A Study of Corporate Failure and the Political Economy of Financial Regulation in Trinidad and Tobago and the Caribbean

Dr. Wayne Soverall
Department of Management Studies
University of the West Indies, Cave Hill
Barbados, West Indies

Wilberne Persaud
Department of Economics
University of the West Indies, Cave Hill
Barbados, West Indies

Abstract

The corporate failure of CLICO/CL Financial in January 2009, the largest conglomerate in Trinidad and Tobago and the Caribbean, is the worst financial crisis experienced by the region to date. Today, more than three years later, despite a disputed bailout by the Government of Trinidad and Tobago (GOTT), the devastating spillover effects of contagion are still unfolding as regional governments struggle to find appropriate solutions to stabilize their financial systems, mitigate risks, and bring closure to the ensuing financial crisis. Thus, despite a partial resolution by GOTT and a proposal offered by the Government of Barbados (GOB) to its policyholders and those in the Eastern Caribbean, there is still a long way to go in finding a lasting solution. At issue is the nexus between corporate failure and the political economy of financial regulation, especially concerns related to the lack of appropriate national and regional financial regulations to mitigate corporate failure of large and complex institutions deemed too big to fail (TBTF) now and in the future. This paper examines these public policy issues, analyzes them to find answers, and in the conclusion, makes suggestions for improving financial regulation, enhancing the capability of regulators, strengthening regulatory oversight, and empowering regulators to aggressively pursue financial fraud and enforce regulations with a view to mitigating systemic risk in the future.

Key words: corporate failure, "too big to fail", political economy of financial regulation, government bailout, risk, financial contagion.

Introduction

Complexity of ownership structure, size and scope of activities associated with Colonial Life Insurance Company (Trinidad) Limited (CLICO) and its parent company, CL Financial (CLF) are today—three years after its devastating collapse in January 2009—still coming to light. Complexity in its structure and operations owed nothing to efficiency considerations but rather, merely to the vagaries of deal-making possibilities and legal schemes to 'get around existing legislative arrangements or regulation'. The CLICO/CLF meltdown posed systemic risk not only to Trinidad and Tobago's financial sector but also that of the wider Caribbean. In fact, the CLICO/CLF collapse had spillover effects in all 15 CARICOM states, with the exception of Jamaica and Haiti. The risk exposure of the Trinidad and Tobago economy was estimated to be as high as 10 percent of GDP or TT$13.6 billion, including the TT$7.3 billion already injected as part of the bailout by the Government of Trinidad and Tobago (GOTT).[1] In the Eastern Caribbean exposures were as high as 17 percent of GDP leading to costly government interventions.[2] The Trinidad and Tobago government bailout, managed by the Central Bank of Trinidad and Tobago (CBTT), disputed though it may be, was perhaps the single most important factor halting a complete meltdown of the local economy as well as others in the Eastern Caribbean.

[1] IMF (2011) IMF Country Report No. 11/74: Trinidad and Tobago Selected Issues, Washington, D.C., January 7:1-38.
[2] Ibid.

The bailout was necessary to avoid meltdown of the financial services sector with its negative impact on the real economy, an inevitable consequential impact of the systemic risk posed by a sudden, unmanaged and disorderly bankruptcy of the region's largest private conglomerate—confidence would rapidly dissipate!. Thus, the GOTT and CLICO/CLF signed a Memorandum of Understanding (MOU) providing financial support for CLICO, British American (BA) and CLICO Investment Bank (CIB).[3] At issue remains the challenge of providing an appropriate policy mix to support economic recovery, while completing the resolution of CLICO's corporate failure.[4] At the heart of this continuing financial crisis, however, is the political economy of financial regulation, especially the silence on the too big to fail (TBTF) problem. This paper examines these issues in the context of the CBTT's regulatory mandate, CLICO/CLF's continuous growth by acquisitions of diverse and potentially conflicting businesses, in great measure funded by creation of new and ambiguous—to say the least—'insurance products', sold to clients/customers in Trinidad and Tobago, Barbados and the OECS grouping of the Eastern Caribbean.

Current evidence of the performance of major financial institutions within the existing regulatory framework suggests the political economy of financial regulation, if effectively understood, certainly does not translate into effective regulation that is sufficiently robust and actively enforced to achieve behaviour understood by all to be necessary for prudential management of financial sector conglomerates with tendencies to deviate from the straight and narrow. At the end of the day there is a clear and urgent need for a coordinated regional regulatory response to financial sector supervision and appropriate mechanisms for crisis resolution. This is particularly urgent given the importance of international financial intermediation in so many Commonwealth Caribbean jurisdictions. Appropriately redesigned regulation, however, will only be effective if there is reasonable coordination among different national regulators in relation to its principles, implementation and enforcement. In short, it is only when financial corporations can fail, go bankrupt as a result of faulty decision-making, without socializing losses having previously accumulated and disbursed privatized profits that the moral hazard of too-big-to-fail (TBTF) shall end. The implicit guarantee of government support in the face of potential contagion due to such failure requires fallback mechanisms funded by these institutions in the good times. Alternatively, the notion TBTF should face questions from its opposite TBTM—too-big-to-manage! In such a framework, financial regulatory institutions would finally be able to use robust regulations and compliance mechanisms to avoid contagion thus ending the threat of future corporate failure igniting a financial crisis.

CLICO/CLF

CLICO is the largest insurance company in Trinidad and Tobago and the Caribbean, the flagship of the parent company, CL Financial (CLF), which is the largest privately-owned conglomerate in the Commonwealth Caribbean with operations spanning its core business of insurance, but which also includes financial services, real estate development, manufacturing, agriculture and forestry, retail and distribution, energy, media and communications (see Figure 1).[5] CLICO/CLF operates in 32 countries through its associated and joint venture companies (see Table 1)[6] and more than 65 subsidiaries spanning the Caribbean, Florida, Europe, the Middle East and Asia (see Table 2).[7] It controls assets in excess of TT$100 billion; owns 55 percent majority ownership of Republic Bank, the country's largest commercial bank as well as Methanol Holdings of Trinidad Ltd. which operates M5000, the world's largest methanol plant at Point Lisas; controls BA which is one of the main insurance companies in the Eastern Caribbean; and the four largest financial institutions in CLICO/CLF manage assets of over TT$38b which constitute approximately 25 percent of the country's GDP.[8]

[3] Budget Statement 2010: 6-7.
[4] IMF (2011) IMF Country Report No. 11/73: Trinidad and Tobago Staff Report for the 2010 Article IV Consultation, Washington, D. C., December 22: 1-56.
[5] CL Financial Annual Report, 2007.
[6] CL Financial Annual Report, 2006.
[7] Ibid.
[8] Ewart Williams, Governor, Central Bank of Trinidad and Tobago, Remarks at the CIB/CLICO Media Conference, January 30, 2009: 3.

Figure 1 Organizational Structure of CLF

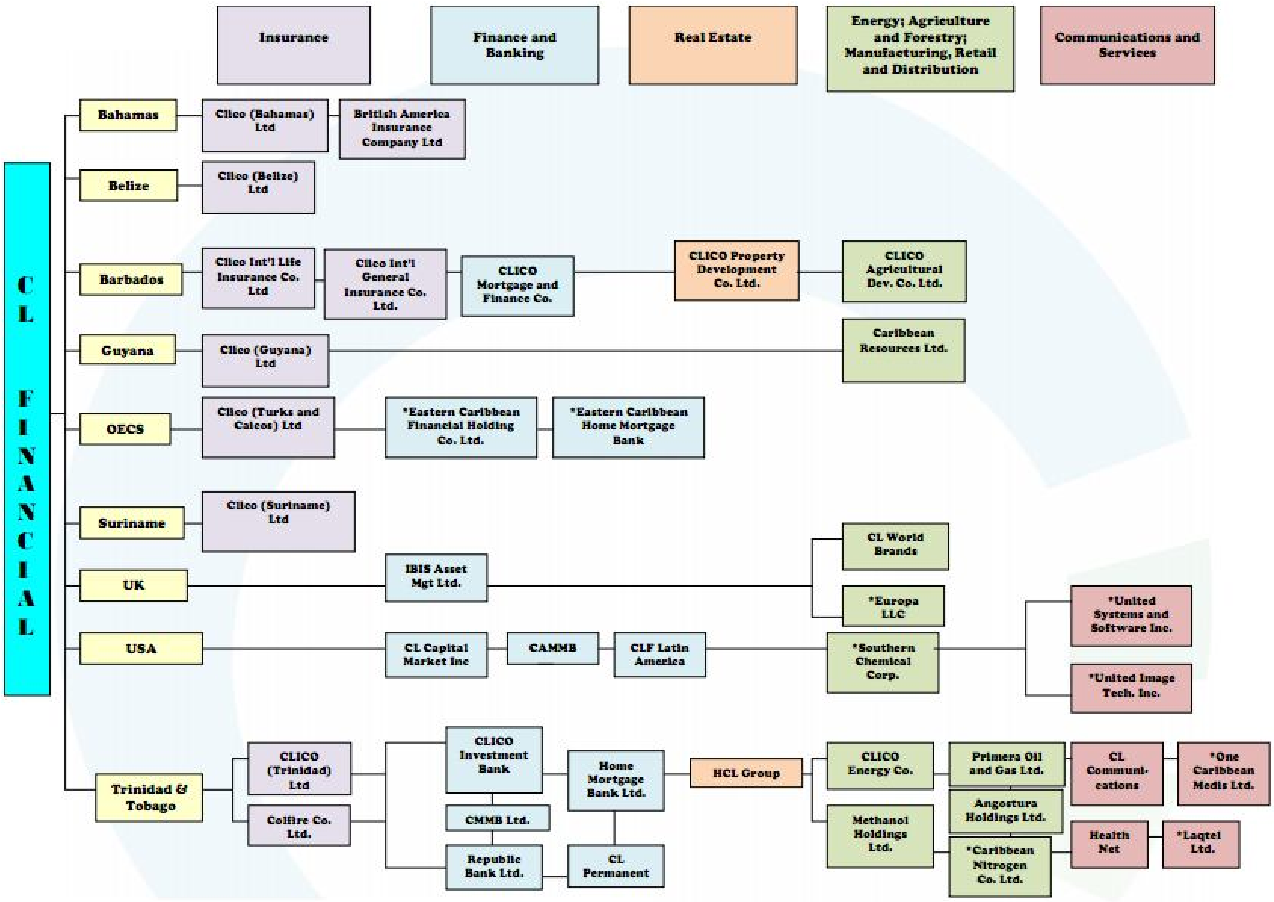

Table 1: Associates and Joint Venture Companies

TABLE 1		
COMPANY	**COUNTRY OF INCORPORATION**	**PERCENTAGE OWNED (%)**
One Caribbean Media Limited	Trinidad and Tobago	33
Southern Chemicals Corporation	USA	48.75
Cumberland Communications Limited	Trinidad and Tobago	50
Bram-Ber Holdings Limited	Bermuda	40
Caribbean Nitrogen Company Limited	Trinidad and Tobago	30.28
Nitrogen (2000) Unlimited	Trinidad and Tobago	27.2
Securicor Trinidad Limited	Trinidad and Tobago	24.5
Infolink Services Limited	Trinidad and Tobago	25
Eastern Caribbean Financial Holding Co. Limited	Trinidad and Tobago	20
Laqtel Limited	Trinidad and Tobago	40.5
United Systems and Software Inc.	USA	49
United Image Technologies Inc.	USA	49
Europa LLC	USA	21
Fidelity International Development Inc.	USA	50
Eastern Caribbean Home Mortgage Bank	Each member state of the Eastern Caribbean Union	20
Source: CL Financial Limited Annual Report 2006.		

CLICO/CLF's imposing presence in Trinidad and Tobago and across the region, coupled with its phenomenal, yet ultimately flawed and therefore transitory business success, made it for a significant period of time, in the eyes of its clients and investors, the entrepreneurial flagship of the entire Caribbean. Thus, CBTT was "very conscious of the contagion risks that the financial collapse of an institution as vast as CLICO/CLF could have on the entire financial system of Trinidad and Tobago and indeed, in the entire Caribbean region."[9] Thus GOTT and CBTT intervened because they were particularly concerned about the potential impact that the CLICO/CLF failure would have as a consequence of its wide scope and its sheer size.[10] However, early warning signs of the impending corporate failure of CLICO/CLF were detected as a result of the operations and investment decisions being made by the group when it bid for the Jamaican insurance portfolio during the indigenous financial sector meltdown that hit Jamaica in the mid-1990s.[11] Resolution of that crisis cost about 30 percent of GDP.[12]

After an initial approach by all but one of the insurance companies operating in Jamaica in April/May 1996, at which time their estimated liquidity shortfall was in the region of J$3 billion, the government established a task force which quickly ascertained that the true problem was insolvency: "Remarkably, several of the troubled institutions either severely underestimated or under-represented their need for support".[13] In January 1997 the Government of Jamaica (GOJ) established the Financial Sector Adjustment Company (FINSAC) to restructure and recapitalize financial institutions. It eventually took control of seven insurance companies, five commercial banks, three investment banks and three building societies by acquiring ownership stakes of at least 26 percent in these institutions to obtain veto power over management decisions, and in some cases, it took over direct management. The resolution institution, FINSAC was effectively acquiring bankrupt institutions for as little as J$1.00. In cases where assets could sustain it, the 26% shareholding was taken as an interim position until the company could be recapitalized and sold back into the private sector. At the end of the rehabilitation exercise, Trinidad and Tobago's Guardian Holdings Limited and Barbados's SAGICOR[14] made successful bids for the merged portfolios of the former leading Jamaican insurance companies which included Crown Eagle Life Insurance Co. Ltd., Dyoll Life, Horizon Life, Jamaica Mutual Life Assurance Society, Island Life Insurance Company Ltd and Life of Jamaica.[15]

Although the failure of CLICO/CLF shares basic similarities with other financial crises in the region such as the Jamaican meltdown of 1996 and the failure of the Stanford Group of Companies (SGC) in Antigua, there are significant differences that set them apart. In addition, financial crises differ as to their details. However, they always reflect the confluence of some underlying economic vulnerabilities and a specific crisis trigger.[16] In this regard, CBTT Governor Ewart Williams, suggests five factors making the CLICO/CLF case different from the Jamaican crisis and the failure of the SGC in Antigua and, therefore, made its resolution more complicated – its enormous size, its regional scope, its occurrence in the midst of the worst international financial crisis for almost a century, the heavy fiscal cost associated with public bailouts.[17] While these are indeed differences, they are rather differences of scope and reach and not differences in character. A financial crash always emerges at the burst of a bubble. CLICO/CLF is no different. The bubble was always expectations of and rising rates of return on investments in CLICO/CLF.

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[9] Ibid: 3.

[10] Karen Nunez-Tesheira, former Minister of Finance, Government of Trinidad and Tobago, Statement at the CIB/CLICO Media Conference, January 30, 2009: 4.

[11] Wilberne Persaud, Commentary – Systemic failure a worrisome possibility in CLICO meltdown, Financial Gleaner, February 6, 2009: 1.

[12] Ewart Williams, Opening Remarks at the CCMF/CARICOM Secretariat and CARTAC Workshop On Regional Financial Stability, March 3, 2010: 2.

[13] Persaud, Wilberne (2006) "Jamaica Meltdown: Indigenous Financial Sector Crash 1996", N.Y. IUniverse Inc.

[14] Barbados Mutual Life Assurance Society and Life of Barbados bid separately but later jointly – SAGICOR post-dated the initial acquisition negotiations.

[15] Ibid, p. 79 and 'Focus on CLICO,' Trinidad Newsday, September 30, 2010: 7.

[16] 'Focus on CLICO': 3.

[17] Ewart Williams, 2010: 3.

Underlying vulnerabilities however, always exist in the genesis of a crisis and include any combination of a number of possibilities, including poor risk management; mismatches between assets and liabilities; excessive leveraging of available capital; poor liquidity management; inadequate capital – whether capital grows insufficiently as the institution's liabilities expand; hubris among management and outright fraud. The trigger could be for example, terms of trade shocks, the collapse of an asset, macroeconomic setbacks resulting from exogenous shocks or as in the recent September Wall Street Meltdown, a burst housing bubble underlying highly leveraged purchases of sub-prime mortgages forming the base of derivatives and CDO swaps exposure the value of which no one could accurately determine.

Table 2: Principal Subsidiaries

COMPANY	% SHAREHOLDINGS			COUNTRY OF INCORPORATION
	2007	2006	2005	
Insurance:				
Colonial Life Insurance Company (Trinidad) Limited		100	100	Trinidad and Tobago
Colonial Fire General Insurance Company Limited		94	94	Trinidad and Tobago
Clico International Life Insurance Company Limited		100	100	Barbados
Clico International General Insurance Company Limited		100	100	Barbados
Clico (Bahamas) Limited		100	100	Bahamas
British American Insurance Company Limited		82	82	Bahamas
Clico Life and General Insurance Company S.A. Limited		100	100	Guyana
Finance and Banking:				
Clico Mortgage & Finance Company Limited		100	100	Barbados
Clico Investment Bank Limited		100	100	Trinidad and Tobago
Caribbean Money Market Brokers Limited	100	55	55	Trinidad and Tobago
CMMB Securities Limited	100	55	55	Trinidad and Tobago
Republic Bank Limited		55	55	Trinidad and Tobago
The Home Mortgage Bank Limited		68	68	Trinidad and Tobago
Real Estate:				
Home Construction Limited		94	100	Trinidad and Tobago
Plaza Development Limited		100	100	Trinidad and Tobago
Valpark Shopping Plaza Limited		90	90	Trinidad and Tobago
Clico Property Development Company (St. Lucia) Limited		100	100	St. Lucia
Colonial Life Development and Company (Grenada) Limited		100	100	Grenada
Mariner's Haven Limited		100	100	Trinidad and Tobago
Energy, Manufacturing, Agriculture and Forestry:				
Angostura Holdings Limited		78	78	Trinidad and Tobago
Burn Stewart Distillers Limited		100	100	United Kingdom
CL World Brands Limited		100	100	United Kingdom
Angostura Suisse		100	100	Switzerland
Caribbean Resources Limited		100	100	Guyana
Clico Agricultural Development Company Limited		100	100	Barbados
Methanol Holdings (Trinidad) Limited		56	56	Trinidad and Tobago
Primera Oil and Gas Limited		100	100	Trinidad and Tobago
Services:				
Clico Holdings (Barbados) Limited		100	100	Barbados
HealthNet Limited		100	100	Trinidad and Tobago
Investors Holdings Limited		100	100	Trinidad and Tobago
Clico Energy Company Limited		51	51	Trinidad and Tobago
Clico Securities limited		100	100	Trinidad and Tobago
Primera Oilfield Management Services Limited		100	100	Trinidad and Tobago
Communications:				
CL Communications Limited		67	97	Trinidad and Tobago
Video Associates Limited		100	100	Trinidad and Tobago
Central Radio Limited		100	100	Trinidad and Tobago
Telemedia Limited		100	100	Trinidad and Tobago
Source: CL Financial Limited Annual Report 2006.				

In the case of CLICO/CLF, the range of vulnerabilities included a mismatch between assets and liabilities, excessive leveraging of balance sheet assets, preponderance of intragroup transactions, absence of an effective risk management framework and plain capital inadequacy.[18] These, in turn, were compounded by a weak legislative and regulatory infrastructure, in which CLF – the holding company – was not subjected to adequate formal regulatory oversight and practiced poor internal governance when it did pay attention to such detail.

[18] Ibid: 5.

In its operating environment, CLICO/CLF faced regulatory arms of state and regional bodies that practiced entirely insufficient regulatory collaboration.[19]

Systemic Risk

There exists a range of financial risks which we list in no particular order but which concern Central Bankers, financial system regulators and of course, the ones that should exhibit ultimate care if not apprehension about them, financial institutions themselves. They include market risk, credit risk, liquidity risk, operational risk, volatility risk, reputational risk, profit risk and the mother of them all – systemic risk. The thing about risk which inexplicably, so many financial firms' operatives' behaviour suggest they may be unaware of, is that it cannot be eliminated unless of course, no financial intermediation is undertaken. Risk may be spread, transferred, avoided through for instance diversification and interconnectivity. Yet, in this connection, recent discourse and modeling of the process suggests that "diversification has an ambiguous effect and beyond a certain levels (*sic*) elicits financial instability. Moreover, we find that risk-sharing restrictions create a socially preferable outcome."[20]

It is well known that in a fractional reserve banking system, no institution can survive a run on its own. Central banks retain the lender of last resort function precisely because of this. A run on a bank leads to waning confidence such that a 'flight to quality' immediately ensues unless the authorities intervene to provide liquidity. If the targeted troubled institution over-leveraged and inadequately capitalized, the only recourse – as in the sale of Wall Street's Bear Stearns, is an enforced sale to a sister institution, with guarantees of the Central Bank subsequent to 'elimination of whatever 'toxic assets' and overhanging liabilities created the panic or loss of confidence in the first place.

CLICO is an insurer, CLF is the holding company. Once CLICO/CLF could not meet its ongoing obligations, meltdown threatened contagion and systemic failure. Governments across the region exercised their power by invoking the legal remedy specifically designed to handle such an eventuality: judicial management. CLICO/CLF diversification, its high degree of intra-company transactions and interconnectedness to other parts of the financial system rendered its meltdown an episode of impending systemic collapse. This was avoided upon the intervention of GOTT and CBTT as they announced the brokered liquidity support we commonly refer to as a bailout, in the parlance of Chess aficionados, a forced move – the inexorable impact of moral hazard.

The presence of government guarantees – explicit (deposit insurance) or implicit (TBTF) – make the political economy of financial institution regulation unique in their function and impact, distinguishing them from other aspects of government regulation. Indeed, the presence of government guarantees creates strong incentives for financial institutions to externalize the cost of soured risk-taking, ultimately onto taxpayers. In other words, as we indicated earlier, losses (costs) are socialized while earlier realised and distributed profits – often the result of faulty high-risk operations are privatized.

A further debilitating impact of contagion leading to system failure is that it substantially reduces the supply of capital to the real economy.[21] The time table of judicial management events is listed in Table 3 below.

[19] Ibid: 5-6.

[20] Tasca, Paolo and Battiston, Stefano, Diversification and Financial Stability (April 30, 2011). CCSS Working Paper No. 11-001. Available at SSRN: http://ssrn.com/abstract=1878596 or http://dx.doi.org/10.2139/ssrn.1878596

[21] Acharya, Viral, Philippon, Thomas, Richardson, Matthew and Roubini, Nouriel: "A Bird's Eye View, The Financial Crisis of 2007-2009: Causes and Remedies", Prologue, February 18, 2009: 1.

Table 3: Regional Response to Failure of CLICO/CLF

Bahamas	CLICO Bahamas placed under provisional liquidation in February 2009 BA Bahamas placed under Judicial Management in September 2009
Belize	CLICO Belize placed under Judicial Management in March 2009
St. Lucia	CLICO and BA deemed insolvent in March 2009
Suriname	CLICO Suriname sold in July 2009
ECCU	BA placed under Judicial Management in August 2009
Caymans	CLICO Caymans closed in December 2009
Barbados	CLICO placed under Judicial Management in October 2010 BA placed under Judicial Management in December 2010
St. Lucia	CLICO placed under Judicial Management on April 11, 2011
St. Kitts-Nevis	CLICO placed under Judicial Management on April 29, 2011

The CLICO/CLF failure classically illustrates the TBTF problem. TBTF financial institutions, without adequate regulatory oversight induce moral hazard in the form of a race to become systemic. Thus, when a crisis hits, it results in wealth transfers from taxpayers to the systemically TBTF institution.[22] The paradox is that government guarantees compromise or remove the discipline normally imposed by the 'market' and depositors on commercial banks, and by debt holders of government-sponsored enterprises (GSEs) and TBTF financial institutions.[23] The reality is that neither CLICO/CLF in Trinidad and Tobago nor the SGC in Antigua, internalized the full impact of their decisions on the rest of the financial system and economy. Nevertheless, it is clear that financial stability remains a critical issue in relation to the financial development of any country. The evidence to date illustrates that financial instability and the failure of the financial system can result in catastrophic economic and financial consequences that lead to severe economic decline that could either be short-term or prolonged. The Trinidad economy has been in decline since 2009 as a consequence of the failure of CLICO/CLF. Indeed, similar declines occurred in the Barbadian economy and those of the Eastern Caribbean. Though aspects of decline may be partly attributable to the Wall Street meltdown and subsequent austerity measures in source countries for tourism activities in the islands, the CLICO/CLF negative impact is undeniable. Contagion effects include bankruptcies among corporate and individual firms, financial institutions and households.[24]

GOTT and CBTT intervention and their ongoing resolution of the crisis prevented systemic collapse ensuring a greater measure of public confidence in the financial system. End-of-the-line enforced intervention provided GOTT and CBTT the opportunity to impose a new board of directors. Effectively, what the regulatory and compliance system failed to do by way of extant regulation, is being remedied through control of the guiding mind of the conglomerate – board membership.[25] Moreover, since it was clear that the intervention would be costly, given the size and complexity of CLICO/CLF, it was agreed that the government, while providing capital and liquidity, would seek through legal remedy, whatever financial compensation the company's available unencumbered assets and its managers could provide. This is the effort to minimize the negative impact on the country's national debt and international credit rating.

Regulatory Failure

Regulation seeks to balance risk taking and innovation against the likelihood of a systemic crisis. Thus, a primary reason for a regulatory framework is the presence of negative externalities imposed by TBTF financial firms on the financial system.

[22] Ibid: 7.
[23] Ibid: 23.
[24] Ibid: 24.
[25] Sharpe, Nicola Faith, Rethinking Board Functions In The Wake Of The 2008 Financial Crisis, Journal of Business & Technology Law, Vol. 5, No. 1, 2010: 106.

Since, however, each firm is motivated to prevent its own failure rather than that of the system as a whole the private market may not be able to solve this problem.[26] Modern financial institutions have become large, increasingly complex and opaque in their activities. This, in part, has been the result of a view once openly held and defended by none other than Alan Greenspan, former Chairman of the U.S. Fed that private contracts such as derivatives, freely entered into by financial institutions and their clients need no government regulatory oversight. Evolution of this system in the U.S. following repeal of the Glass-Steagall Act weakened external governance that operated through capital markets (accurate prices), market for corporate control (takeovers) and boards.[27] These deficiencies underscore the need for strong internal governance which is easier achieved in principle than obtains in practice. The net result of this situation is weak risk controls, excessive leverage, innovation aimed at achieving regulatory arbitrage and the practice of shifting assets to riskier and illiquid ones, as manifested in the case of CLICO/CLF.

Governance failure has been exacerbated by the traditional factor of ill-designed and mispriced regulatory guarantees. Essentially, the TBTF guarantee to large, complex financial institutions (LCFIs), in this case, CLICO/CLF, encourages the consolidation of diverse activities under the one umbrella. In all this, the TBTF guarantee and deposit insurance have not been appropriately priced.[28] In this regard, government guarantees are essentially a double-edged sword since they are aimed *ex post*, at containing risks from institutional failures to the rest of the system while TBTF and deposit insurance are designed to limit the risks of contagious runs on financial institutions. The problem, however, is that *ex ante*, guarantees blunt the edge of market discipline that the potential of such runs impose.

The corporate failure of CLICO/CLF underscores the critical need for appropriate legislation and regulation that keeps pace with the rapidly evolving operations of financial institutions, especially the insurance industry. The evidence indicates that CBTT's "soft touch approach to regulation", essentially based on moral suasion and aligned to the philosophy of the market mechanism allowed, or even encouraged the excesses that caused the crisis.[29] An effective regulatory framework, empowered by the requisite legislative arrangements, implemented for compliance with appropriately trained officials is an absolute requirement. Without this, neither national nor regional regulators can have true supervisory oversight of the operations of conglomerates which have become the preferred form of organization for large financial institutions in the Caribbean. Many analysts blame the failure of CLICO/CLF squarely on CBTT, the regulator. Four reasons were advanced for the failure of regulators to master the job of regulation, namely, rapidly evolving innovation and creativity in terms of services and products offered by financial institutions; recognition that risk taking should not be totally outlawed since under certain conditions it benefits consumers; laws cannot legislate good behavior or by extension, good governance; and an ideological shift towards free markets and minimal regulation.[30]

It must be noted that CLICO/CLF was a pioneer in the local financial sector through the provision of its insurance services in Trinidad and Tobago and the wider Caribbean. For the most part, however, CLICO/CLF growth proceeded under conditions of limited regulation as the Office of the Insurance Supervisor, located in the Ministry of Finance, lacked the resources to act effectively. Thus, by the time regulation of the insurance industry was transferred to the Central Bank in mid-2004, CLICO/CLF had already become a major conglomerate in Trinidad and Tobago and the region. In addition, CLICO/CLF was the leader in the creation of new investment products to satisfy the demand given that the capital market had failed to expand to meet such demand. Over the years, it became apparent that one of the major vulnerabilities of CLICO/CLF was the excessive amount of related-party transactions. The regulator knew that it would be difficult, at best, to manage a large and complex institution such as CLICO/CLF which had grown accustomed to being unregulated.

[26] Acharya et al, op. cit.: 25.
[27] Ibid: 26.
[28] Ibid: 27.
[29] Ewart Williams, Governor, Central Bank of Trinidad and Tobago, "The Future of the Financial Industry After the Crisis," Opening Address, The Caribbean Centre for Money and Finance 14th Caribbean Business Executive Seminar, Port of Spain, April 30, 2010: 6.
[30] Ewart Williams, Governor, Central Bank of Trinidad and Tobago, "The Paradoxes Inherent in the Role of Central Banks: The Case of the Central Bank of Trinidad and Tobago," Opening Address to the British-Caribbean Chamber of Commerce, March 11, 2009: 6.

In addition to regulatory gaps, deficiencies in the corporate governance structure of CLICO/CLF, particularly too much individual control by the chairman who was also the chief executive officer and the failure of the directors to insist upon performing their fiduciary duties, conflicts of interest and poor risk management combined with significant political influence and weak supervision by CBTT to provide almost a free-for-all in the conglomerate's operations. Effective regulation requires convergence of a number of factors working in tandem with an adequate legislative and regulatory framework. Appropriately trained regulators require a regime of supporting and enabling institutions such as the accounting and auditing profession, as well as support from an informed and vigilant investor community.[31] These requirements were absent in the case of CLICO/CLF. For example, as a consequence of outdated legislation, CLICO with assets in excess of TT$24 billion, was legally required to have capital of TT$3 million in comparison to a bank which must have capital equivalent to a minimum of 8 percent of its assets. In other words, were CLICO a bank it would have required to have a capital base of at least TT$2 billion.

There were other consequences of limited market discipline. The insurance legislation had remained fundamentally unchanged since its enactment over twenty-eight years ago and the CBTT had only incrementally updated the regulatory framework governing licensed and registered financial institutions to enhance its regulatory oversight.[32] The deficiencies in the operations of CLICO/CLF highlighted the inadequacies in the legislative framework of CBTT which in 2009 still did not have the authority to conduct onsite supervision, share information with other regulators, or demand the required changes from CLICO even though since 2004, the regulatory authority for insurance companies and pension funds had been transferred from the ministry of finance to CBTT.[33] There were also significant loopholes in relation to counterparty transactions. Moreover, the legislation remains silent on actuarial methodology which allowed companies to use their own standards that could result in lower statutory fund requirements. In addition, the CBTT encountered resistance from CLICO/CLF in 2008 when it tried to enforce compliance with the admissible asset regulations that placed restrictions on the balance sheet and in the statutory fund. On the question of why the regulators did not intervene earlier to avert the near collapse of CLICO, it has been argued that highly recognized auditors gave the company a solid financial statement since 2004 and it received a solid rating from a reputable rating agency. In addition, any such action by CBTT would have precipitated a lawsuit and the prolonged court proceedings that would entail. An interesting dimension to this analysis is that despite its tremendous growth over the years, CLICO/CLF chose to remain a private company thereby shielding itself from the kind of scrutiny, for example, that submission of quarterly accounts, to which public companies are exposed, would have allowed.[34]

It has now been acknowledged by regulators that it is an inescapable fact that LCFIs must be subject to even more stringent regulation so that they do not become a burden on the public purse. Regional regulators now admit the need to collaborate much more closely. In this regard, the failure to benchmark and learn from the Jamaican experience of the 1990s is quite disturbing since it could have served as a model in the post-CLICO restructuring process since there is currently no consensus on a corporate governance model for the Caribbean. The GOJ has led the way in corporate governance practice in the region. In 2001, it reformed and strengthened financial sector supervision by establishing a Financial Services Commission as a new oversight body empowered to supervise and regulate the securities industry, the insurance industry and the private pensions industry. [35] In addition, there is further support from the Private Sector Organization of Jamaica (PSOJ) Corporate Governance Code which is similar to the United Kingdom Combined Code.

Despite this, however, Cash Plus and OLINT did occur – essentially two Ponzi schemes, the former in the Jamaican courts, the latter having its principal, David Smith, imprisoned in the U.S. for money laundering. OLINT claimed it was engaged in forex trading, offered in excess of 100% return on deposits and claimed it was outside the purview of the Jamaican FSC since it was an investment club and not operating in the securities industry.

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[31] Ibid: 7.
[32] Karen Nunez-Tesheira, op. cit: 1.
[33] Ibid: 3.
[34] Ibid: 10.
[35] Goldson, Suzanne, Commonwealth Caribbean Corporate Governance: A One Size Fits All?, Faculty Workshop Series, Faculty of Law, University of the West Indies, Cave Hill Campus, Bridgetown, 2008: 2.

Policy Implications

The failure of CLICO/CLF underscores the need to strengthen the regulatory framework for the insurance industry in Trinidad and Tobago. To this end, new pieces of legislation were introduced after extensive consultation with industry personnel in an attempt to correct some of the glaring deficiencies that contributed to the crisis in January 2009. Thus amendments to the Insurance Act, No. 3, 2009 as well as the Central Bank (Amendment) Act No. 4, 2009 were implemented on February 6, 2009 in order to provide financial assistance to banking, financial and insurance companies with a view to preventing the collapse of any such institution. In addition, the Central Bank issued a circular on July 10, 2009 stating that quarterly returns, as required by Section 61A of the Insurance Act were updated to include a computation of the statutory fund requirements in order to monitor compliance in accordance with Section 37 (7) of the Act. Moreover, the Central Bank also issued circulars on July 2, 2010, January 13, 2011 and March 21, 2011 respectively, providing guidelines for the information requirements to facilitate the product approval process, statutory fund requirements and, the approval and/or notification of new or amended insurance and banking products.

These policy changes are meant to strengthen the regulatory framework and to reinforce Corporate Governance Guideline issued on May 8, 2006. The former guidelines reflect existing legislative and regulatory requirements, characteristics of the financial sector and comments submitted by stakeholders within the industry and international best practices. However, although these amendments reflect a modern approach to the supervision of the insurance industry, including measuring company solvency against a risk-based capital formula and establishing more effective protection of policyholders, the new procedures must be constantly monitored and evaluated by supervisory personnel in order to achieve the desired results. There still are however, weaknesses in the regulatory framework. For instance, the statutory fund requirements are a cause for concern because the investment limits of statutory funds have not been clearly defined.

Another area of weakness is the need for comprehensive supervision of local and regional institutions or conglomerates that are increasingly active internationally. The present danger is masked by informal relationships and interlocking directorships that often blur the boundaries of due diligence and diminish the responsibility of fiduciary obligations and effective corporate governance practices. Such deficiencies result in poor application and enforcement of corporate governance practices which undermine the goals of transparency and accountability. To this end, greater market discipline and supervision of the activities of LCFIs such as CLICO/CLF should be significantly improved by encouraging them to disclose much more than mere pro-forma information in their published financial reports. This is particularly critical to their credit and market risk management policies and practices since it speaks to their capability to manage exposures during the reporting period.

In view of the clear, present and future danger posed by perceived and real threats of regional contagion risk arising from failure of LCFIs such as CLICO/CLF, there should be an identification system of early warning signals in a comprehensive risk management approach to supervision. This approach must include both qualitative and quantitative stress tests of the portfolios in question and counterparty risk management practices of these large financial institutions in order to identify likely sources of contagion risk on a timely basis. The results of such analysis should be discussed with all relevant stakeholder institutions in an attempt to ensure that effective mitigation mechanisms are implemented, monitored and evaluated to ensure compliance.

Policy Recommendations

The corporate failure of CLICO/CLF had multiple reinforcing causes which combined to produce devastating economic and financial consequences for Trinidad and Tobago and the wider Caribbean. Regulation should focus on appropriate corporate governance and risk management, mechanisms to prevent regulatory arbitrage and ensure compliance. As much as risk measurement since the failure of CLICO/CLF revealed gaps in regulation and unknown interconnections among the CLF group of companies, no regulator was charged with the responsibility of monitoring and evaluating these institutions. Thus, despite the shift in the supervision of CLICO's operations from the ministry of finance to the CBTT, surveillance remained weak at best. The government must implement tough measures with appropriate sanctions in order to overhaul the regulation of the financial services sector because the existing light regulation of the insurance industry, in particular, has severely compromised the supervisory reach and effectiveness of the CBTT. There is need for a regulatory financial precautionary principle with respect to new products and processes created by financial innovation. Regulators must determine whether innovative products are likely to increase systemic fragility and associated risk.

This is absolutely essential in an environment in which financial innovation facilitated avoidance of regulation and regulatory arbitrage, increased informational asymmetries and encouraged unethical and deceptive practices in the sale and promotion of financial products and services. For example, the CBTT could not determine the legal status of the financial instrument referred to as an EFPA and therefore, consumer protection was neglected and placed at risk. Regulators are faced with new challenges such as contagion between certain financial market segments and the absence of a comprehensive risk management system to contain the rapid transfer of risks. The new capital adequacy framework commonly referred to as Basel II, can be used for policy and regulatory coordination among central bankers and regulators. In addition, regulations approved during the financial crisis must be subsequently fine-tuned and periodically adjusted to ensure that they retain their effectiveness in a changing environment. There were several regulatory requirements not being enforced by the regulators; this practice must be changed – the legal statutory requirement that CLICO left unfulfilled was just one instance of the failure of CBTT to regulate and/or to impose penalties for such deliberate non-compliance or negligence.

The larger and more complex an institution, the higher the standards for capital, liquidity and leverage to which it should be held because the size and scope pose greater risks to the system and they should be internalized. Additionally, a more adequate capital structure is needed to strengthen corporate governance and provide a greater buffer in the event of difficulties. Thus, LCFIs such as CLICO/CLF should maintain regulator-approved liquidation plans and, if their plans are consistently weak then they should be required to divest businesses until their failure poses significantly less risk of spillovers. No institution should be allowed to become too big to fail without such buffers. There will always be the need for a lender of last resort bailouts, notwithstanding the implementation of appropriate policies. However, there should be a key distinction between the financial institution and their agents who made the decisions to take risks and benefitted from these decisions, i.e. executive management, agents and other highly rewarded operatives. There should be disincentives for decision-makers whose activities lead to collapse and bailout.

Conclusion

This paper concludes with the caveat that these policy recommendations or any other regulations will not have the desired impact unless the political economy of regulation is dramatically changed. Effective regulatory reforms will not take place until there is a broad political mandate in support of effective financial regulatory reform. For too long, business has corrupted the political process and, by extension, compromised the implementation of public policy. In addition, the attitude of regulators has to change substantially and financial regulatory institutions must be empowered by law to enforce regulations. The regulatory gap has to be closed immediately and regulators adequately trained so that they are competent to deal with financial innovations and complex products.

The political economy of financial regulation underscores the urgent need for a coordinated regional regulatory response to financial sector supervision and an appropriate mechanism for establishing a framework for crisis resolution. Effective and enabling regulation will only be work if there is reasonable coordination among different national regulators on its principles and implementation. Clearly, improving monitoring and risk management, consolidating supervision of the non-bank financial intermediaries within some form of financial services oversight institution, strengthening the supervisory capability of national and regional regulators and twinning the size and riskiness of major elements of the financial sector with appropriate safeguards against default and risk events must be implemented without delay. Without this, the region shall not have the flexibility to react positively when the next crisis inevitably occurs. In short, the real issues are size, governance and arrangements to mitigate as well as provide for risk. It is only when large corporations can fail without socializing their losses, having previously privatized profits that the perception of TBTF, with its attendant guarantee of government bailout shall be brought under control. Central banks can decisively use robust regulations to minimize the probability of corporate failure igniting another financial crisis.

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