionary phase, some intermediaries may experience liquidity problems or may sustain losses which in turn may lead to a loss on confidence on the part of their stakeholders –investors, depositors or policyholders - prompting a withdrawal of funds which could accelerate into a run. In some instances the loss of confidence is sudden, as for example, with the arrest of a principal of the institution concerned.

Historically, central banks acted as ‘lender of last resort’ for commercial banks which dominated the financial sector, providing liquidity during the contractionary phase and forestalling insolvency and runs on particular banks, which if left unchecked could become contagious. Insurance companies have a different business model and hence a different pattern of failure. General Insurance (Property and Casualty) companies whose business is short-term are unlikely to pose systemic risk and the losses which arise from failure tend to be limited and do not usually destroy personal or company balance sheets. The failure of Life and Pensions companies are rather more problematic since personal balance sheets and/or cash flows may be seriously affected and this may occur at a time (e.g. persons of pensionable age) when policyholders are unable to repair the losses sustained. The growth of money and capital markets over the last few decades has witnessed the creation of new types of financial instruments resulting in the decline in the dominance of commercial banks and prompting the establishment of Securities and Exchange Commissions to regulate or oversee the new institutions.

Regulation of financial institutions now involves several kinds or levels of interventions. First there is licensing which regulates the entry of firms into the industry, and the ‘fit and proper’ criteria which regulates the entry (and exit) of directors of financial institutions. Second, there is the promulgation of various standards or prudential guidelines in respect of capital adequacy, asset quality, and corporate governance, as well as guidelines or rules in respect of liquidity, dividend policy, shareholder control, etc. Third, there is the supervision of financial institutions to assure compliance with the rules and guidelines and to provide some assurance that risk management frameworks within the institutions are adequate. Fourth, there are the (statutory) procedures for the regulator’s taking control of a failing institution. Fifth, and this is now being elaborated in the wake of the recent financial meltdown, the procedures for the safe dismantling of a (large) financial institution so as to avoid adverse systemic effects, sometimes termed ‘living wills’.

This all seems pretty straightforward and clinical. Why then is it that financial crises and interventions always seem so messy and complicated? The answers lie, I think, in factors such as equitable treatment (who gets ‘bailed out’ and who does not), the extent to which *caveat emptor* should apply, the use of *taxpayers’ money*, the partisan political interests of the government in power, in short, the Political Economy of Financial Regulation to which I now turn.

THE POLITICAL ECONOMY OF FINANCIAL REGULATION

It is congenial, especially for regulators themselves, to believe in the intrinsic rightness and nobility of financial regulation. It is after all in the service of the public interest, for the greater good, for the protection of the weak and the less well-informed. But the reality of financial regulation is not quite so benign. Here are five (5) reasons why.

Politics

Regulation of any kind is fraught with politics. Regulation determines winners and losers. Winners are those who obtain licences, losers those who don’t. Winners are those bailed out by the financial regulator in a crisis, losers those who are not. Richard Posner describes politics as a ‘ubiquitous impediment to effective regulation’. Regulations and the systems and structures which support them invariably have to be legislated. This means that governments have to put the legislation in place and opposition parties have an opportunity to comment on, modify or even to block the legislation, if they have sufficient power. All forms of regulation impose costs on the entities that are regulated. It is also the case that many kinds of regulation affect the constitutional rights of persons –individual or corporate - directly or indirectly. Media regulation

affects freedom of expression and freedom of the press. Financial regulation affects property rights, as when for example, the regulator intervenes and takes control of a financial institution.

However, regulation is not usually carried out by politicians or within the mainstream public service. In the case of financial regulation, central banks are more often than not, given the job of regulation and supervision of financial institutions in addition to their primary responsibility for monetary policy.

Within recent times, special financial services commissions have been established as in Jamaica and now proposed in Barbados. Historically, the regulation of insurance companies has been located within the mainstream public service in most countries. The United States has perhaps the most complicated regulatory structure involving state and federal agencies, two regulators of securities business – SEC and CFTC – state regulation of insurance companies, and overlapping regulators of banks – Comptroller of the Currency, the Office of Thrift Supervision and the Federal Reserve, a system sometimes described as ‘regulatory competition’, but which probably only the United States and the European Union can afford. Congressional hearings in the United States allow politicians there to get deeply into regulatory matters in a manner which no other country has yet seen fit to introduce.

Legislation governing most forms of regulation, including financial regulation, usually provides for some role for elected officials in the process, either the approval of licenses, in setting policy or in times of crisis, where public funds may need to be expended. While this is unobjectionable in principle, in practice it opens the way for political interference motivated not necessarily by the public interest but by narrow partisan concerns.

Politics may intrude more directly and perversely through influence-peddling by financial institutions for example with campaign contributions, or where politicians are related to or were themselves employed by the financial institutions they are now called upon to regulate or to bailout.

Globalisation

A second factor complicating financial regulation is the fact, established over 100 years now, that financial institutions move to operate globally to follow their client’s businesses, to achieve scale economies and to exploit new markets for higher returns. Here in the Caribbean, in addition to the several international banks we have had for 100 years, we now have a few genuine regional financial corporations in companies like Sagicor, Guardian Holdings, Grace, AIC and Republic Bank. And of course we had CLICO, of which more later.

When financial institutions cross borders, regulators get a headache. Who is responsible for the activity of the branch or subsidiary in the host country, the host country regulator or the home country regulator? How can regulatory arbitrage be avoided or minimized? What is the capacity of the host country regulator to oversee sophisticated multinational financial corporations? How does the host country regulator protect against contagion arising from failure overseas, exemplified for example in the case of BCCI in the 1980s? Is it appropriate for financial legislation and capital requirements to be harmonized across the world, and if so how do we deal with variants like Islamic Banking, very small local banks, insurance companies in developing countries, etc? What are the modalities by which regulators can cooperate to deal with troubled institutions *ex ante* and *ex post*? Can information sharing among regulators be sufficiently comprehensive that local regulators are not surprised by events? These are all very difficult questions which regulators have been wrestling with over the last three decades as cross-border provision of financial services becomes increasingly common.

The international regulatory system, *soi disant*, has developed over the last 30 years in response to the global expansion of very large banks and securities companies and some insurance companies. The system is messy and complicated, but at its heart is the Basel Committee (banking), IOSCO (securities), IAIS (insurance), and various standards bodies for accounting, actuarial valuations and audit. Caribbean banking supervisors have been talking to each other regularly for many years, but cooperation among insurance supervisors has been slower to develop because these were located within ministries of finance, and there was little impetus for developing a common agenda.

Moral Superiority

Financial regulators take on the mantle of the ‘good cop’, or for those who prefer Western movies, the honest, fearless and upright sheriff of a lawless town. What this requires is that the entities that are regulated be perceived as ‘bad’ or ‘naughty’. Here are some of the moral positions which arguably underlie financial regulation:-

- Bankers and insurers are profiteering, greedy capitalists who have little or no regard for the public interest
- Bankers and financiers do not want regulation and supervision at all
- Depositors who seek high interest rates are greedy and reckless
- Regulators are paragons of virtue, guardians of the public interest against venal financiers
- Regulators need more power to act and to sanction.

To be sure financial institutions do little to exonerate themselves when the executives of Wall Street investment banks are paid huge bonuses, and in their midst can be found characters like

Bernie Madoff, Allen Stanford, currently charged in the USA, and David Smith the mastermind of the Olint scheme in Jamaica, now convicted in the USA.

But before financial regulators stand taller on their moral high horses, it might be useful to recall that Bernie Madoff's story had an important chapter written within the walls of the US SEC itself where warning signs of his schemes were ignored or glossed; the auditors of Enron were found wanting in their oversight of that failed entity, and the governor of the Bank of England was criticized for his slow reaction to the Northern Rock problem. We should recall as well as the regulator of Stanford's businesses in Antigua was apparently suborned and compromised; the authorities in Jamaica dithered for a long time over the Olint and similar schemes, with the Olint scheme running rampant for some three (3) years according to the indictment filed in the US courts. We might also recall the judgment of the Privy Council in the matter of Gulf Insurance and the Central Bank of Trinidad and Tobago where the Privy Council commented adversely on the central bank's use of its powers of intervention under section 44D which was *ultra vires* and which in that case amounted to "unlawful expropriation without compensation".

Another dimension of conflicted morality in financial regulation occurs in societies like Trinidad and Tobago where, for historical and other reasons, some institutions are patronized more by one ethnic group than another. If such an institution fails, the regulator is supposed to act professionally and blind to ethnic and other considerations which may threaten to intrude. Failure to do so may open up the proverbial can of worms. The rescue of the shareholders of the Hindu Credit Union in Trinidad and Tobago, justified on the ground of 'equity' since the CLICO policyholders were to be rescued, may well be a case in point. It is difficult to see how shareholders of any credit union which now fails, posing not the slightest systemic risk, can be denied a government rescue.

Monetary Policy v Financial Policy

I believe that central bankers have always understood the connection between monetary and financial policy, linked as they are by the traditional central banking function of lender of last resort. Economic contraction leads to liquidity problems and liquidity problems can lead to solvency problems, and one insolvent bank can potentially upset confidence in the entire banking system. A new term expressing this old idea – 'macro-prudential considerations' – has entered the lexicon of regulators around the world. But it is important to remember that this also works in the reverse. Monetary policy that is too easy or lax creates incentives for risk-taking which can result in problems for some financial institutions and possibly for the system as a whole. This is at the heart of the meltdown and is discussed in greater detail later.

Knowledge and Information Gap

The fifth complication is that there are not only information asymmetries between customers and shareholders of financial institutions and the managers of those institutions, but there are also information asymmetries between the regulators and the financial institutions they regulate. Regulators cannot effectively regulate what they do not understand very well.

There are several dimensions to this dilemma. First, economic growth and development prompts financial innovation and financial innovation stimulates economic growth by improving the efficiency and effectiveness of financial intermediation. Regulators should not stand in the way of financial innovation, and indeed they should encourage it. Yet financial innovation by definition takes the institution, its customers and the regulators into uncharted territory where risk morphs into uncertainty. Second, regulators tend to be typecast. They are conservative and public-spirited. Financial institutions may harbor flamboyant risk-takers whose sole concern is profit and the thrill of making even more profit. It is perhaps no surprise that few regulators come from the ranks of financial institutions. Human Resource departments at central banks and other regulatory agencies probably do not embrace easily the candidate for the job of regulator who displays a penchant for risk-taking and an inordinate love of money!

It is no surprise that much of the angst in the recent meltdown was caused by the regulators' and public's lack of understanding of what the financial instruments were, how they operated, where they went when sold, how counterparties perceived the instruments, trading for own account versus trading for client's account, and sometimes the Chinese walls between these activities within the same financial institution. The visceral reaction in times of crisis is to prohibit the creation and sale of these new instruments, to stop innovation. But the long term effect of such prohibition could be adverse for economic growth and development.

I think that these five factors help to explain why financial regulation, particularly in times of financial crisis, becomes complicated and sometimes messy. I would now turn to the recent global financial meltdown and to the CLICO/CL Financial matter as illustrative of some of these points.

REGULATORY FAILURE

Financial Meltdown of 2007-2009

We are all aware that the financial meltdown was triggered by the sub-prime mortgage crisis in the middle of 2007. The story of the subsequent and continuing unraveling has been documented by official writers and journalists. The question is, what caused the problem in the first place? I

am quite clear in my own mind that the root cause of the problem was the inordinately low interest rates maintained by the US Federal Reserve after the recession of 2000-2001 and after the September 11 event. The Greenspan Fed was uncertain about what the terrorist attack might do to the financial system and the economy and fearful that the economy would remain stuck in recession as confidence waned. Greenspan wrote in his memoir, *The Age of Turbulence*:-

“For a full year and a half after September 11, 2001, we were in limbo. The economy managed to expand, but its growth was uncertain and weak. Businesses and investors felt besieged. The immediate crisis of the first few months...gave way to the low-grade strain of coping with domestic security’s anxieties and costs. Enron’s bankruptcy in December 2001 compounded the uncertainty and gloom...” (p.227)

“The Fed’s response to all this uncertainty was to maintain our program of aggressively lowering short-term interest rates. This extended a series of cuts we’d already made in early 2001 to mitigate the impact of the dot-com bust and the general stock market decline. After the September 11 attacks we cut the fed funds rate four times more and then once again at the height of the corporate scandals in 2002. By October of that year, the fed funds rate stood at 1.25 percent, a figure most of us would have considered unfathomably low a decade before.” (p.228)

Interest rates were declining globally and more significantly, the yield curve became inverted around the middle of 2006 as long term rates fell precipitously. Low interest rates for such a prolonged period (almost five years) led banks and customers to believe that rates would remain low ‘forever’, and the mortgage lenders acted on that belief, with consequences we have seen. But Greenspan’s motivations were not only dictated by fear and uncertainty, he had this to say on home ownership:-

“By early 2003, thirty-year mortgages were below 6 per cent, the lowest they’d been since the sixties. Adjustable-rate mortgages cost even less...By 2006, nearly 69 percent of households owned their own home, up from 64 percent in 1994 and 44 percent in 1940. The gains were especially dramatic among Hispanics and blacks, as increasing affluence *as well as government encouragement of subprime mortgage programs* enabled many members of minority groups to become first time home buyers. This expansion of ownership gave more people a stake in the future of our country and boded well for the cohesion of the nation, I thought.” (p.230, my emphasis)

We see here the confluence of fear and uncertainty and the intrusion of political concerns on homeownership in the decision-making of the Fed. Parenthetically, in a presentation at the Business Insight Caribbean Investor Conference in December 2006, I stated:-

“The US Federal Reserve is probably getting to the point of a policy dilemma. It has to make a judgment as to whether inflation has been contained or not, when the signals from the market are conflicting. ... If the Fed judges that inflation is contained, but elects not to reduce the Fed Funds rate, it is possible that the yield curve inversion may be sustained and eventually precipitate a recession. If the Fed judges that inflation risks are still too high and continues to pause or even tightens further, and the bond market continues to reflect a different view, the inversion will be sustained and may eventually precipitate a recession in late 2007 or early 2008.”

Well, as they say, the rest is history.

The other factor in the mix during this episode was the Knowledge Gap. Greenspan for one believed that the market would manage the new exotic instruments which were being created, notwithstanding the Long Term Capital Management problem in 1998 which presaged the events a decade later. Greenspan’s view was:-

“As a bank regulator for more than eighteen years, I came to recognize that government regulation cannot substitute for individual integrity. In fact, any form of government guarantees of credit lessens the need for financial counterparties to earn a reputation for honest dealings. It is conceivable of course that government guarantees are superior to an individual’s reputation. But guarantees – even the most widely praised, such as deposit insurance – have costly consequences. I concluded, and I suspect most regulators agree, that the first and most effective line of defence against fraud and insolvency is counterparties’ surveillance. For example, JP Morgan thoroughly scrutinizes the balance sheet of Merrill Lynch before it lends. It does not look to the Securities and Exchange Commission to verify Merrill’s solvency”. (*The Age of Turbulence*, p.257)

Not surprisingly perhaps, Greenspan was sanguine that the financial markets would manage the risks inherent in the exotic derivatives and other instruments created by the so-called ‘shadow banks’ and which were based on subprime mortgages and other debt obligations. Given the testimony in the case which Goldman Sachs recently settled with the SEC, Greenspan may now be less sanguine on the matter, and even less so in respect of the ordinary depositor who, most would agree, should have the benefit of deposit insurance. Indeed in his testimony to Congress in October 2008, and in ‘shocked disbelief’, Greenspan acknowledged that he had made a mistake in assuming that the self-interest of financial institutions would serve to ensure that they were best capable of protecting their own shareholders and their equity in the firms.

I do not at all mean to suggest that the Federal Reserve had an easy call and made a mess of it. In fact, one of the points of this lecture is that financial regulation is very, very difficult. But that episode highlights the nexus between monetary policy and financial policy, how expectations are

set and how investors act on those expectations. It also indicates perhaps that policymakers and regulators are influenced by other factors which compromise their clarity of judgment and the professionalism of their decision-making, especially in a crisis.

But does this episode tell us that monetary policy and financial regulation need to be in the same place, that is, co-located in the central bank so that ‘macro-prudential considerations’ are always brought to the fore? Or does it suggest that monetary policy should proceed without consideration of the impact on expectations and risk-taking in the financial sector, leaving those considerations to another regulatory body?

CLICO and CL Financial

CLICO (and British American Insurance) have grabbed the headlines in territories from Belize in the west and the OECS in the east, The Bahamas in the north to Guyana and Suriname in the south, with the epicenter of the crisis in Trinidad and Tobago. The latest developments in this saga have been:-

- CLICO companies in Barbados have now been placed under judicial management
- CLICO in Guyana is now in liquidation
- CLICO in The Bahamas is being wound up
- The liabilities of BAICO in the OECS are supposed to be transferred to another company
- CLICO policyholders in Trinidad and Tobago in non-traditional products have been offered a bailout comprising an immediate payment of \$75,000 and the balance paid in annual installments over 20 years by means of a government ‘bond’. In addition the Government of Trinidad and Tobago will institute a commission of enquiry into CLICO and CL Financial.

The collapse has ramified throughout the region and affected tens of thousands of persons. So the question is, what went wrong from a regulatory standpoint? I ask this question even though I am quite clear that the purpose of regulation is not to prevent financial crises from ever occurring, and no professional regulator ever takes the view that he can prevent financial institutions from failing.

While it is clear that the regulators in all the jurisdictions in which CLICO or BAICO operated needed to have taken earlier action, if only to notify the regulator in Port of Spain that the operations there were risky or unhealthy, we must examine the regulatory circumstances and response in Trinidad and Tobago as the home country of CLICO and the CL Financial group.

There were two regulated financial institutions within CL Financial – CLICO Investment Bank (CIB), and CLICO – and a third unregulated entity, CMMB. CIB and CLICO were regulated by

the Central Bank. The central bank's response to CIB, which was always within its regulatory purview, is puzzling to say the least. It was well-known that CIB attracted marginal borrowers who risks would probably not have been entertained at commercial banks. Information which has emerged from the ongoing litigation between the central bank, the CIB and its former chairman shows an institution with weak governance. In his affidavit to the court petitioning for the winding up of CIB, the Inspector of Financial Institutions charges that CIB:-

“...was not maintaining high standards of financial probity and sound business practices... was experiencing significant liquidity problems, through its linkage to CLICO ...had a potentially significant contagion risk to the rest of the financial system and therefore posed a danger of disruption, substantial damage and injury and impairment to the financial system of Trinidad and Tobago.”

This prompted the Central Bank to assume control, bring suit the former chairman and refuse to treat with holders of the CIB's Investment Note Certificates on the ground that these were not truly deposits. But what was happening over the previous years when CIB was supervised by the Central Bank? And as Camini Marajh, Trinidad's leading investigative journalist, inspecting the emperor's new clothes, has asked:-

“...why did the Central Bank as regulator allow CIB (a regulated financial institution) to sell INCs if it (sic) failed to measure up to the acid test of a fixed deposit?”

I remain perplexed by the Central Bank's apparent vacillation and inaction in respect of CIB's business over several years prior to the intervention but I remain hopeful that as the litigation unfolds or as the commission of enquiry proceeds, we will get the answers to those questions and learn of the steps the Central Bank took to curb and curtail CIB's imprudent banking practices prior to its intervention in January 2009.

CIB was intervened at the same time as CLICO in January 2009 under Section 44D and along with CMMB quickly and indeed clinically closed, assets and liabilities transferred, and the entire process was done and dusted in about a year. Of course issues remain to be resolved with the realization of assets, and there are other legal challenges by certain depositors, but these matters in any event take many years to be completed. So why has this not happened with CLICO?

First, the issue of non-compliance with the Insurance Act by CLICO goes back 15 or 20 years. At that time CLICO was supervised by the Ministry of Finance which had limited supervisory capability. Financial reports were usually obtained late and the Supervisor of Insurance relied largely on compliance with statutory fund requirements. Responsibility for the supervision of insurance companies was transferred to the central bank only in 2004, but it must be noted that the Insurance Act was not amended and the Central Bank as the regulator had the same weak

powers of supervision and no real powers of intervention as the Ministry's department— Supervisor of Insurance -- had. The intervention in January 2009 therefore required that Section 44D of the Central Bank Act be amended to include insurance companies, and the Insurance Act to be amended to accommodate the central bank taking control.

The real question therefore is why did the government of the day not see it fit to introduce in a timely fashion appropriate new legislation to govern the regulation and supervision of insurance companies, especially when it had been known for a long time that the largest insurance company, CLICO, was operating in a highly risky manner? There is a parallel history of legislative inaction in respect of credit unions where the legislation to bring these under the purview of the central bank is still in process, and several large and important financial institutions – Unit Trust Corporation, T&T Mortgage and Finance –remain regulated by nobody at all!

Second, CLICO is a financial institution whose operations were intricately intertwined with those of CL Financial its parent and other subsidiaries in the group through a host of related party transactions. CLICO was used to obtain funds from the public and from institutions, including state enterprises, and channeled these funds into various CL Financial projects in petrochemicals, land and property development, housing construction, forestry, beverages, etc. Those projects themselves borrowed money from third parties which encumbered the assets acquired or developed with the funds obtained from CLICO. An intervention of CLICO is more like delicate brain surgery than a simple appendectomy.

Third, CLICO has become intensely political. Its former chairman, Lawrence Duprey, was openly aligned with the former leader of the UNC, one of the constituent parties of the current administration, the People's Partnership, while the CL Financial Group Financial Controller, Andre Monteil, was the Treasurer of the PNM and a constituency campaign manager. The former Finance Minister's late husband was a senior executive of CLICO and the former Junior Minister of Finance was himself once a senior executive of the CL Financial group. Two other senior CL Financial executives were government ministers in the UNC government. CLICO is known to have made campaign contributions to the PNM and more than likely to the UNC as well. CLICO was the largest black-owned and controlled company in the country. Its policyholders, especially of the EFPA product, comprise a broad cross-section of middle and upper-middle class Trinidadians and Tobagonians while the political profile of the current administration is non-urban, populist or grassroots, with connections to the trade union movement.

Another factor, which was however quickly 'kicked to the curb', was the regional ramifications of the crisis and whether the authorities in Trinidad and Tobago would accept responsibility or lead a regional response to the CLICO problem. It was made clear early on by the Trinidad and

Tobago regulator that every territory would have to ‘paddle its own canoe’ and there would be no regional coordination in respect of a resolution of the crisis, much to the chagrin of committed regionalists like Owen Arthur, former prime minister of Barbados, and Norman Girvan, retired professor of economics.

These factors have complicated the search for a resolution of the CLICO/CL Financial crisis.

CL FINANCIAL/CLICO OPTIONS

What options were open to the regulator to deal with the problem of CLICO and CL financial when these came into the open in January 2009? Attempting to address this question in the absence of all of the information which the Central Bank and Ministry of Finance would have had at the time is of course fraught, and I stand to be corrected.

I think that there were, and are essentially four (4) options open to the regulators.

(1) Muddling Through

Characterising ‘muddling through’ as an option can be challenged, but it is actually how people and organisations behave when confronted with complex and/or fast-moving circumstances. One deals with situations and issues as they arise and goals and objectives hopefully become clearer as one proceeds. At the time of the first intervention in January 2009, the stated objectives were:-

- a) To stem the increasingly serious liquidity pressures being faced by the financial services companies within the Group – i.e. CLICO Insurance Company Limited (CLICO), CLICO Investment Bank (CIB), British American Insurance Company Limited (BAICO) and Caribbean Money Market Brokers Limited (CMMB);
- b) To maintain public confidence in these institutions which constitute a significant part of the country’s financial services industry, and
- c) To ensure the continuing stability and integrity of the financial system.

It is clear that the regulators defined their objectives in relation to what they perceived to be a systemic threat posed by a likely failure of CLICO and related companies. The Central Bank was clear what it was going to do about CIB and CMMB, but was less clear about how it was going to deal with CLICO itself, though it was aware that it had to extricate assets tied up within the wider CL Financial group. I recall at the time being quite puzzled at the specific actions indicated in that media release in respect of Republic Bank and Methanol Holdings, the only two profitable subsidiaries in the CL Financial group. The Central Bank has been muddling through the CLICO problem since, as it began to unravel the tangled web. The problem with ‘Muddling

Through' is that decisions may be taken on the basis of exigency which compromise or make impossible the exercise of certain options and actions later on.

(2) Liquidation

The argument for liquidation, favored by several commentators, mainly it would seem those who are accountants by profession, is that the CL Financial group as a whole is insolvent and its assets encumbered. The purpose of the intervention should be to effect an orderly liquidation, with policyholders getting whatever can be realised from the assets of the group after satisfying secured creditors. The question of 'protecting' policyholders would not arise, except to ensure that the value of the assets realised was maximised. Liquidation would have serious consequences for policyholders and pensioners and change the landscape of the life and pensions business in Trinidad and Tobago in a significant way by eliminating its largest company. The problem with Liquidation is that it is final. Once the process is embarked upon, it will not be possible to retrieve it or to change course.

(3) Restructuring of the Financial Institutions in CL Financial

The third option would be to attempt to preserve the financial institutions within CL Financial, that is, CLICO and CIB. The focus of this effort would be to use techniques well-known to the central bank including hiving off bad assets and substituting these with government paper, sale to another financial institution, or some combination of these. Shareholders and some creditors are left with the loss. The objective is to maintain confidence by the preservation of depositors and policyholders, and the process is done as quickly and surgically as possible. Indeed this is what was done quickly with CIB and CMMB being transferred to First Citizens Bank. The process is more difficult with insurance companies however, especially one as large as CLICO and with the Executive Flexible Premium Annuity product apparently accounting for the bulk of its liabilities. Restructuring will serve to ensure that the life and pensions industry continues to be served by several strong players.

The problem with Restructuring is that it requires the commitment of resources (cash) early on, partly to shore up confidence and partly to preserve asset values as best as possible. In circumstances which may be fiscally constrained or where the regulator's balance sheet is not 'infinite', finding the resources could be challenging and considerable financial engineering may be needed to give this option a real chance of success.

(4) Strategic Reorganisation of CL Financial with Financial Restructuring

This option is open to the possibility that the CL Financial group or parts of it may be of strategic value to the country and the region over the long term and indeed is premised on the view that

any financial restructuring will in any event take a long time. Certain businesses within CL Financial are clearly strong and viable, such as Republic Bank and its petrochemicals businesses. Some other parts of the CL Financial group such as its Beverages business (now including Lascelles de Mercado in Jamaica), and its property development capabilities built up in Home Construction Limited might have the potential to be reorganised and revived. The issue becomes how can the long run benefits, if any, be realised and what needs to be done in the short run to keep stakeholders committed.

In addition to the challenges with attend the Restructuring option, Strategic Reorganisation is challenged by the fact that there is no Chapter 11 type bankruptcy protection in the Caribbean that would provide protection from creditors or even force the subordination of senior creditors as occurred with General Motors and Chrysler in the United States. Moreover, this option requires a set of business skills and capabilities which are typically absent from central banks and ministries of finance.

Although the recently-elected Government of Trinidad and Tobago has announced a new plan to deal with policyholders of CLICO, it is not clear whether it proposes to pursue Liquidation or Restructuring. Based on the new team selected to run CLICO and CL Financial, one can infer that, as with the previous administration, the option of strategic reorganization with financial restructuring is not one of the options being considered. We are apparently continuing to muddle through.

CONCLUSIONS

I believe that there are important parallels between the global financial meltdown centered on the United States, but also impacted the United Kingdom and some European countries, and the regional financial crisis precipitated by the collapse of CLICO and CL Financial, which followed the Stanford and Olint situations.

First, both situations had at their hearts financial instruments which were effectively unregulated – EFPAs and INCs in the case of CLICO/CIB, and credit default swaps and CDOs created from mortgages and other instruments in the case of the subprime mortgage crisis. Second, there were financial institutions which were unregulated or weakly regulated – the broker-dealers such as Goldman Sachs, Lehman Brothers and Bear Stearns in the USA, and CLICO itself in the Caribbean was weakly regulated.

Third, there was considerable leveraging of assets in both cases. In the case of CLICO/CL Financial, this took the form of significant intra-group and related party transactions combined with third party debt secured on group assets. Fourth, leverage plus the new instruments created

plus the nature of the transactions between and among the parties (e.g. three party repos) made for considerable complexity. It was difficult for the regulator and even for the parties themselves to disentangle what was going on.

Finally, in both cases, the regulators failed. In the USA, the regulators failed to appreciate the impact that monetary policy was having on the perception of risk and the behaviour of financial firms and individuals. In the UK, the regulators failed to identify the problems building up in the financial system, failed to take steps to mitigate these problems, and failed to deal adequately with the crisis when it broke. In Trinidad and Tobago and the rest of the region, the regulators, (and here we include the ministries of finance), though aware that CLICO and its sibling companies were engaged in risky practices, did not do enough to curb these practices, and up to now almost two years on, have not settled on a coherent, consistent strategy for dealing with the crisis.

Responses to the Crisis

So what are the lessons of these financial crises and what should be done? At the international level, regulators have rushed to institute Basel III, new capital adequacy rules for banks and other financial institutions to be implemented over the next several years. The outlines of Basel III will be presented to the G-20 leaders meeting in November 2010. Basel III proposes:- (1) an increase in the minimum common equity to 4.5%; (2) Tier 1 capital requirement of 6%; (3) a 'conservation buffer' of 2.5% comprised of common equity so that Tier 1 capital will be 8.5% and Total Capital will be 10.5% from the current level of 8%; (4) a countercyclical buffer ranging from 0 to 2.5% to be implemented during periods of 'excessive credit growth and which will be an extension of the conservation buffer; (5) stronger definition of 'capital' and stricter criteria for regulatory adjustments to the definition of capital; (6) application of higher capital requirements for trading, derivatives and securitization businesses; (7) phase in of the higher capital requirements over a period up to 1 January 2019. In addition Basel III proposes that higher capital requirements should apply to 'systemically important banks'.

The proposals have already provoked considerable comment and criticism. Some of the more potent comments and criticisms relate to:- (a) the fact that regulatory reform at the national level may compromise the implementation of the Basel III accord or be inconsistent with it; (b) the issue of regulatory coordination remains hanging, including and especially coordination between the international regulatory agencies for banking (BIS), securities (IOSCO) and insurance (IAIS); the Financial Stability Board was established in 2009 to replace the Financial Stability Forum; (c) the length of the phase in period for full implementation of the capital requirements; (d) the impact of the new requirements on the ability of banks to lend and hence on the pace of economic growth; (e) the implications for the structure of the banking industry as capital-raising becomes more challenging for smaller and medium-sized banks.

Given that the Basel Accord promulgates minimum guidelines for countries which may implement tougher rules if they so desire, Caribbean regulators need to assess carefully the likely impact of the implementation of Basel III on banking and financial services in the region. In particular, the notion of counter-cyclicality which informs Basel III may not be applicable in economies which do not experience business cycles in the same way industrialized countries do, and may therefore curb credit expansion and growth when there is really no threat of increased risk to the financial system.

The second level of response has been to address the structure of regulation. In the UK, the new Coalition Government has moved to reform the tripartite model of financial regulation by co-locating prudential financial regulation in the central bank under a Deputy Governor reporting to a new Financial Policy Committee. In the USA, the response in the form of the Dodd-Frank legislation has effected some structural reform with the establishment of the Financial Stability Oversight Council, a Vice-Chairman of the Federal Reserve responsible for Supervision, and a Consumer Protection Agency. The Americans are clearly disinclined to the actual co-location of monetary and financial policy, preferring instead regulatory competition and the ‘oversight committee’ approach to coordination. Dodd-Frank has also instituted reforms in respect of corporate governance and executive compensation, new registration requirements for hedge fund and private equity fund advisers, heightened regulation of over-the-counter derivatives and asset-backed securities and new rules for credit rating agencies with oversight by the SEC. The Act also mandates significant changes to the authority of the Federal Reserve and the Securities and Exchange Commission as well as enhanced oversight and regulation of banks and non-bank financial institutions.

One important innovation in the United States which resonates with the Caribbean situation in respect of CL Financial is the authorization of the Oversight Council to identify systemically important domestic or foreign non-bank financial companies “whose material financial distress, or whose nature, scope, size, scale, concentration, interconnectedness or mix of the activities, *could* pose a risk to the financial stability of the United States and require the regulation of such companies by the Federal Reserve”.

In Europe, the European Union has opted to establish the European Systemic Risk Board from January 2011, headed by the President of the European Central Bank and with the responsibility for macro-prudential oversight of the European financial system and specifically to “...actively monitor the various sources of risk to financial stability in the EU – across Member States and financial sectors – with due consideration of also global developments”. Information sharing and coordination across member states may well prove challenging although it is clear that this is vitally necessary if the ESRB is to be effective.

In the Caribbean, Barbados is moving to set up a Financial Services Commission to license and regulate financial institutions other than banks. This is a curious move in light of (1) the contemporary imperative of co-locating monetary and financial policy as far as possible; (2) the additional costs of regulation in a small country; and (3) the precedent in Jamaica of tensions between the central bank and the FSC where institutions to be supervised and regulated straddle both regulatory agencies. The government of Guyana has promised reform but has not specified what form this will take. Trinidad and Tobago is mired in controversy in respect of CLICO and CL Financial and regulatory reform is not on the agenda. Two important pieces of legislation which Caribbean governments should put on the front burner are (1) provisions along the lines of Dodd-Frank legislation in the USA that would allow the financial regulator to intervene in a non-bank financial company where that company poses a systemic risk, and (2) a Chapter 11- type provision in Bankruptcy legislation where such exists. It is difficult to see how the CL Financial group can be re-organised without such powers in place that would allow the regulator to deal with its subsidiaries and creditors.

Lessons: The Rules of Financial Crisis Intervention

The period from 2007 to 2010 has not been the finest hour of regulators in general and central bankers in particular. Regulators hold the managers of financial institutions to a higher standard of governance and probity than in other industries. They must be ‘fit and proper’. It is fair and reasonable that regulators themselves be held to account for their performance or failure to perform. Financial regulation is a very difficult art, requiring judgment, institutional memory and professional action based on principles. Financial regulators can over-react and trample on the property rights of the owners of financial institutions, or they can dither and vacillate and allow a financial crisis to take hold. It is a delicate high-wire balancing act, especially when the political winds are blowing hard.

So to assist financial regulators and in the hope that this lecture has some useful points to make, I offer the following four (4) rules for regulators, critical points to remember in the face of financial crises.

1. The purpose of a bailout or rescue of a financial institution is *not* to save depositors or policyholders or the ‘fat cats’ of Wall Street, but always to save the financial system and by extension the economy from potential collapse by restoring confidence as quickly as possible. The bailout of depositors or policyholders or Wall Street bankers is a *by-product* of the intervention, not its purpose. Regulators would do well to remember this in their communication with the public after an intervention.
2. Politicians must get out of the way and leave crisis resolution to the professional regulators; politicians are ill-equipped to deal with these problems, are in a no-win situation, and may make the problems worse.

3. The resolution of financial crises takes time, upward of 10 years for all the dust and litigation to settle; resolutions must be approached with this in mind; there is no quick fix even if the public relations machinery employed by the regulator rightly must seek to restore confidence as quickly as possible.
4. It is not possible to prevent financial crises from occurring. The dialectic which precipitates crises is inherent in the processes of financial innovation and human behaviour in the face of risk and uncertainty. This does not mean that legislation should not be updated and supervision and regulation improved. But at some time in the future, there will be another crisis precipitated by some factor we cannot now anticipate. When this happens, go back to Rule #1.

Terrence W. Farrell
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