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Panel Discussion **New Directions in Financial Regulation: A Perspective on the Agenda for Caribbean Regulators**

THE CURRENT CONTEXT

Financial sector activity in the Caribbean is being driven by several inter-related trends:

- the rising importance of non-bank financial activity;
- a gradual convergence in financial products;
- the increasing importance of financial conglomerates; and
- the growth in cross-border financial activity.

It is well documented in the literature on economic development that as economies develop, their financial systems tend to evolve from bank-based systems to capital-market-based systems. The current financial landscape in the Caribbean may be characterised as an “intermediate financial structure”. This structure lies between, on the one hand, a bank-dominated financial structure

where banks are the primary channel through which liquid public savings are transformed into more illiquid investment projects, and on the other hand, a fully-fledged capital market-based financial structure where a large number of borrowers have direct access to corporate bonds and there are numerous investors that are willing to diversify their asset portfolios.¹

For instance, in Jamaica today, one can find a reasonably well functioning securities market with short and long-term fixed income instruments traded in an over-the-counter (“OTC”) market, exchange-traded equities and collective investment schemes. The assets of “core” securities market institutions (securities firms, unit trusts and pension funds) amounted to 74% of GDP at the end of 2004, compared with 91% for deposit-taking institutions and 19% for insurance companies, although it should be remembered that a significant share of the assets of deposit-takers reflect their securities market transactions (see table 1). It would be fair to say that the securities market has assumed a role in Jamaica’s financial system that compares quite favourably to the traditional dominance of bank-based intermediation and one could argue that this trend is certainly not unique among Caribbean countries.

As one experienced observer has recently pointed out, *“for a long time, we lived in a world in which we kept our deposits at the bank, purchased insurance from an insurance company... and stocks/bonds from a securities broker. However, technology, capital market innovations and globalisation have irreversibly changed all of this. The technologically driven growth of new financial products that enable the unbundling of*

¹ See Sayuri Shirai “*Searching for New Regulatory Frameworks for the Intermediate Financial Structure in Post-Crisis Asia*” **Wharton Financial Institutions Center Working Paper 01-28, July 2001**, p. 13-14

risks has created new financial instruments that increasingly combine the characteristics of banking, insurance and securities products".²

The simplest example of this product convergence phenomenon in the Jamaican context is what may be loosely termed "bancassurance", where life insurance subsidiaries of commercial banks offer in the banking hall savings products with a nominal amount of insurance marketed as target savings instruments for purposes such as future educational financing for young children or retirement planning.

However, the phenomenon extends to more exotic situations such as structuring fixed deposits tied to stock market returns and derivatives, or transforming illiquid loans held permanently by a bank into a liquid capital markets instrument via the securitisation process. To be sure, regulatory arbitrage (in addition to technological innovation) has also contributed to the trend of product convergence. Regulators worldwide have grappled with the need for the harmonisation of regulatory requirements across different financial market segments so as to prevent regulatory arbitrage. In recent times, regulators have also sought to "ring fence" the activities of financial firms operating in different market segments so as to limit contagion.

The Caribbean has not been immune to the worldwide trend of financial conglomeration. In Jamaica, financial conglomerates currently account for

² Quote from Tasna Rajatabhothi, Assistant Governor, Bank of Thailand "*Financial Convergence and Supervisory Policy from the Bank of Thailand*" Conference on "Thai Insurance: Regulatory & Market Updates" organised by Asia Business Forum at Regent Hotel, Bangkok, July 11, 2002

approximately 78% of total financial assets in the financial system. These conglomerates also tend to be multi-national (and increasingly regional) in character, with seven of the top ten financial conglomerates having extensive linkages within the Caribbean either because of the location of their corporate headquarters or the existence of branch establishments, subsidiaries or affiliates in other Caribbean countries, notably in Barbados and Trinidad and Tobago. In fact, four of Jamaica's life insurers are local subsidiaries of a foreign group and two of these foreign groups are Caribbean-based conglomerates.

The concentration of ownership of major financial entities within an organisational structure of the regional conglomerate also speaks to a related pattern of considerable cross-border financial activity, which is evidenced by (a) investments by Jamaican financial firms in assets domiciled in other Caribbean territories, (b) the raising of debt and equity capital for Jamaican enterprises through securities issue in Caribbean markets and (c) the cross-listing and trading of stocks across the equity exchanges of Jamaica, Barbados and Trinidad and Tobago (11 of 38 stocks in Trinidad and Tobago, 6 of 26 stocks in Barbados and 9 of 42 stocks in Jamaica were cross listed on the three exchanges). On the Jamaican stock exchange, the market capitalisation of Jamaican firms represents only approximately half of total market capitalisation.

These trends raise some important regulatory issues. Consider, for instance, the market surveillance requirements for the following transaction: a Jamaican-based client utilises a stockbroker based in Trinidad and Tobago ("T&T") to execute an order for a Jamaican stock listed on the Trinidad and Tobago Stock Exchange. Under the current legislative framework, the Jamaican authorities (in this case, the FSC and the Jamaica Stock Exchange) can access transaction details of trades

executed on the Jamaican exchange but it is obviously more problematic to pursue a market abuse investigation for trades executed by Trinidadian and Barbadian brokers on their respective exchanges on behalf of Jamaican clients.

THE REQUIRED REGULATORY RESPONSE: AN AGENDA FOR CARIBBEAN REGULATORS

Within a market context of product convergence, regional conglomeration and increased cross-border activity, Caribbean regulatory frameworks, in the first instance, need to be aligned to achieve tighter coordination both within national borders and among different Caribbean jurisdictions. The matrix below summarises the regulatory options.

		Market Trends			
		Product Convergence	Domestic conglomeration	Regional Conglomeration	Cross-border Trading
Regulatory Options	Lead Supervision	√	√	?	
	Unified Supervision	√√	√√	√	
	Cross-border supervision protocols (information sharing, home-host supervision/examination)			√√	√√

The debate over the appropriate institutional structure for domestic financial regulation is still ongoing (ie, functional or sectoral regulation combined with

lead regulator arrangements vs unified regulation). In our view a unified regulatory structure has clear advantages over the functional regulator structure in facilitating more effective supervision of conglomerates, quite apart from its cost-saving advantages. What is also clear, in our view, is the need for more effective arrangements for supervising cross border activity. Currently, Caribbean regulators (especially securities market regulators) are exploring some practical steps in this regard, for instance, in the harmonisation across jurisdictions of fit and proper requirements for market intermediaries and disclosure requirements for issuers. The harmonisation initiatives being explored by regional stock exchanges, if implemented, will also yield some positive regulatory spin-offs.

The above trends and associated regulatory solutions speak to a creeping integration of financial markets driven by private profit motives. That is to say, financial market integration is taking place without formal mechanisms for the consistent coordination or harmonisation of policies and rules. However, the establishment of the Caribbean Single Market (“CSM”) has increased the urgency for Caribbean regulators to address in a structured way the challenges to cross-border supervision and regulation that are posed by financial market integration. This imperative does not depend on the institutional form chosen by national jurisdictions to regulate domestic markets.

In particular, regulators will, in very short order, need to address some key issues related to regulatory harmonisation, *viz*:

- Participate fully in the development of the *CARICOM Financial Services Agreement* to ensure that the provisions for, among other things, market

access for financial services, intra-regional trade in financial services and cross-border supervision are consistent with the regulators' mandate to maintain financial stability, ensure proper market conduct and protect the customers of financial institutions;

- Achieve regulatory and supervisory consistency across jurisdictions to reduce the compliance burden for regional firms and remove competitive biases;
- Establish well articulated arrangements for the exchange of supervisory information.
- Establish well articulated arrangements for financial stability monitoring and crisis management of systemically important regional entities.

An important question to be answered in resolving these is: what will Caribbean regulators (or more accurately, the Caribbean polity) choose to be the organisational framework for rule-making and enforcement? At least two approaches could be considered:

1. Centralised rule-making and decentralised enforcement (the EU Approach)
2. Decentralised rule making (with a coordinating mechanism) and decentralised enforcement

With the first approach, financial sector legislation and regulations are developed and issued by a central regional body and supervisory authorities are given the mandate of enforcing the directives in national jurisdictions. This approach implies a full legislative harmonisation across jurisdictions.

With the second approach, the development of legislation and regulations may be coordinated centrally to ensure consistency (perhaps through an appropriately incorporated association of regulators) but promulgation and enforcement of directives are solely the responsibility of regulators and supervisors in each jurisdiction. Thus legislative harmonisation is not guaranteed but there may be “legislative convergence.” The voices of Caribbean regulators need to be heard more forcefully in these debates.

SUMMARY

Financial activity in the Caribbean is occurring in a context of creeping financial integration that is evidenced by, among other things, the growing importance of regional conglomerates in domestic markets and the increasing level of cross-border trade in financial instruments. Regulatory responses can be developed to deal with the challenges posed by this profit-driven integration, but of even greater importance and urgency is the need for Caribbean regulators and the wider Caribbean polity to develop the institutional arrangements appropriate for effective supervision within the context of the CSME.

Table 1: Jamaica: Financial Sector Assets, 2004

Jamaica	J\$ Billion	Percentage of GDP
Commercial Banks	350	63
Merchant Banks	51	9
Building Societies	80	14
Credit Unions	29	5
Financial Houses and Trust Companies	1	0
Life Insurance Companies	68	12
Non-life Insurance Companies	40	7
Unit Trust Funds	14	2
Securities Firms	301	54
Pension Funds	99	18
Total Assets	1,033	186
Caribbean Comparators:		
Trinidad and Tobago (billion TT\$)	118	150
Barbados (in millions B\$)	4,334	80

Source: International Monetary Fund

Thank you.

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