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"THE T&T FINANCIAL SECTOR – CREATING THE FUTURE WE WANT"

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Presentation on

The Right Regulatory Environment

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PROTOCOL

Ladies and gentlemen, thank you for inviting me to speak on a subject that so topical these days not only because of developments internationally but also regionally and locally. The right regulatory environment is one which has as its primary objective, a fair deal for consumers. A fair deal for consumers is achieved when markets are efficient; companies develop products and services that are appropriate for the society and culture in which they sold; and most of all are able to meet their obligations when they come due.

In light of these objectives, the right regulatory environment is one built on a system of early detection of problems and taking remedial action early in order to prevent more serious problems later. For the regulator, this means a reliance-based system is the best option. A reliance based system means that all critical players need to independently carryout their responsibilities in a competent, unbiased and professional manner. The critical players in the system are the board including members of the audit committee; senior management; auditors, both internal and external; actuaries and regulators. Whenever there is a problem in the system the cause is usually a failure of one of more of

these parties. I now want to comment on the role of these parties because the right regulatory environment is highly dependent on each party doing their job. However, consumers also have role to play and I want to comment on this also.

Corporate Governance

Boards are responsible for providing the right level of oversight but all too often this fails; poor corporate governance practices lie at the heart of the global financial crisis. Many of the large international companies that failed had one common trait – high growth rates year after year. This was probably due to misaligned compensation packages which in turn led to misaligned incentives. Boards must recognize that financial institutions are unlike commercial enterprises and high compounded rate of growth year after year is not prudent.

Governance is all about integrity and integrity is a function of one's values and ideals. If these are well placed the organization will be on a more secure footing because effective governance may have a better chance of providing early warning signals even before markets and regulators are able to spot the problem. However, markets are dynamic and consistently results in innovative products and services. This therefore means that boards are challenged to keep up and continuing education is the surest way to deal with this issue. Where necessary boards

should seek external expertise and should be independent of advice provided by management.

A critical element of good corporate governance at the board level is the level of oversight on risk management practices. History has shown that in general, institutions that have failed, had pretty bright, competent and experienced individuals at the helm. But the failures occurred because of risk creep. Risk creep from innovative products and services in a changing environment coupled with a herd mentality. Over time, and we had a long period of benign economic conditions, the sheer quantum of the change overwhelmed everyone: management, boards and regulators.

Risk management need to be embedded in strategic planning, resource allocation and performance management. It needs to shift from being a side constraint on financial activity to a core function underpinning that activity. Boards need to better appreciate the importance of risk management during good times and bad times.

There has been a lot of discussion in international fora about the need to strengthen capital requirements and it goes further to suggest that systemically important financial institutions should hold even higher levels. One could argue that labeling companies as systemically important is a moral hazard. While

capital is important, it is more relevant to recognize that it is not a substitute for proper risk management. Risk management should be the first line of defense when a company's operation comes under stress. In recent times, this meant that risk management failed. Many of the international companies that got into difficulty were in compliance with regulatory capital requirements.

Another aspect of corporate governance that needs attention is disclosure practices. Greater information on risk exposures and the management of those risks are required. In order for this to occur, the right tone at the top is important.

Auditors and Actuaries

External Auditors need to take a more aggressive stance with their clients. Recent experiences have shown that this has not always been the case. Also, in the case of insurers, they need to employ independent actuaries verify an insurer's actuarial reserves. More importantly, the auditing profession needs to embrace international requirements for practice monitoring and peer review seriously and effectively. I am encouraged that our local accounting body has started down this path.

Internal auditors also have a crucial role to play especially in ensuring that the various units in the company, particularly the higher risk units, receive the attention that they deserve. However, the audit committee should ensure that internal audit department is appropriately resourced and positioned within the organization. In addition, it is critical that the audit committee support the internal auditor in ensuring that senior management complies with the recommendations.

Actuaries also have a crucial role to play in the risk management and governance of an insurer. They have a critical role to play in the computation of actuarial reserves which we know generally account for about 80% of an insurer's liabilities. The introduction of Risk-Based Capital rules is heavily dependent on the integrity of Actuarial Reserves. Furthermore, their emerging role in the local environment in the preparation of Financial Condition Reports of insurers is important.

The Right Regulatory Environment requires sound judgment at the board, auditing, actuarial and regulatory levels because there is a crucial symbiotic relationship here, and the sooner we accept this, the better off the consumer will be.

Regulators

Financial services legislation that keep up with changing market conditions, consumer expectations, product innovations, societal norms and international best practice is critical to establish a sound and robust system. In reality though, rapidly changing economic conditions make it challenging for legislation to keep pace. In practice it is almost always impossible and as such legislation will almost always be lagging. This is a risk that we cannot escape. We should however recognize the limitations of laws. Laws are better at punishing those that commit violations but are less effective in influencing good behaviour. For any legislation to be effective, we must first engender a culture of compliance.

The Right Regulatory Environment also requires regulators to move away from focusing on prudential ratios and spend more time on assessing the qualitative elements of an institution's control environment in order to identify early warning signs. This allows the best course of action to mitigate losses to policyholders.

Financial Groups operate cross sector (Banks, Insurers and Securities), operate cross border, have multiple interdependencies and comprise both regulated and unregulated

entities. They do this to take advantage of differences in taxation, regulation and supervision. In addition, internationally and regionally, regulators need to close ranks and eliminate opportunities for regulatory arbitrage. This means greater and more meaningful efforts to cooperate and share information. Systemically important, cross border companies should be at the centre these discussions. Inter group transactions which are inter-country require collaboration.

If we are going to avoid a repeat of past problems, we need to aggressively evaluate and appreciate the link between macroeconomic forces and micro-prudential supervision. Macroeconomists however should not shoulder the blame alone because the finance gurus were equally at fault. What is required is for macroeconomists to develop a better appreciation for finance, and finance gurus to better understand how the markets work. At a more mundane level however, boards, risk officers, appointed actuaries and prudential regulators need to better appreciate the link with financial markets.

It is almost impossible to talk about legislative and regulatory initiatives without talking about AML. *F*inancial institutions are attractive targets for money laundering activities because the services offered can be easily utilized to conceal the true origins of funds. It is therefore the duty of each financial institution to

ensure that preventive measures are in place to deter such activity. Failure to comply fully with AML/CFT requirements has far reaching consequences as it could result in reputational risk not only to the individual institution but also the country, as well as the entire region.

The Right Regulatory Environment requires that companies comply with AML requirements. The Central Bank will assess compliance with anti-money laundering laws and regulatory policies of all financial institutions through its onsite supervisory process.

Consumers

Ladies and gentlemen consumers also have a role to play in any regulatory environment but we need to empower them. We can do this by not only providing the right information but also by educating them. Enhancing individual awareness and literacy relative to products and markets needs to be taken seriously. On this front, the Central Bank has implemented a National Financial Literacy Program in Trinidad and Tobago and this has been well received. Well informed consumers and those who represent them, will attain far better results if they take an active interest in the corporate governance of companies they have invested in.

The financial crisis has raised issues of marked and conduct-of-business regulation. The Right Regulatory Environment inspires trust and confidence in the financial services industry. We would not give our neighbor our money to invest for us yet we are prepared to give it to a perfect stranger at a bank or insurance company. Companies build trust by ensuring that their agents and sales representatives are properly trained and only sell products that the customer needs. Before the sale is completed the customer should fully understand the inherent risks and limitations of the policy. Successful companies are those that take a long term view of the customer.

Conclusion

The viability of a financial institution is highly dependent on captains of industry doing the right thing. I do not think we necessarily need a paradigm shift in leadership, instead I believe we need morally conscious leaders. The current crisis has taught us that, more effective regulation is inevitable but better corporate governance is the surest way to achieve success. The road to a successful financial institution is also a narrow one and can only be achieved when the interests of management are aligned with those of consumers. Only then will we achieve a fair deal for consumers.