6TH ANNUAL CONFERENCE OF THE CARIBBEAN GROUP OF SECURITIES REGULATORS

Improving Regional Regulatory Cooperation – The Role of the College of Regulators

An Address at the
Hyatt Regency Hotel

October 22, 2009

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The recent financial crisis has been analyzed by academia, consultants, by regulators, companies' boards and management, and of course, many newspaper columnists across the globe. There are probably more speeches and presentations on this subject over the last two years than probably any other subject. Interestingly, the causes of the crisis and the recommendations identified by these individuals are not too dissimilar. However, the common causes and recommendations that have gained most prominence can be categorized as prudential or regulatory failings. There are recommendations that are more intangible and behavior-oriented which have not gained as much notoriety even though, in my opinion, they are equally important. These recommendations include the need for more effective corporate governance and a more determined attempt to empower

consumers by **educating** them to better understand financial markets and products.

One of the more common findings is the need to establish a College of Regulators to foster greater cooperation and communication among regulators. My remarks today will centre on the College of Regulators as a mechanism for dealing with systemically important financial institutions that operate cross border. I will highlight the benefits and the challenges of this powerful regulatory tool. But first of all, and in order to put the College of Regulators into context, I want to touch on some key causes of the crisis and recommendations that have been put forward to prevent a further occurrence.

The most commonly cited **causes** for the international crisis include global imbalances, lack of appreciation of the effects of macro prudential economic factors on micro prudential supervision, poor stress testing, poor liquidity management, poor capital management, inappropriate leverage ratios, misaligned compensation incentives and failures of rating agencies and regulators.

The most common **recommendations** are increased capital, greater liquidity management, more effective risk management, regulating of rating agencies and more effective use of College of Regulators for systemically important financial institutions. These recommendations are intended to strengthen sustainability of the financial system and to particularly deal with counter cyclical economic cycles.

It is interesting to note that too little regulation did not cause the financial crisis and therefore more regulation will not prevent another crisis. However smarter regulation is needed. The establishment of a College of Regulators is one such strategy to achieve this objective.

In my remarks today on Colleges of Regulators I will approach the subject from two different angles: the conditions and benefits that warrant such an approach and the challenges with implementation. I will also conclude with initiatives that are underway in the Region.

Conditions and Benefits of College of Regulators

Systemically important financial institutions can cause massive damage to the financial system not only when they fail but even when negative rumors about their financial condition exist. The consequences increase when these large institutions are part of a conglomerate and operate cross border. Furthermore, the problems are compounded when these institutions not only operate cross-border but cross-sector.

Companies that operate cross-border have both home and host regulators. The home regulator is where the institution is registered and usually where its head office is based. Host regulators have responsibilities for cross-border branches, subsidiaries and representative offices. Through collaboration with home and host regulators, the College of Regulators is intended to achieve group-

wide solvency and supervision for the ultimate purpose of facilitating consumer protection regardless of jurisdiction. More importantly, it is intended to promote equity in the levels of consumer protection across the different entities within the group.

When dealing with cross-border groups, there are two factors or risks that could be a source of strength of weakness to all entities within the group. These are contagion risks and reputational risks. These risks arise not only from prudential deficiencies but also from poor market conduct practices. They could negatively affect all entities within a group regardless of how far they are physically removed from the problem. It is important to note that poor market conduct practices can have significant financial consequences for an institution as a result reputational risk. The UK, Canadian and U.S.A. markets have ample evidence of the financial implications of reputational risk.

Companies that operate within a group and particularly cross border usually find it more cost efficient and effective to centralize their risk management, internal audit and compliance functions. Furthermore, important functions such as liquidity and capital management are also centralized again for efficiency and effectiveness. While these arrangements have significant advantages, they are also risky. For example, a host jurisdiction's liquidity needs could evaporate if the parent company is downgraded by a rating agency. Also, following from this rating agency action, the parent may come under pressure to hold higher levels of capital. Because capital is fungible, this could be done at the expense of a subsidiary or branch. Under these

circumstances, the need for on-going cooperation and communication between regulators becomes even more evident and necessary.

Some groups may operate under a complex structure, including a holding company structure that can lead to opaqueness. This opaqueness and complexity can hinder communication and coordination of activities and frustrate even the group's internal management team. Such structures can mask the true intent and effects of intra-group transactions and this in turn increases risks to the group. More importantly, it makes the assessment of risk and solvency more difficult. Multiple gearing/internal generation of capital in this corporate structure is a particular concern for all regulators – home and host.

Branches and subsidiaries of companies that operate cross border may pose differing levels of risk to a firm's head office or even the home regulator. In other words, although the operations in a host jurisdiction may be material relative to its economy, it may be small relative to the operations of the company as a whole. Nevertheless a depositor, policyholder or investor who suffers a loss feels the same pain regardless of the size of the company. This, in and of itself is a compelling reason for regulators to cooperate.

In addition, an important benefit of College of Regulators is the ability to stamp out regulatory arbitrage. Arbitrage occurs when companies exploit differences in regulation or complexity in regulation for commercial or competitive advantages at several different levels.

Furthermore, companies may chose to arbitrage between regulated sectors, for example, between insurance and banking sectors.

Challenges with Implementation of College of Regulators

Differences in legislation

The reality is that laws will never be identical. Laws differ not only among jurisdictions but even within a single jurisdiction such as the US and Canada where more than one level of government is responsible for regulation of financial institutions each with differing laws. The applicable laws cover several pieces of legislation – not just banking, securities or insurance. You invariably have to deal with company law, insolvency law and contract law. Harmonization of laws is therefore an elusive goal. The trick is to recognize the equivalence in each other's laws.

The most common legal problem for regulators is a restriction on the ability to share information. As you know, the ability to treat company-specific information confidential is crucial to the efficient functioning of a regulator. Maintaining confidence also promotes stability of the financial system.

Over the years, international organizations such as IOSCO, BIS and IAIS have recognized the importance of the need for regulators to share information and to assist with the attainment of this objective, they have developed Multilateral Memorandum of Understanding

(MMOU). These MMOUs have become standard and are being embraced by regulators worldwide. As a matter of fact, it was IOSCO who made this a very practical tool for sharing of information among regulators. The MMOU also acted as a catalyst for countries to change their legislation to permit sharing of information for regulatory purposes.

In the Region, we have also developed a Memorandum of Understanding as our banking and insurance laws have been revised to allow for sharing of information with other regulators.

Regulatory Mandates Differ

Most regulators have a single mandate, that is, prudential regulation. Some have the additional responsibility for market conduct. Regulators with a double mandate, find themselves at a disadvantage vis-à-vis regulators who only have prudential responsibilities. It is not usual for host regulators to focus a bit more on their market conduct activities and leave overall prudential monitoring to the home regulator. In this scenario, the discussion at a College of regulators meeting becomes "one-way street".

In addition to this concern over mandate, there are two fundamental problems that need to be addressed before there can be an effective functioning of a College of Regulators. This has to do with mutual recognition and trust in each other's regulatory framework and confidence in each other's ability to supervise companies effectively.

This is a major challenge. Resourcing constraints and outdated legislative frameworks are usually at the heart of resolving this issue.

Logistic Challenges with Companies that Operate both Cross Border and Cross Functional

There are also challenges for companies that operate on both a cross border and a cross-functional basis. Companies that operate in insurance, banking and securities sometimes could have three different regulators to deal with even in their home jurisdiction. However, this becomes more complicated when they operate cross-border and also have to deal with several sets of functional regulators. This becomes even more daunting depending on the number of jurisdictions in which they operate. Nevertheless, we all have first hand experience with problems in one sector affecting other sectors. Colleges of Regulators that function well are supposed to stem this nasty fallout.

Based on the three points noted above, it is clear that operating a College of Regulators needs to be carefully considered and planned and the logistics involved in accomplishing this are not simple. The organizing and planning is not easy as College of Regulators is by definition, company-specific. In other words, every systemically important, cross border institution should have its **own** College of Regulators.

Regional Initiatives

I now want to comment on initiatives and any other regulatory action taken in the Region and ultimately to deal with systemically important financial institutions.

Ladies and Gentlemen, despite these challenges significant progress has been made in terms of establishing a College of Regulators both internationally and regionally. On the international front, OSFI Canada has set formally set up a College of Regulators for each of their major commercial banks. These College of Regulators meet annually, are well attended and effective. Because Canadian banks have significant presence in the region, Caribbean regulators all participate in these very productive meetings. These meetings accomplish four important objectives:

- We obtain a very comprehensive understanding of OSFI's views of the bank. More specifically, we get a good overview of the effectiveness of the bank's approach to governance, compliance and risk management;
- We gain insight into OSFI's regulatory methodology;
- We hear first hand, the views of other regulators where the bank operates; and
- We build relationships with fellow regulators.

In the region, we have also begun to take our responsibilities for College of Regulators more earnestly. The Caribbean Group of Banking Supervisors (CGBS) and the Caribbean Association of Insurance regulators have taken the initiative to effectively construct meaningful College of Regulators. Several meetings have already a occurred.

In addition, CGBS is the final stages of completing a crisis management plan that would provide guidance not only in planning for a crisis but also how to operate during a crisis. This is perhaps the greatest benefit of a well functioning College of Regulators. You do not want to wait till a crisis occurs to get to know your fellow regulators because crises tend to produce socially unacceptable and irrational behavior even among friends.

At the end of the 30th Heads of Government Conference of the Caribbean Community (CARICOM) in June 2009, Caribbean leaders issued a directive which seeks to establish a new framework of financial regulation for the region.

Other recommendations to improve regulations and supervision of the sector included:

1. Continued improvement in standards for disclosure, transparency and corporate governance for both public and private companies.

2. Early warning systems, stress-testing and the publication of financial soundness indicators as these are important for monitoring at the national and Regional levels in order to improve detection and assessment of threats to Regional financial stability.

The Council for Finance and Planning (COFAP) is charged with ensuring coherence, co-ordination and harmonization in the development and integration of the regional financial system and in reporting on regulatory gaps and deficits. In this regard, the leaders requested the finalization of the CARICOM Financial Services Agreement (CFSA).

A successfully operating college should change the way that national supervisors work, as it should give them a better understanding of the risk profile of the firm. Challenges exist but I am confident that they can be solved.