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Feature Address
delivered by
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at the
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Introduction

I have used the theme of your conference – *Financial Architecture and Economic Prospects beyond the crisis in the Caribbean* – to fashion my remarks to you. Reforms are always designed to prevent the recurrence of the last undesirable event and to reduce the frequency and severity of similar events in the future but, as Kindleberger (1978)[1] and Mackay (1841)[2] have recorded, financial crises remain hardy perennials in the garden of human folly and greed. Nevertheless it would be a counsel of despair to argue that little should or can be done to render them less frequent and less severe. That is why the reforms proposed to strengthen the international financial architecture now encompass broader aspects of crisis management in both industrial and developing countries and the cast of characters has extended beyond the Bretton Woods Institutions (BWI) and the Bank for International Settlements (BIS) which was the bank of the central banks of the industrial countries.

The International Financial Architecture

When we think of architecture we think of buildings, their style, the practice of designing and constructing them, their unifying and coherent structure; and we think of the conceptual and logical organisation of systems that make them function to satisfy their purposes. In the aftermath of the Asian Crisis of a little more than a decade ago, the concept of an architecture crept into the lexicon of international finance following Barry Eichengreen's proposal of a practical agenda for reform of the international monetary system. This change in terminology ". . . conveyed a change in the framework of world monetary and financial relations . . . attributed

1 Kindleberger C.P. (1978), *Manias, Panics and Crashes: A History of Financial Crises.* Wiley Investment Classics, New York .
2 Mackay, C. (1841), *Extraordinary Popular Delusions and the Madness of Crowds*, Republished in 1980 by Harmony Books, New York,

to the growing importance of international capital flows, the explosive growth of world financial markets and the array of new financial instruments developed by the private sector."[3]

The international monetary system that emerged after the 1944 Bretton Woods Conference focussed on exchange rates, international reserves and the balance of payments of the major industrial countries. It survived largely intact for the next three decades until the first oil crisis (1973-74) when questions about the reform of the system emerged and received the serious attention of policy makers. Further impetus for reform came from the first debt crisis of 1982 when many developing countries had difficulties servicing their debts, and from a subsequent series of currency, banking and debt crises from 1994 to 2002 in a number of emerging market economies.[4] It is not surprising, therefore, that the reforms envisioned in what was soon to become known as the "international financial architecture"[5] were focussed on the problems of emerging market and developing economies (EMDEs)[6]. But, as we now know, many structural fault lines remained well hidden and largely unsuspected deep in the bedrock of the financial systems of the major industrial countries. These would shift in 2007-08 with consequences for the world economy similar to the combined impact of a major earthquake and tsunami. As a result of these shifting fault lines strengthening the international financial architecture is receiving even greater attention and assuming even greater urgency than when the financial catastrophes were limited to EMDEs.

Institutions and the Reforms.

After the collapse of Lehman Brothers in September 2008, the scope of reforms and initiatives contemplated in the new international financial architecture also had to address concerns with the soundness of the financial systems of industrial economies and the G-20 became the leading body for inter-governmental policy making. The G-20 works through the existing institutions, namely: the BWIs, the Bank for International Settlements and the Organisation for Economic Cooperation and Development (OECD). But in an effort to ensure that the emerging market economies were closer to the centre of the discussion and to create an appearance of global democracy where there was none before, the Financial Stability Forum (FSF), established by the Bank for International Settlements in 1999, was transformed into the Financial Stability Board (FSB) in April 2009 with an expanded membership and with a broadened mandate to promote financial stability[7]. The FSB has evolved as the forum in which national authorities from the G-20 countries, international financial institutions, and international standard-setting

3 De Beaufort Wijnholds, J.O. (2010) The International Financial Architecture: Yesterday, today and tomorrow, World Economics Vol. 11 No. 2 April-June (pp 113 – 129) (p115).
4 Goldstein, M., (2005) The International Financial Architecture (pp373-407). In Bregsten, C. Fred (ed), *The United States and the World Economy*, Institute for International Economics, Washington DC.
5 Eichengreen, B. (1999) *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*. Washington DC: Institute for International Economics, February. Robert Rubin used the term "international financial architecture in a speech at the Brookings Institution in 1998 and Eichengreen claims he popularized it in the title of his book in 1999 See Eichengreen: Reforming the International Financial Architecture, 2011 Edition, Key note Address, Bank of Korea, Seoul, May 26th , 2011).
6 Peterson, Peter G. And Hills, Carla: The future of the International Financial Architecture, *Foreign Affairs,* November/December 1999
7 Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, Spain and the European Commission were invited to join the members of the FSF, namely Australia, Canada, France, Germany, Hong Kong, Italy, Japan, Netherlands, Singapore, Switzerland, the UK and the US as well as a group of international organisations and central bank bodies, to convert that body into the FSB., see www.fsforum.org

and central bank bodies[8] address vulnerabilities and propose regulatory, supervisory and other policies designed to promote financial stability.

A second international forum with a much broader representation than the G-20 was the ***Commission of Experts … on Reforms of the International Monetary and Financial System*** created by the President of the United Nations General Assembly following the 2008 Doha Summit. This Commission, chaired by Joseph Stiglitz and with broad global membership that included Avinash Persaud (Barbados), had a UN mandate to evaluate and formulate proposals vis-à-vis the global economic crisis; and identify the broad principles underlying institutional reforms required to ensure the sustained global economic progress and stability for the benefit all countries. In their Report[9] the Commissioners made a very cogent case for global reform of financial sector regulation and of international institutions but conceded that proposals from smaller groups will necessarily play an important role in developing a global consensus on key and complex issues. This is the Commission's way of saying that although it may have the universality and political legitimacy that stems from UN sponsorship, its recommendations will not be acted upon unless they are congruent with those of the FSB and other bodies with mandates from the G-20.

The aspects of the IFA that are of utmost importance to us in the Caribbean are:

1. The effective implementation of the FATF 40+9 Recommendations on the fight against money laundering and the financing of terrorism (AML/CFT);
2. Undercapitalisation of banks, insurance companies and other financial institutions, a condition that has been aggravated by the expected losses on euro zone debt; and
3. Implementation and monitoring.

The listing is order of importance although I must confess that I can be persuaded that implementation and monitoring should take priority over capital adequacy. Agreeing on what is important to us is vital to the preservation of our self interest but if we ignore those issues that are vital to the rest of the world we will do so at our peril. In no particular order of importance, the additional issues that are also vital to the rest of the world are:

4. Poor risk management practices and distorted incentives;
5. Contaminated balance sheets;
6. Striking the appropriate balance between better regulation and supervision and over-intrusive public intervention; and
7. Forestalling the disruptive effects of derivative transactions and aggressive action by hedge funds.

Financial Action Task Force (FATF) and AML/CFT

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8 The international financial institutions are the BIS, the IMF, the OECD, and the World Bank. The standard-setting and central bank bodies are the BCBS, Committee on the Global Financial System (CGFS), the Committee on Payment and Settlement Systems (CPSS); and the standard-setting bodies are the International Accounting Standards Board (IASB), the International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissioners (IOSCO).

9 U. N.: Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, September 21, 2009, United Nations (especially chapters 3 and 4).

Concern about anti-money laundering and combating the financing of terrorism (AML/CFT) is relevant to us in the Caribbean because of the number of regional jurisdictions which the OECD, and by extension the FATF, have eyed with suspicion. The issue is often presented as unfair tax competition but the insinuation of money laundering and, after the attack on the World Trade Centre, the financing of terrorism, is never far from the surface, notwithstanding the findings of the CIA, the State Department and other agencies of the US Government to the contrary[10]. In the introduction to its 40+9 AML/CFT recommendations the FATF refers to experience obtained through its ". . . Non-Cooperative Countries and Territories process . . ."[11], a concept that parallels the "non-cooperative jurisdictions" of the OECD's campaign against harmful tax competition. Although the FATF has tried through its network of FATF-style regional bodies, including the Caribbean FATF (CFATF)[12], to garner a measure of universal acceptability, it is still a body with restricted membership created by the G-7 in 1989. It is instructive to note that the CFATF created in 1992, three years after the FATF, was the last of the five regional bodies to become an associate member of the FATF. One has to wonder why it took the CFATF 16 years of effort to prove its *bona fides* to the FATF. I know that it was not for want of trying. At last we have a voice in the room and we should ensure that it is heard promoting and defending our interests.

Even with the concession to wider representation through regional bodies the FATF still remains a very top-down body. It is in that fashion that it has called on all countries to take the necessary steps to bring their national systems for combating money laundering and terrorist financing into compliance with its recommendations and to effectively implement them. In addition to its own evaluations and those of the FATF-style regional bodies, it also relies on assessments conducted by the IMF and World Bank, to ensure that its recommendations are effectively implemented by all countries.

I am not going to take you through the FATF Recommendations; instead I will illustrate by the story of Riggs Bank that failure to implement the recommendations is terminally expensive. Riggs Bank, founded in 1840 billed itself "as the most important bank in the most important city in the world."[13] It was the banker to US Presidents and foreign heads of state, to high ranking US Government officials, and to embassies and ambassadors in Washington DC; it was the bank that financed the Alaska purchase (1867) and it was the first manager of the US Treasury's CashLink System. In May 2004 it came under scrutiny for its failure to report suspicious transactions and was fined $25 million[14]. This triggered a US Senate investigation which discovered a long standing disregard for know-your-customer (KYC) and anti-money laundering obligations on the part of the bank and, on the part of the regulators, a "disinclination to

10 Mitchell, Daniel J. "US Government agencies confirm that low-tax jurisdictions are not money-laundering havens", Journal of Financial Crime, Vol. 11 Issue: 2, 2003 (pp.127 – 133)

11 *FATF 40 Recommendations,* FATF/OECD, 2010, Paris, (p 1)

12 The Caribbean Financial Action Task Force was created in 1992 and became the fifth associate member of the FATF in February 2008. See http://www.cfatf-gafic.org

13 See: "Riggs Bank Hid Assets Of Pinochet, Report Says Senate Probe Cites Former U.S. Examiner", By Terence O'Hara and Kathleen Day Washington Post, Thursday, July 15, 2004 available at http://www.washingtonpost.com/wp-dyn/articles/A50222-2004Jul14.html ; and "At Riggs Bank, a tangled path led to scandal" by Timothy L. O'Brien, New York Times July 19/2004 at http://www.odiousdebts.org/odiousdebts/index.cfm?DSP=content&ContentID=10917

14 US Treasury, FINANCIAL CRIMES ENFORCEMENT NETWORK IN THE MATTER OF RIGGS BANK, N.A., ASSESSMENT OF CIVIL MONEY PENALTY No. 2004-01, May 2004

compel the bank to correct its deficiencies."[15]. Some of the more egregious breaches by the bank included transactions designed to disguise the ownership and control of the accounts of the former Chilean dictator, Augusto Pinochet, after a Spanish court ordered them frozen in 1998; and the deposit of suit cases full of cash ($11.5 million from 2000 to 2002) to accounts controlled by the President of Equatorial Guinea. The Senate found that the Examiner-in-Charge from the Office of the Controller of the Currency (OCC) had advised the OCC not to take formal enforcement action against Riggs and, in a highly unusual move, excluded details of the examination of the Pinochet accounts from the OCC's electronic files. A month later the officer accepted a position at Riggs and, in contravention of Federal Law and OCC rules, attended meetings with the OCC on matters related to Riggs.[16] As a result of these revelations Riggs' reputation was in tatters and the institution which had $6.0 billion in assets, $4.0 billion in deposits and $4.0 billion in shareholders' equity at the end of 2003 was forced to close its doors and sell to PNC Bank for under $800 million in July 2004.

Capital Adequacy – The Basel Rules

I now turn to the capitalisation. The discussion on capital adequacy is usually focused on banks but it applies to the entire financial sector. For the industrial countries and for many EMDEs this is one of the more, if not the most, important of the pillars in the new international financial architecture and the one to which most attention is devoted. It is a dull and dour topic even though it recently grabbed the headlines when Jamie Dimon, the CEO of JP MorganChase described the latest rules as 'anti-American'[17] by which he was suggesting that American banks will be at a disadvantage because the European jurisdictions were going to be lukewarm in implementing the new rules. The rules on the capitalisation of banks, the Basel Rules, are in their third iteration and because the details are complex and arcane I have to crave your indulgence as I try to compress them. The first set of rules on capital adequacy, Basel I, was issued in 1988; the second set, Basel II, was issued in 2001; and Basel III, was approved by the G-20 in November 2010. The rules are prepared by the Basel Committee on Banking Supervision (BCBS) for the FSB and since 2008 for approval by the G-20.

From the time of Basel I two fundamental objectives were at the heart of the work on regulatory convergence: firstly to strengthen the soundness and stability of the international banking system; and secondly to have a high degree of consistency across countries so as to diminish competitive inequality among international banks[18]. This first set of rules on capital adequacy was designed to create a level playing field for competition among the major international banks of the G-10 countries by standardising the measurement and accounting treatment of capital. The rules introduced a minimum capital ratio and the risk weighting of assets as the preferred method for assessing the adequacy of capital. Banks were required to

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15 Schwartz, A. J., Regulatory Lapses in Monitoring Anti-Money Laundering Performance by Financial Institutions, National Bureau of Economic Research, (Prepared for the Shadow Open Market meeting, November 13-14, 2004) (p 3) available at http://www.shadowfed.org/wp-content/uploads/2010/03/schwartz_1104.pdf

16 The Professional Risk Managers' International Association, *Riggs Bank*, , available at http://prmia.org/pdf/Case_Studies/Riggs_Bank_Short_version_April_2009.pdf

17 See Are Global Banking Rules 'Anti-American'? *New York Times Room for Debate,* 28 September 2011, at http://www.nytimes.com/roomfordebate/2011/09/28/are-global-banking-rules-anti-american/banking-rules-are-in-the-interest-of-americans

18 International Convergence of Capital Measurement and Capital Standards, Basel Committee on Banking Supervision (BCBS), BIS, Basel 1998, at http://www.bis.org/publ/bcbs04a.pdf (page 1)

hold a minimum capital equivalent to 8 percent of their risk weighted assets. This approach which related capital to different categories of assets and off-balance-sheet exposures weighted according to their relative riskiness was thought to be superior to an institution's leverage or gearing ratio. As an aside you may wish to note that claims on or guaranteed by OECD central governments were deemed to be risk free assets. Today try telling that to the holders of Greek government bonds! Criticisms of this new approach were that: it limited the differentiation of credit risk; it adopted a static measure of default risk; it failed to recognize the term-structure of credit risk; it did not recognize the effects of portfolio diversification; and it also underestimated the importance of leverage.

The modified rules of Basel II were designed to eliminate the short comings of Basel I and to further strengthen the soundness and stability of the international banking system while still maintaining a level playing field for internationally active banks[19]. The ratio of capital to risk weighted assets remained unchanged but the definitions and measurement of capital and risks were refined[20]. As was the case with Basel I, the new framework was circulated to supervisory authorities worldwide and they were encouraged to consider adopting it when they believed it was consistent with their broader supervisory priorities. The Committee noted that although the new framework may not be a first priority for all non-G10 supervisory authorities . . . each national supervisor should consider carefully the benefits of the revised Framework in the context of its domestic banking system when developing a timetable and approach to implementation."[21] This really is code for saying to non-G10 countries that they should fall in line and quickly! Indeed the Basel capital adequacy standards were often implemented by developing countries as a condition for assistance from the IFIs. In September 2010, the IMF agreed that stability assessments under the FSAP, which evaluates a country's progress on implementing the Basel agreements and other internationally approved codes and standards, will be a mandatory part of bilateral surveillance every 5 years for 25 jurisdictions with systemically important financial sectors[22].

In addition to their identified short-comings, which could be addressed in a third iteration of the rules, Basel I and II also had at least three unintended consequences or architectural flaws if you prefer, that sowed and fertilized the seeds of the 2007-08 crisis. The law of unintended consequences is the bug-bear of regulators especially in the financial sector because the forces of innovation and avoidance arrayed against them almost always secure an outcome contrary to the expectations of the well-intentioned and often under resourced regulators. The first of these unintended consequences was the rapid rise in securitization as a mechanism for regulatory capital arbitrage (RCA) which allowed banks to eat their cake and have it too; the second was the rise and fall of the credit rating agencies (CRAs); and the third was that under Basel I and II bank lending was pro-cyclical i.e. it prolonged both the boom and the downturn.

Let us examine these claims before moving on to Basel III.

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19 International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Comprehensive Version: June 2006), BCBS, BIS, Basel 2006 at http://www.bis.org/publ/bcbs128a.pdf (p2)

20 An Explanatory Note on the Basel II IRB Risk Weight Functions – July 2005, BIS at www.bis.org/bcbs/irbriskweight.pdf

21 BIS, Basel 2006 op. cit (p1)

22 IMF, Factsheet: The Financial Sector Assessment Program (FSAP), September 2, 2011, at http://www.imf.org/external/np/exr/facts/fsap.htm

First securitization: This is the process by which financial institutions convert assets on their balance sheets, such as individual mortgages, auto loans, student loans, credit card receivables and other debt obligations, into bundles of marketable securities, known collectively as asset-backed securities (ABS). These assets are sold to reduce the amount of regulatory capital required to satisfy the risk on their books or to tap a funding source at an attractive price and with a known maturity, or for both of these reasons. The use of asset backed securities gave rise to such a rapidly expanding over the counter (OTC) market in derivatives that it attracted the attention of the US Commodity Futures Trading Commission (CFTC). The Chair of the CFTC, Ms. Brooksley Born, suspected that what she termed the "dark market" of OTC trading was a hidden fault line in the US financial system. Because she was concerned about the lack of transparency, the lack of tools for enforcement and the lack of prohibitions against fraud and manipulation she proposed in 1998 that OTC derivative trading should be regulated. This was just before Long-term Capital Management (LTCM), the firm that had among its principals Myron Scholes and Robert Merton, Nobel Laureates for their work on the Black-Scholes-Merton model for calculating the price of traded securities, was brought to its knees by derivative trading. Even after the collapse of LCTM proposals to regulate the OTC market were opposed by the banks, by Alan Greenspan then Chairman of the Federal Reserve Board, Larry Summers Deputy Secretary of the Treasury, Robert Rubin the Secretary of the Treasury, and Arthur Levitt, then head of the SEC[23]. The fault lines shifted and in 2008 unleashed a tsunami, which rearranged the landscape of Wall Street. Citigroup was threatened as its share price fell from $282.40 on 4 January 2008, to $37.70 on 21 November 2008, so too was AIG which had insured all these transactions; Bear Stearns and Washington Mutual were under water and were salvaged by JPMorgan Chase in a government brokered deal, the same happened to Merill Lynch and Bank of America came to the rescue; Lehman Brothers was completely swept away; and the US Government provided a $700 billion lifeboat called the TARP (troubled assets relief program). Failure to regulate the OTC derivatives market in 1998 had disastrous consequences for financial institutions on both sides of the Atlantic in 2008.

David Jones, an economist at the FRB in Washington DC, observed in an article published in 2000 that securitization and the financial engineering associated with it provided "unprecedented opportunities for banks to reduce substantially their regulatory measures of risk, with little or no corresponding reduction in their overall economic risks – a process termed "regulatory capital arbitrage (RCA)"[24]. He also noted that the 1997 change to Basel I which allowed banks to use their own value-at-risk (VaR) models for calculating their risk-based capital requirements . . . potentially created additional opportunities for regulatory capital arbitrage[25]. Here is a snapshot of how this market exploded: ABSs outstanding in the US bond market rose from $1.2 billion in 1985 to $75.8 billion by 1990 and $1069.6 billion by 2000. They more than doubled again to $2692.8 billion by 2007 but since then they have fallen to $2032.0 billion at the end of 2010 and to $1913.1 billion by June 2011[26]. US banks were unquestionably

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23 *Credit Crisis Cassandra: Brooksley Born's Unheeded Warning Is a Rueful Echo 10 Years On,* Manuel Roig-Franzia, Washington Post Tuesday, May 26, 2009 http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009052502108_pf.html

24 Jones D., Emerging problems with the Basel Capital Accord: Regulatory capital arbitrage and related issues, Journal of Banking and Finance 24 (2000) 35-58 (p36)

25 Jones D., op.cit (p48)

26 Outstanding US Bond Market Debt, SIFMA , available at http://www.sifma.org/research/statistics.aspx

the market leaders with almost 88 percent of the new issues and 95 percent of outstanding bonds in 2000 and 75 percent and 77 percent, respectively, in 2010[27]. No complaints then about the anti-American nature of the rules which provided an incentive for US banks to earn considerable income as the leaders in securitization.

The explosive growth in this market activity allowed banks to move assets, some of which we now know carried very high regulatory risk and some of which were allegedly fraudulent[28], off their balance sheets and into special purpose vehicles (SPVs) for packaging and sale to the public. In the process banks effectively reduced their risk-based capital requirements while earning substantial income from underwriting, structuring and placing these assets which, because of their investment grade credit rating and distribution to a large number of holders, were thought to have minimized or even eliminated risk by spreading it – the medical equivalent of sneezing in a crowded room and thinking that you are cured by spreading cold germs around! These were not the junk bonds deals that brought down Drexel Burnham Lambert and landed Michael Milliken in jail, no these were investment grade securities.

This brings me to the second unintended consequence, the credit rating agencies (CRAs). They played such an important role in the growth of securitization that it facilitated their rise to the status of oracles and their subsequent precipitous fall to the level of outcasts. Overnight they ceased to be the darlings and became the demons of the financial industry, so much so that Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires federal agencies "to remove any reference to or requirement of reliance on credit ratings"[29]. The European Commission has also proposed rules to curb the CRAs freedom of expression on the grounds of "prevention of disorder"[30]. The value of almost everything the CRAs had rated declined sharply in the financial crisis; but credit ratings are not a judgment on the value of an investment, a misconception perhaps reinforced by the use of the term "investment grade" to refer to certain ratings. The CRAs deserve some sympathy. In the first place their opinions relate solely to the likelihood that a given debt or security will perform according to its terms[31]. Secondly, even when they get it right they get it wrong. No sooner had S and P downgraded US debt than US Treasuries became the haven for investors seeking safety. The downgrade was on the very reasonable grounds that in S and P's opinion the agreed fiscal consolidation plan of the Congress and the Administration would not be sufficient to stabilize the medium-term trends in the government's debt, an opinion shared by anyone witnessing the stand-off in the US over the increase of the debt ceiling. In the securitization boom every SPV and every asset had to be rated and the higher the rating the less the amount of regulatory capital the banks would be required to provide. The CRAs were engaged by the issuers of the securities but it is hard to

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27 Global Securitization Update 2010, SIFMA, 2011 (p2) available at http://www.sifma.org/research/item.aspx?id=8589934715

28 *Accused of Deception, Citi Agrees to Pay $285 Million*, Edward Wyatt, New York Times, October 19, 2011, at http://www.nytimes.com/2011/10/20/business/citigroup-to-pay-285-million-to-settle-sec-charges.html?pagewanted=all

29 In complying with this requirement one agency replaced the reference to rating agency fees with "fees paid to an organization to evaluate the credit quality of the issue." This change is followed by the comment that "No substantive change is intended." *Modification of Treasury Regulations Pursuant to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, A Rule by the Internal Revenue Service on 07/06/2011,* ***Federal Register***, available at http://www.federalregister.gov/articles/2011/07/06/2011-16856/modification-of-treasury-regulations-pursuant-to-section-939a-of-the-dodd-frank-wall-street-reform#p-11 (para76, FR 39279)

30 *Brussel eyes curbs on rating agencies*, Alex Barker, Financial Times, Tuesday November 15, 2011

31 The Role of Credit Rating Agencies in Structured Finance Markets, IOSCO Technical Committee, IOSCO, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD263.pdf

believe that the outcomes would have been different if they were engaged by the purchasers. In 2004 Standard and Poor's argued that if implemented as proposed, the new Basel II framework will discourage originating banks from holding exposures rated less than investment grade at the time of funding.[32] FitchRatings took this up in 2009[33]. The easy way out was to rate everything at investment grade!

The third unintended consequence is that Basel I and II made financial institution behaviour pro-cyclical: meaning that banks, in response to the Basel capital adequacy requirements, will amplify business cycle fluctuations by extending credit in the boom and withholding it in the downturn. This behavior leads to a credit crunch[34] which aggravates and extends the downturn. Because of the 8 percent ratio of capital to risk weighted assets banks would ramp up their lending during the boom as asset prices rise relative to their risks and restrict their lending during recession to avoid finding the additional capital required to offset the increased risk in their portfolio. The BCBS recognized this possibility, as well as the possibility of regulatory capital arbitrage in 1999[35] but a 2003 survey found very little agreement on whether or not risk-based capital requirements were pro-cyclical[36]. By 2008, however, there was a clear consensus that the Basel capital requirements were pro-cyclical[37] and multiple committees, institutions, central banks and supervisory authorities were working on mechanisms to abate this effect. For example, the G-20 in 2008[38] and again in 2009[39] called for agreement on measures to mitigate pro-cyclicality in the Basel agreements. The Basel Committee also highlighted the need to dampen the pro-cyclicality in the financial system[40] and the European Union created a working group to address the issue and to propose policy responses[41].

The framers of Basel III, in what seems like a mission impossible task, drew on lessons from the financial crisis to address these and other problems including improving financial sector regulation and preventing the exposure of taxpayers to losses while leaving the enjoyment of profits to shareholders and managers. The new proposals have two main objectives and fall

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32 What Effects Will Basel II Have on the Global ABCP Market? Standard and Poor's, October 2004, available at http://www.securitization.net/pdf/sp/Basel_Global_11Oct04.pdf

33 Proposed Basel II Amendments to Impact Structured Finance, Particularly ABCP, Fitch Ratings (February 18, 2009), London available at http://www.securitization.net/article.asp?id=1&aid=8794

34 Defined by the Council of Economic Advisors in its 1992 Report of the President as a "situation in which the supply of credit is restricted below the range usually indentified with prevailing market interest rates and the profitability of investment projects"

35 *Capital Requirements and Bank Behaviour: The Impact of the Basel Accord*, BCBS, BIS, Basel, 1999, available at http://www.bis.org/publ/bcbs_wp1.pdf

36 Allen, L., *The Basel Capital Accords and International Mortgage Markets: A Survey of the Literature,* Baruch College, CUNY, December 2003 (p24) available at http://pages.stern.nyu.edu/~lallen/mortgage.paper.pdf

37 See: Repullo R., Saurina J. and Trucharte C., *Mitigating the Pro-cyclicality of Basel II*, Centre for Economic Policy Research Conference on "The Future of Regulatory Reform", 4th October 2010, Grocers' Hall, London, EC2R 8AD, available at http://www.cepr.org/2432a/default_htm_files/RepulloFinal.pdf ; Kashyap, Anil K., and Stein, Jeremy C. *Cyclical implications of the Basel II capital standards* Economic Perspectives Federal Reserve Bank of Chicago, 1Q/2004 (pp18-34) available at http://www.economics.harvard.edu/faculty/stein/files/basel-chicago-fed-04.pdf ; and *Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System*, April 2009, available at http://www.financialstabilityboard.org/publications/r_0904a.pdf

38 G-20 Declaration, Summit on Financial Markets and the World Economy, November 15, 2008 (para10, p4) http://www.g20.org/Documents/g20_summit_declaration.pdf

39 G-20 Leaders statement, The Pittsburg Summit September 24-25 2009, (para 13, p8) http://www.g20.org/documents/pittsburgh_summit_leaders_statement_250909.pdf

40 Comprehensive strategy to address the lessons of the banking crisis announced by the Basel Committee, BCBS, BIS 20 November 2008 http://www.bis.org/press/p081120.htm

41 See: Council conclusions on pro-cyclicality 2954th Economic and Financial Affairs, Brussels, 7 July 2009, Council of the European Union, available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/109050.pdf

under two headings. The objectives are: to strengthen global capital and liquidity rules needed for a more resilient banking sector; and to improve the banking sector's ability to absorb shocks from financial and economic stress, which would reduce the risk of spillover from the financial sector to the real economy. The headings are capital reform; and liquidity reform. The capital reforms are designed to improve the quality, the quantity and transparency of the capital base with additional requirements for systemically or global systemically important financial institutions (SIFIs or G-SIFIs), enhancement of risk coverage, controls on leverage, and the introduction of a capital conservation buffer and a counter-cyclical buffer of up to 2.5 percent during the boom. Under Basel III banks could therefore be required to hold capital equivalent to 10.5 percent of RWAs. In addition to these changes Basel III has introduced harmonized global liquidity standards and measures to move the trading of over-the-counter derivative contracts to central counterparties (CCPs) that meet criteria determined by the Committee on Payments and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO)[42], a need that is being met more than a decade too late. Member countries are expected to begin national implementation on January 1, 2013 and all aspects of the new rules should be effective by 2019.

A novel and important component of Basel III is the incorporation of macro-prudential regulation in the aftermath of the 2007-08 economic crisis. The idea of macro-prudential regulation was revived through the advocacy of the UN Commission of Experts, Avinash Persaud, Claudio Bario and others, who recognized its absence as a major deficiency of the earlier Basel agreements[43]. The term was in the lexicon of the BIS since the late 1970s but it was not until 2000 that it was defined more precisely ". . . to derive specific implications for the architecture of prudential arrangements"[44]. Macro-prudential regulation focuses on the behaviour of the financial system as a whole with the objective of limiting the macro-economic costs of the failure of financial institutions and it treats systemic risk as the outcome of the behaviour of all financial institutions. Since the seeds of the bust are sown in the boom[45], an appropriate macro-prudential response by regulators would be to require financial institutions to build up a buffer of resources in the boom that would dampen rather than amplify the business cycle. This idea, along with the limit on leverage, and the net stable funding ratio, should prevent excessive credit creation. But everyone likes a boom: politicians like it because it enhances their electoral prospects, business likes it because it generates profits, consumers like it because it is an opportunity to improve their standard of living, and policy makers like it because it is a vindication of the policies they are implementing. The danger is therefore, that in the absence of binding rules, regulators will be under great pressure to delay applying the

42 *Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs Consultative report*, May 2010, BIS at http://www.bis.org/publ/cpss89.pdf

43 Persaud A., *Macro-Prudential Regulation; Fixing Fundamental Market (and Regulatory) Failures,* IFC Note No.6, The World Bank, Washington DC, July 2009, (p 2)

44 Bario, C., The macroprudential approach to regulation and supervision, 14 April 2009, available at http://voxeu.org/index.php?q=node/3445

45 Bario, C., *Towards a macroprudential framework for financial supervision and regulation?* BIS Working Papers No. 128, BIS, February 2003 (p 7) available at http://www.bis.org/publ/work128.pdf

brakes in a boom or as a former Chairman of the FRB put it, to order "the punch bowl removed just when the party was really warming up."[46]

Application to the Region – Implementation and Monitoring

Even when rules are carefully crafted in a process that is transparent and inclusive the real test of acceptance and applicability is in implementation. But accepting and agreeing to implement the new rules are not sufficient; the quality of implementation is also coming under scrutiny.

Caribbean jurisdictions have no room for manoeuvre in complying with FATF recommendations because there is too much at stake if countries and financial institutions fail to comply. That is why I put AML/CFT regulations at the top of my list. In an effort to ensure greater compliance, the FATF in 2000 began listing – naming and shaming – non-cooperative countries and territories. Fifteen jurisdictions were on the first list of NCCTs and eight more were added in 2001[47]. Six of the listed jurisdictions were in the Caribbean but by 2003 they were all delisted, prompting one to conclude that the FATF was either hasty or ill-informed when it decided to list these countries, or that the countries were under great pressure to put their house in order and they moved quickly to avoid opprobrium, enhanced due diligence, especially in the international financial and business services industry, and the disadvantage their indigenous financial institutions might suffer if they were unable to participate in lucrative international transactions. Financial institutions, while they may complain about the cost of implementing the FATF regulations, will be reluctant to expose themselves to the risk of criminal prosecution, the potential for loss of business, reputational damage and ultimately, as in the case of Riggs Bank, the loss of their franchise. In October 2006 the last of the NCCTs, Myanmar, was de-listed but the FATF still continues to issue statements highlighting deficiencies in the AML/CFT regimes of countries and territories.

The relative ease with which the FATF has been able to achieve compliance with its recommendations is in complete contrast to the contentious resistance that surrounds Basel III. Bankers in both the US and Europe have been marshalling resources and arguments against the modifications to the rules introduced by Basel III. In the US the financial industry has already spent an estimated $126 million lobbying the US Congress and Administration; the Chairman of JP MorganChase, has also claimed that the new capital requirements will stifle growth[48] a view shared by Peter Sands, CEO of Standard Chartered, who observed that "the pursuit of financial stability imposes too great a cost on economic growth and job creation at a fragile time for the world economy."[49] The financial industry claims that additional capital will reduce lending capacity, is expensive, and makes the financial sector uncompetitive by reducing the return on

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46 Martin, W. McC., *Address to the New York Group of the Investment Bankers Association of America*, New York, October 1955, available at http://fraser.stlouisfed.org/docs/historical/martin/martin55_1019.pdf

47 FATF, Annual Review of Non-Cooperative Countries and Territories 2006-2007: Eighth NCCT Review, FATF/OECD, Paris, 12 October 2007 (Annex 3, p13). The listed Caribbean jurisdictions (with the year of de-listing in parenthesis) were: The Bahamas (2001), Cayman Islands (2001), Dominica (2002), Grenada (2003), St. Kitts and Nevis (2002) and St. Vincent and the Grenadines (2003).

48 *Jamie Dimon gripes to Bernanke, by* Annalyn Censky, CNNMoney June 7, 2011 available at http://money.cnn.com/2011/06/07/news/economy/jamie_dimon_bernanke_dodd_frank/index.htm

49 *Financial Services: Banks and regulators at odds*, Brooke Masters, Financial Times, November 2, 2011, available at http://www.ft.com/cms/s/0/7ecfa838-f99f-11e0-a805-00144feab49a.htm l

equity (ROE), a view also shared by large accounting and consulting firms[50]. Alan Greenspan, having recovered from his *mea culpa* on what he thought was the capacity of "self-interest of lending institutions to protect shareholders' equity. . ."[51], joined the debate and in an article in the *Financial Times* of July 27 argued that "excess bank equity . . . would constitute a buffer that is not otherwise available to finance productivity-enhancing capital investment."[52] Bankers also fear that the exercise of supervisory discretion, especially in light of the European debt crisis, leaves scope for some jurisdictions to apply a less rigid interpretation of Basel III and that political issues and debate around implementation will create an uneven playing field for global competition among banks.

There is considerable push back from the G-20, the regulators and the academic community against these views. A number of academics have argued that equity is not expensive and that regulators should use it as a powerful, effective and flexible tool to maintain the health and stability of the financial system[53]. Commitment to the Basel III capital and liquidity framework and the implementation timeframe for other reforms was reinforced by the agreement at the G-20 Cannes Summit to strengthen the FSB and to develop "macro-prudential policy frameworks and tools . . ."[54]. Mark Carney, the new chairman of the FSB and Governor of the Bank of Canada, has stated quite emphatically that if banks feel they are under pressure to implement the new rules ". . . it is because they have done too little for too long, rather than because they are being asked to do too much, too soon."[55] Switzerland has already passed legislation requiring its two major banks, UBS and Credit Suisse, to hold capital equivalent to 19 percent of RWAs, compared to 10.5 percent under Basel III. Sweden and Norway are also considering higher limits (between 12 and 15 percent); and in the UK the Independent Banking Commission has recommended that, in addition to ring-fencing the retail operations of the high street banks, the ring-fenced banks with risk-weighted assets of 3 percent or more of UK GDP should be required to have an equity-to-RWAs ratio of at least 10 percent[56].

Although the FSB still has to agree on detailed guidelines, which may provide additional opportunities for opponents of the new rules, it is working with the standard-setting bodies to jointly develop an implementation-monitoring framework that will include annual progress reports on a country-by-country basis to the FSB and G-20, as well as less frequent, but more in-depth, peer reviews. Once the rules are agreed enhanced mutual-surveillance processes should ensure even-handed global application and allay suspicions of non-compliance. The Chairman

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50 See for example: *Basel III: Issues and Implications*, KPMG at http://www.kpmg.com/global/en/issuesandinsights/articlespublications/pages/basel-issues-implications.aspx; and *In search of a sustainable model for global banking*, McKinsey Quarterly, September 2011, at https://www.mckinseyquarterly.com/Financial_Services/Banking/In_search_of_a_sustainable_model_for_global_banking_2859

51 *Greenspan Concedes Error on Regulation*, by Edmund L. Andrews, New York Times, October 254, 2008, at http://www.nytimes.com/2008/10/24/business/economy/24panel.html

52 Regulators must risk more, intervene less, Alan Greenspan, Financial Times, July 27, 2011, at http://parasadenwala.blogspot.com/2011/07/alan-greenspan-regulators-must-risk.html

53 See: Admati, A.R., DeMarzo, P.M., Hellwig,M. F. and Pfleiderer, P., Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive, March 23, 2011 at https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf

54 G-20: Cannes Summit Final Declaration, (pp 7 and 9) at http://www.g20.org/Documents2011/11/Cannes%20Declaration%204%20November%202011.pdf

55 *Some Current Issues in Financial Reform,* Remarks by Mark Carney, Governor of the Bank of Canada at the Institute of International Finance, Washington, D.C., 25 September 2011, at http://www.bankofcanada.ca/wp-content/uploads/2011/09/sp250911.pdf

56 IBC Final Report and Recommendations, September 2011, Independent Commission on Banking, Victoria House, Southampton Row, London, WC1B 4AD (pp 233, 237)

of the FSB has suggested that a review of the new European and American rules would be an important confidence building measure in the consistency of the application of the rules in major jurisdictions. The new monitoring mechanisms are in addition to the IMF's annual Article IV surveillance and the IMF and World Bank's periodic financial sector assessment programmes (FSAPs) and reviews of standards and codes (ROSCs) across countries. Regulators also hope for a virtuous outcome, namely, that market discipline might trigger a race to the top and ensure compliance ahead of regulatory timetables because some banks may see early implementation as a competitive advantage and a demonstration of their soundness to regulators and to the market.

In the early stages of the Basel process policy makers in the Caribbean did have some room, limited albeit if they required assistance from the IFIs, to stand back and take stock. But this space has largely disappeared after the 2009 G-20 Summit mandated the FSB to launch a non-cooperative jurisdictions initiative similar to that of the FATF and the OECD to encourage adherence to the financial standards. This naming and shaming is a bitter pill, in the words of Delisle Worrell an "initiative that is puzzling and unhelpful"[57] but to make it more palatable the FSB member jurisdictions have committed to lead by example. In parallel with this initiative, the FSB is establishing regional consultative groups that will bring together financial authorities from FSB members and non-members to broaden the range of input into its work and hence the applicability and implementation of its policies and standards. Let us hope that we do not have a repeat of the CFATF experience and wait for sixteen years before our regional voice could be heard at the table! The FSB has identified 61 jurisdictions for evaluation. Bahamas and Barbados are among the select and along with 16 others, are deemed to be in an intermediate situation, which means that either the assessment of one or more sectors has found shortcomings that are being corrected, or the assessment is incomplete or out of date, but the country is cooperating to bring itself into compliance with the FSB's proposals[58].

Since 2001 the IMF and World Bank have conducted FSAPs for the ECCU (2004), Barbados (2003 and 2009), Trinidad and Tobago (2006), Jamaica (2006) and Haiti (2008). These assessments reveal that the ratio of capital to risk-weighted assets for commercial banks in every case already exceeded the Basel III minimum, and in one case are equal to the ratio imposed by Switzerland on its largest banks. This is why I would suggest that concern with capital adequacy could rank after implementation and monitoring. The FSAPs also reveal a wide variety of weaknesses in the regulatory and supervisory framework. These include: the absence of contingencies to deal with deposit withdrawals and capital flight; the need to strengthen supervision of nonbank financial institutions and the offshore banking sector; the need for a clear legal framework for the consolidated supervision of banking groups; improved

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57 Worrell, D, Statement by Dr. Worrell on behalf of Caribbean countries, on the initiative of the Financial Stability Board on "non-cooperative jurisdictions", 21 October 2010, at http://www.centralbank.org.bb/WEBCBB.nsf/vwNews/20FE9B1CEB6ECC0D042577C4005DCC31?OpenDocument

58 *Global adherence to regulatory and supervisory standards on international cooperation and information exchange: Public Statement*, FSB (p.3) at http://www.financialstabilityboard.org/publications/r_111102.pdf

cooperation between home and host supervisors; inadequacies in asset classification and loan-loss provisioning; and poor supervision and data for insurance sector. The IMF-WB FSAP teams have made recommendations which authorities in the region are in various stages of implementing to strengthen supervision of banks, insurance companies, credit unions and the securities industry.

Because of the structure of ownership in the banking system Caribbean supervisors can count on the support of a strategic partner and an extra-regional financial supervisory agency to help them ensure that domestic banks comply with the FSB and other international standards. In the case of indigenous banks there is no such support but the banks will be subject to the global standards and may themselves have a market incentive to comply since they may wish to appear as sound as their foreign competitors, which may be a condition for retaining the business of their major clients, especially those outside the public sector; they may also be nudged by their external correspondents and by the lessons learnt from financial institution failures in Jamaica which was the subject of one of the lectures in this series – ***Storm in a Tea Cup or Crisis in Jamaica's Financial Sector*** – delivered by Gladstone Bonnick in 1999.

Caribbean supervisors are not able to count on external support or domestic market discipline in the regulation and supervision of indigenous financial institutions such as credit unions, which compete with commercial banks for much of the same business, insurance companies and finance companies. Only recently have Caribbean jurisdictions started to establish the appropriate domestic institutions and build the internal and cross-border cooperation and information sharing networks that are needed to effectively supervise these indigenous domestic and regional financial institutions. They were galvanized in this direction by the failure of CLICO which forced national regulators of the different financial institutions to work together to develop models for preventing the spread of contagion from one financial service to another, for example from insurance to mortgage finance; to develop crisis containment and resolution measures; and to develop stronger cross border cooperation. Such cooperation already existed for the banking sector through the Caribbean Group of Banking Supervisors (CGBS), established in 1983 to organise training and serve as the lead agency in maintaining interface with the Basel Committee and other international regulatory bodies on technical issues[59]. But, with CLICOs failure, the need to go further is evident. A beneficial outcome of this catastrophic event should be the creation of a sector-wide national and regional college of financial industry supervisors to bring together all the regulatory and standard setting bodies – a national and a regional Financial Stability Board, if you wish.

Conclusion

Ladies and gentlemen, I have taken your time – perhaps too much of it – to explore the background and origins of the new international financial architecture; to highlight its key components of relevance to us in the region; and perhaps to stray into some of the unintended consequences and major themes in the global debate the proposals have generated. For us in the Caribbean I re-iterate the importance and primacy that we must give to the fight against

59 See Caribbean Group of Banking Supervisors at www.cbgs.org

money laundering and financing of terrorism; to implementation of agreed regulatory and supervisory standards and to the capitalisation of our non-bank financial institutions. Whether by default or otherwise we have ensured that our commercial banks are well capitalized, we must now do it for the non-bank financial institutions as well. Our commercial banks are by and large also well supervised and regulated, we must ensure the same for the non-bank financial institutions as well. We should use the experience of failure to build national and regional financial sector-wide colleges of supervisors; and we must ensure that there are no chinks in our armour against money laundering and the financing of terrorism. Thank you.