FINANCIAL SERVICES
COMMISSION

"The Impact of Regulation on the Stability of the Financial System"

Presented by

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President of the Barbados Chamber of Commerce and Industry (BCCI), Ms. Tracey Shuffler; other Council members; Executive Director, Mrs. Lisa Gale, BCCI staff and members of its Committee; fellow presenters and panelists; members of the media; ladies and gentlemen – good morning.

It is always my distinct pleasure to partner with the Chamber on any event it is hosting for its members. The Executive Director, Ms. Lisa Gale, as you all know is the consummate professional and extremely difficult to say no to when she does ask for support. In addition, I much appreciate the efficiency of the Chamber's staff and Ms. Carol Charles in particular, has always watched my back during my career so when Carol tells me to come I just ask "when do you need me?"

Notwithstanding the quality of the Chamber's staff and Council, I, of course will always accept an opportunity to speak on topics of regulation and stability in the Barbados financial system. After all, promoting stability in the financial system is a key objective of the regulator and one which FSC and the Central Bank of Barbados take very seriously and work closely to promote.

The Barbados financial system has two main domestic regulators – the Central Bank, which along with its primary role in monetary policy has responsibility for the banking sector; and FSC which regulates the non-bank sector inclusive of insurance, occupational pensions, securities, mutual funds and credit unions.

For the purposes of this presentation it may be beneficial to establish a working definition of financial stability. In this context, financial stability has two components:

1. Sound financial entities operating in Barbados that can withstand unexpected shocks to their business
2. A strong financial system that can withstand unexpected shocks to the sector as a whole

The first pillar of financial stability is having sound regulated entities operating in Barbados. Regulators expect that companies will make strategic plans to ensure their continued growth and development. No one expects that all operations will go perfectly according to plan. On occasion, there will be unexpected events that impact the performance of a company. The regulator, however, considers the company a sound one if it is able to absorb the often negative financial impact that comes from the unexpected event, and if that company is able to continue serving its clients with minimal disruption. What we are intent on avoiding as regulators, is the circumstance where a company has to close because of an unexpected event and is subsequently not able to service its responsibility to the customers.

The second pillar of financial stability is having a strong financial system. On a macro level, regulators expect that even if one company has a challenge, the negative impacts are contained so that the entire sector continues to operate and service clients. For example, we would not want a situation where one mutual fund had a challenge and the negative impact of that one fund eroded the value in the entire mutual fund sector, leaving it inaccessible and unattractive to investors. If one fund had a challenge, we would want other funds to remain strong and be in a position to assume the activity from the challenged company. Circumstances such as these came to the forefront in the recent global financial crisis as the theory of contagion risk showed how impactful defaults in one jurisdiction or sector could be on otherwise seemingly uncorrelated sectors. As regulators, we therefore strive to mitigate the macro circumstance of contagion risk crashing the system. Having both soundly regulated entities and a sound financial system leads to financial stability and many restful nights for regulators.

The promotion of financial stability benefits companies in the following ways:

- ***It leads to public confidence***

  If consumers have confidence that the entities operating in the market are sound, they are more inclined to purchase the financial products being offered. This confidence is derived from the comfort consumers get when they appreciate that there is an independent oversight body in the regulator, who is working to ensure that their principal investments in the companies are protected. Confidence in the market has historically been linked to increased economic activity.

- ***It creates a platform for growth and innovation***

  Creating a financial hedge below which operations of a company should not drop provides a platform for them to be innovative and create new products. This innovation may then be supported by the regulator through the creation of frameworks and legislation aimed at facilitating the growth. If there is instability in the market place, the focus is less on innovation and more on restriction in order to achieve the necessary stability.

- ***It aids investors and financiers' in their decision making***
  Volatility in the markets tends to more breed conservatism and a wait –and-see approach. Stability gives investors historical performance indicators such as asset values; investment returns; interest rates; and profitability, all of which are key inputs into the calculation of the net present value; internal rate of return; market size; standard deviations; and market risk beta, which companies and financiers rely on to support investment decisions. These elements are much easier to analyse in a financial system characterised by stability.

- ***It positively raises the profile and reputation of the country globally***
  International business partners gain comfort in doing business with a company registered and operating in a stable system because they can better monitor the financial performance of their business partners. Importers, exporters, creditors, and lenders all prefer to do business with companies in Barbados whose output and performance demonstrate the characteristics of stability and reliability.

These are all significant benefits of having a stable financial system. The opposite of financial stability, of course, would be financial volatility. I would ask you to consider operating your businesses in a volatile system where in addition to the basic worries of competition and consumer demand, you now have to consider:

- *randomly changing interest rates on your borrowing and savings*
- *volatile insurance premium rates increasing your expenditures*

- *potential consumers who lose their purchasing power because of investment failures and loss of personal wealth*
- *savings in accounts becoming inaccessible because of runs on a bank or credit union caused by a lack of confidence*
- *overseas business partners pulling out of deals because of uncertainty about future performance*

This would be akin to a financial nightmare on the proverbial Elm Street and although we are near to Halloween, this is a nightmare that neither FSC nor the Central Bank intend to ever allow to occur in Barbados.

Having established the ***benefits*** of financial stability, we now turn attention to ***the impact of appropriate regulation*** on financial stability. The ability to balance regulation and business facilitation may be the greatest skill a regulator can acquire. I dare say, both tenets are needed – regulation to support stability and ensure Barbados' reputation as a pristine country is maintained, and facilitation to ensure that we have sustained growth. Despite the obvious prejudice in this next comment, I am of the firm belief that regulation is germane to Barbados' success as a financial centre.

I make and support the comment because a financial crisis may be caused by several factors; it may originate in many jurisdictions and it may be driven by instability in one of many financial sectors. However, one constant aspect of the onset of a financial crisis is that it has always brought a regulatory response aimed at determining the cause of the crisis and mitigating the probability of recurrence. The concept of a regulatory response held true in the Wall Street crash of the 1920s; the banking run in the 1930s; the hyper-inflation crisis in Latin America; the dot-com bubble crisis; the derivative market crisis; and the recent global economic crisis fuelled by contagion – in each case there was a regulatory response.

FSC's establishment was itself a response to turbulent economic times where it was felt that as a developing global financial centre, Barbados needed to ensure it had a robust regulator in the non-bank financial sector to help build and maintain stability in the financial system. As a regulator, FSC seeks to support financial stability not by eliminating risk from the system, but instead, by understanding and managing risk so that excessive risk-taking activity is discouraged and appropriately structured growth is encouraged. We achieve this by applying regulation in the following ways:

- ***Establishment of legislation***

  Appropriate legislation constructed in a principle-based manner gives the regulator the authority to implement regulation. In addition to actual law, the regulator issues guidelines to fill any gaps in the legislative framework and FSC issues guidance notes and circulars to give entities additional information and clarifications on application of legislation as needed. The legislative framework creates the basis for corporate behaviours in regulated markets.

- ***Creation of an early warning system***

  FSC has created an early warning system where entities are required to submit financial statements on a quarterly basis. These statements are then trended on a quarterly basis so that if an entity is moving in the wrong direction we are able to address the matter in a corrective way before it is advanced.

- ***Full risk assessment of regulated entities***

  FSC conducts full risk assessments on regulated entities inclusive of an onsite examination. With the onsite examination, we are able to scope and test the appropriate empirical evidence to confirm that the entity is operating in practice, as it says. We also use the opportunity during the onsite examinations to monitor the corporate governance of companies. Any variances between stated policy and actual practices are highlighted.

- ***Utilisation of stress testing models***

  FSC uses and encourages our regulated entities to also use stress testing models. These models present a scenario-based predictive model that can give companies some insight on how their performance would look under various circumstances. Should these circumstances occur, we are able to predict the outcomes for the company and more importantly, we can plan today for what actions would be needed in the future to ensure the entity does not default.

- ***Utilisation of crisis funding to support stability***
  In the event that supervisory tools are tried but could not correct the issue and the entity does go into default, crisis funding is then utilised to ensure that losses are minimised while a resolution is sought. For example, we have deposit insurance on bank accounts and we are moving towards deposit insurance for the credit union sector and eventually to an equivalent system for the insurance sector.

- ***Promotion of transparency in our decision making***
  Lastly, FSC will continue to promote transparency in our decision making and we will engage our stakeholders as often as possible. This allows us to understand the business side of the market and we can then make better decisions to create an appropriate and enabling business environment which would support growth.

In summary, the achievement and retention of financial stability over time is critical to sustained economic development for all economies irrespective of their size. It is vital to the sustained socioeconomic development of small states such as Barbados. The central benefits that accrue pertain to the generation of confidence among investors (local and foreign), workers, savers, and the nation at large. This leads to increased consumer activity, better decision making and a good reputation both locally and internationally. FSC will continue to tenaciously carry out the activities that will support financial stability while creating an enabling environment that would allow for appropriate risk taking and growth.

It was my pleasure engaging with you this morning on this topic which is so dear to me and it will always be my pleasure to engage with this esteemed group whenever you will have me.

I thank you for your kind attention.