



Ongoing changes in the supervisory landscape and how to effectively deal with the ensuing challenges as a small jurisdiction

Speech delivered by Mrs. Jeanette R. Semeleer, President of the Central Bank of Aruba (CBA), on the occasion of the BES seminar held on March 29, 2010 in Curacao, Netherlands Antilles.

Ladies and gentlemen good afternoon,

I am pleased to have been invited by the Dutch Ministry of Finance to deliver a speech at this important seminar, aimed at providing information and exchanging views related to the upcoming changes in the regulatory and supervisory framework in the BES-islands in connection with the constitutional changes that will take effect on October 10, 2010.

In my today's speech I will primarily focus on our supervisory experiences over the years and how we, as a small jurisdiction, dealt with the many challenges we faced, and also with those we are currently facing. In view of the limited time, it will only be possible to give you just a flavor hereof.

1. Introduction

Before doing so, allow me to briefly highlight some notable events surrounding the establishment of our central bank and also to provide you with a broad overview of Aruba's economic performance over the years since its Status Aparte.

In the run-up to our own central bank, as you can imagine the first major challenges already surfaced, and one of them was the lack of experienced central bankers, particularly on senior level. Therefore, the IMF was approached – through the government of the Netherlands upon petition of the Aruban government– with the request to provide technical assistance to the CBA.

Fortunately, they quickly agreed hereto and supplied two senior officers, of whom one became de facto the first president of the CBA and the other manager of the supervision department. On January 1, 1986 the Central Bank of Aruba became operational with a budget of Afl. 2.5 million, while the total number of staff was 28.

Today, our operational expenses amount to about Afl. 17 million. Our staff also increased considerably over the years, reaching a full-time staff of 70 persons. These personnel expansions took place especially in the statistics, research and supervision departments. However, further personnel expansion remains necessary in view of the additional tasks that have or will be assigned to the CBA, most notably in the supervisory area.

In probably most, if not all, monetary and supervisory authorities, one of the main challenges is the hiring and retaining of highly qualified, motivated and well-trained staff. This is also in the case of Aruba. In this regard, it should also be noted that many of our students who go to the Netherlands for their higher education degree choose to stay there. The expensive euro vis-à-vis the Aruban florin plays a significant role in this regard, as most of our students build up significant euro debts related to loans received from the Dutch government.

After a negative start at the eve of its Status Aparte, Aruba made great economic progress in the past twenty four years. Its per capita GDP increased from less than US\$ 7,000 in 1986, when Aruba obtained its Status Aparte, to approximately US\$ 25,000 at present. This impressive gain was achieved through the execution of market-friendly policies that have fostered a stable macroeconomic environment and a rapid expansion in the tourism sector.

However, the recent global financial and economic crisis has again shown Aruba's vulnerability to external shocks due to its one-sided economic base. Our economy continues to face a contraction in economic activities. The uncertainties surrounding the international financial system, which came at the brink of collapse in the last quarter of 2008, and resulting deteriorating employment conditions in the United States, negatively impacted tourism mostly through reduced spending on the island.

In addition, tightened international credit conditions brought about a substantial drop in foreign direct investment on the island. Consequently, the execution of

several projects, particularly in the tourism and real estate sectors, was either postponed or cancelled, thereby affecting employment in both the construction and tourism sectors.

Furthermore, Aruba had to deal with the sudden operational shutdown of the Valero oil refinery in mid-2009. It is still highly uncertain whether the refinery will re-open, although the prospects have improved somewhat as Valero and the Aruban government reached an agreement recently to settle the tax disputes that were ongoing for several years. In case the refinery remains idle, this year economic activities will show a further decline, albeit at a lower pace compared to 2009 (-2.5 percent in 2010 compared to -7.6 percent in 2009).

To mitigate the vulnerability of our economy, it is imperative that we target new geographical tourist markets and pursue other economic activities that could broaden our economic base. Considering the carrying capacity of Aruba, it is important to diversify the economy by concentrating more on capital and knowledge-intensive sectors, e.g. telecommunication and international financial services, to offset the risks associated with a one-sided economy.

2. The financial sector

Aruba's financial sector, however, has weathered the global financial storm quite well. With the exception of some company pension funds, and the more severely impacted government pension fund (APFA), the direct impact of this global crisis on the domestic financial sector has been rather mild so far.

Nonetheless, we have noticed a deterioration in the quality of the loan portfolios of the commercial banking sector. The nonperforming loans ratio (i.e., all loans with past due status of more than 90 days in percentage of the gross loans) of this sector increased from 6.9 percent in 2008 to 7.8 percent in 2009, mainly as a result of the worsening of the economic climate in Aruba. Our banks are however well-capitalized, highly liquid, and in general very profitable.

Aruba's financial sector is relatively small. It comprises, amongst others, 4 commercial banks, 3 bank-like institutions, 2 offshore banks, 2 credit unions, 20 insurance companies, 4 captive insurance companies, 11 company pension funds, and 4 money transfer companies. The combined assets of the banks, insurance companies and pension funds (including APFA) amount to approximately Afl. 8.1 billion.

The four commercial banks, operating on the domestic market, are all subsidiaries of banks licensed in the Netherlands Antilles. Since 1986 total assets of the commercial banks grew almost tenfold, i.e., from Afl. 449 million to Afl. 4.3 billion, which is approximately 90 percent of nominal GDP.

The four commercial banks are mainly engaged in domestic lending. The products and services offered by them are largely in the traditional retail sector, with interest on domestic credit being the predominant source of income. As a result of the oligopolistic market structure, typical of a small island, profits are generally high in the banking sector. The interest margin lies around 7 percent, which is

quite high compared to the interest margin in highly developed countries with more sophisticated capital and money markets.

As noted earlier, the banks in Aruba are well-capitalized and are required to maintain a minimum risk-weighted-solvency ratio of 14 percent. At the beginning of this year, this ratio was increased from 12 percent to 14 percent, as the current crisis has clearly demonstrated the need that banks should have sufficient capital and liquidity buffers to absorb unforeseen losses on their loan and investment portfolios. Also, in view of Aruba's one-sided economy and the ensuing vulnerabilities for external shocks, the increase in the minimum risk-weighted-solvency ratio is fully warranted.

3. Scope of supervision

The CBA is entrusted with the prudential supervision of the banking and insurance sectors, money transfer companies, company pension funds, and more recently the trust service providers on the basis of the respective state ordinances regulating these sectors.

The supervision department currently consists of 12 staff members. The CBA is in the process of hiring more staff for this department, including a section head for the newly established Integrity Unit within the Supervision department. In view of the additional tasks that have or are in the process of being assigned to the CBA, the number of staff will have to be expanded further in coming years. This is also in line with IMF and FATF recommendations. Both institutions have noted in their last assessment reports that the number of supervisory staff is insufficient and

should be expanded quickly, in order to strengthen and broaden our supervisory activities, notably in the area of AML/CFT oversight.

4. Some selected contemporary and past supervisory challenges

Over the last decades, the international standards and norms in the areas of financial sector supervision and AML/CFT have changed enormously. For small jurisdictions like ours, where the staff is multi-tasked and has little room for specialization, it is a daily challenge to remain fully updated on recent developments.

Although much improvement has been made over the years in updating the supervisory and AML/CFT framework, it must be concluded that there are still many gaps that need to be addressed. The scarcity of full-time available law draftsmen specialized in the AML/CFT area also forms a big challenge for small jurisdictions like ours.

Moreover, the issuance and revision of sometimes highly complex standards, norms, and recommendations (e.g. the Basel II capital Accord and the FATF 40+9 recommendations), best practices papers, and discussion notes takes place on a much faster pace than ever before. The timely translation of these new or revised standards, norms, best practices in the supervisory regulations and practices requires highly skilled and well-trained supervisory staff.

Outsourcing, e.g., via technical assistance and the hiring of external consultants, is often a must to cope with the aforementioned challenges. Additionally, although

the CBA has quite a healthy financial position, there are budgetary constraints. In this regard, it is imperative that we broaden the charging of the supervisory costs to all sectors we supervise on a very short term.

Furthermore, the global financial landscape has changed dramatically over the past two decades, as a result of the ongoing globalization and integration of financial markets. Also, albeit at a much smaller scale, we have found that the financial products and services have become more sophisticated and in certain cases more complex, putting additional requirements on the expertise level of our supervisory staff.

In 1986, supervision was mainly aimed at the banks, life insurers, and money transfer companies on the basis of an outdated State Ordinance on the Supervision of the Banking and Credit System. This ordinance, which was basically a copy of the Netherlands Antilles banking ordinance of 1972, provided the CBA with very limited tools to effectively supervise banks and other institutions that were or supposed to be captured under this law.

To give an example, offshore banks were completely exempted from ongoing supervision. They only needed a declaration of no objection to commence their activities from Aruba. In this regard, it should be pointed out that the Venezuelan banking crisis that started early 1994 with the collapse of Banco Latino also negatively impacted the Venezuelan offshore banks registered then in Aruba.

All these banks had to cease their operations, while some were not able to repay all their depositors in full. The reputational damage was considerable. The obsolete legislation gave the depositors at these offshore banks no protection at all as they were basically exempted from supervision.

It is interesting to note that in the Netherlands Antilles a completely new ordinance was implemented in order to deal with the problems resulting from the Venezuelan banking crisis. In Aruba's case, it took four more years before a complete new banking ordinance, based upon the Dutch Act of 1992 on the supervision of the banking sector, was introduced, giving the CBA thereby more effective tools to supervise the banking sector.

Thus, it takes too long to introduce new or revised supervisory legislation. As mentioned before, an important bottleneck we are facing in this regard is also the limited availability of law draftsmen.

Noteworthy is that the obsolete banking ordinance was primarily based on the notion that supervisory problems should be resolved via moral suasion. As experience has also clearly shown in other jurisdictions, it is not always possible to resolve supervisory issues via this route. The parties concerned may have different views on the subject matter and also have their own short-term interests, which sometimes conflict with the general interest.

A supervisor, who does not have all the necessary legal instruments at his disposal to halt (possible) negative developments at a supervised institution, becomes

very vulnerable to reputational and even financial risk if things go wrong. On the one hand, the public's perception may be that the supervisor has not acted timely on the negative developments, while on the other hand the legal possibilities to act may be very limited.

In addition to the laws that were implemented regulating the banking and insurance sectors in, respectively, 1998 and 2001, new ones were introduced to regulate the money transfer companies (2003) and trust service providers (2009). Still, also based upon recommendations of the IMF and the FATF, the existing supervisory laws need to be strengthened further, while the supervisory scope has to be broadened as well, inter alia, to the currently unregulated investment business, including the electronic stock exchanges.

Without going into detail, it can be easily stated that some of the major supervisory challenges we have faced over the years were related to individually-owned banks and more specifically to the related party transactions that took place at these institutions.

In general, the CBA has found over the years that the corporate governance framework, the general banking practices, and controls at these types of institutions were at best "up for improvement". Noteworthy is that since 2008, the CBA requires, as part of its revised licensing and admission policy rule for credit institutions, that the majority of the shares of banks must be held by financial institutions that have a solid financial strength and reputation, and are subject to effective consolidated supervision by the home country supervisor. In

addition, the CBA has always followed a very strict admission policy for the sectors it supervises.

In view of the changed market conditions, inter alia, the departure of some large Dutch financial institutions from the Aruban market, and with a view to improve its monitoring and supervising capabilities, in 2006 the CBA decided to revise its policy with regard to credit institutions and insurers operating via branch offices or agencies in or from Aruba.

Under the revised policy, only large internationally active banks or insurers, subject to comprehensive and consolidated supervision, with a combined balance sheet total of US\$ 10 billion or more and with an “A” rating issued by Standard & Poors or a comparable rating agency are allowed to operate via a branch office or agency in Aruba.

As a result of this policy change, some of the branch offices or agencies had to transfer their assets and liabilities to the newly incorporated Aruban subsidiaries. This policy change took more time than anticipated before it was fully implemented, also in connection with the sometimes complex (fiscal) issues that had to be dealt with.

It should also be mentioned that, on the one hand, this revised policy provides the CBA with better monitoring and supervising tools. On the other hand, it brings additional supervisory responsibilities with it, especially in the areas of corporate governance, and solvency and liquidity supervision.

Let me now briefly highlight some of the issues related to the main findings of the recent IMF-OFC and the FATF assessments.

5. IMF-OFC and FATF evaluation

In 2008, Aruba was evaluated by an IMF mission to assess, amongst other, its degree of compliance with the Basel Core Principles for Effective Banking Supervision. The assessment team found Aruba to be compliant or largely compliant with 26 of the principles, materially non-compliant with two principles (risk management process and interest rate risk) and non-compliant with one principle (market risk).

The report concluded that banking supervision in Aruba is carried out in a manner largely appropriate for the size and sophistication of the banking sector. However, according to the IMF, supervision in Aruba would benefit from moving to a more risk-based approach. The recommendations issued by the IMF, including the conduct of regular stress testing on the domestic banking sector as part of the strengthening of its risk management and the shift towards a more risk-based supervisory approach, have been or are being implemented.

As you probably already know, the outcome of the 2008 evaluation of Aruba's compliance with the 40+9-FATF recommendations was not favorable at all. In the issued Mutual Evaluation Report (MER), Aruba has been found to be non-compliant or partially compliant with 13 of the 16 key and core

recommendations. Furthermore, Aruba's AML/CFT framework is qualified in the in this report as incomplete, incoherent, and ineffective.

The MER identified serious weaknesses in the AML/CFT legislation, compliance with UN resolutions in the area of AML/CFT, company registration, law enforcement, AML/CFT oversight, and international cooperation. With respect to the institutional set-up of the AML/CFT oversight, the report notes that the current division of tasks between the CBA and the FIU is inefficient and ineffective. FATF also concluded that there is a lack of awareness and training in the AML/CFT area, and that the Aruban authorities are understaffed, including the FIU, the CBA, and the Prosecuting Office.

To avoid any sanction whatsoever, it is very important that we take swift measures to address the numerous deficiencies in a short period of time. In this regard, it is encouraging to point out that the detailed and prioritized action plan designed by the Aruban authorities was well-received during the recent FATF plenary meeting.

The ambitious action plan and the steps already taken, including the approval by Parliament of a state ordinance separately and independently punishing terrorist financing and the transfer of the oversight with respect to the unusual transaction ordinance from the FIU to the CBA, were recognized as positive steps to bring Aruba's AML/CFT framework more in compliance with FATF standards.

However, as you can imagine the implementation of the recommendations contained in the MER requires a massive effort by the Aruban authorities. Also, the scarcity of qualified resources forms a big challenge for small jurisdictions like ours. Nonetheless, we have always found ourselves fortunate to be able to approach our larger sister institutions in the Netherlands Antilles and the Netherlands for technical assistance. In the meantime, the Dutch Central Bank has agreed to second a person for at least two years to our institution to beef up the recently established Integrity Unit within our Supervision department, which I referred to earlier.

6. Conclusion

We, as the central bank and regulator of the Aruban financial sector, are ready to take up the many challenges ahead. The CBA has a very good track record in this regard, notwithstanding the many structural deficiencies and limited resources we are daily faced with, particularly associated with the smallness of our island.

CBA's important role in maintaining the soundness and integrity of the sectors it supervises is fully recognized and respected. As the financial markets in the Netherlands Antilles and Aruba are closely knit, and considering that there is also a mutual interest at the Kingdom level that the financial markets in the Caribbean part of the Kingdom of the Netherlands remain sound and reputable, it is of crucial importance that the three central banks in the Kingdom continue to closely work together.

In this regard, it is noteworthy to mention that consideration is currently being given to even further enhance the cooperation between the supervisors within the Dutch Kingdom, which is a clear sign of mutual recognition of common interest.

Herewith I would like to conclude my presentation and thank you for your attention.