CONCEPT PAPER ON BANKING SERVICES IN CARICOM

by

Professor Roland Craigwell
Department of Economics
University of the West Indies
Cave Hill Campus
Barbados

June 2009

INTRODUCTION

Commercial banks (with both foreign and local interests) took root in the Caribbean soon after the abolition of slavery in the 1830s, essentially to localise financing of the trade in sugar and its by-products and the related business. Since then commercial or retail banking has remained critical to the development of the Caribbean economies for several reasons. Capital markets in these countries are typically underdeveloped – lacking both the wide range of financial institutions and the plethora of instruments which are available in countries like those that are members of the Organisation for Economic Co-operation and Development (OECD).

The dependence of Caribbean economies on merchandise, and more recently, invisible trade, has resulted in a high demand for foreign currencies, particularly the pound sterling and the US dollar. Since the conversion of currencies has been the traditional preserve of commercial banks, the openness of the economies has given the banks significant influence in the area of foreign trade. The banks' domination of the market for credit is also another reason for their importance to Caribbean economies.

It is obvious therefore that any serious discussion about the transformation of Caribbean economies would be incomplete unless due regard is paid to the role of banking services in that process.

2. OVERVIEW

Banking services include the provision of various types of accounts, the acceptance of deposits, contracting of loans, the financing of various transactions, payment and money transmission, trading in money market instruments and foreign exchange, provision of derivatives, exchange rate and interest rate instruments, money broking, asset management, settlement and clearing services as well as financial information and advice.

Banking services in the CARICOM region are provided largely by commercial or retail banks although a few finance companies and merchant banks also take deposits and make loans.

The region is well-served by commercial banks whether locally-incorporated entities, branches of foreign banks or state-run institutions.

With respect to the type of ownership, most jurisdictions have a combination of foreign and locally-owned operations. In the Eastern Caribbean Currency Union, for example, there are 20 foreign, 16 domestic and three state-owned banks. Conversely, Barbados is the only country with no domestic banks.

As expected, the more populous countries have among them the largest number of banks – Jamaica, Trinidad and Tobago and the Bahamas have seven, eight and eight respectively. However, seven banks operate in Antigua and Barbuda and six are found in St. Kitts and Nevis, St. Lucia as well as in Barbados.

New opportunities for business are opening up to commercial banks operating in CARICOM. As the economies are transformed through the advent of the Caricom Single Market and Economy financial deepening will increase the need for intermediation. Moreover, the liberalization of trade and financial services allows the possibility of penetrating foreign markets. However, regional governments need to provide the enabling environment and the banking industry has to reposition itself in order to exploit these opportunities.

2. POLICY FRAMEWORK

Human Resource Requirements

Banking in the region does not appear to be hampered by a human resource constraint. Entry-level and supervisory positions require, in the main, a secondary education, and generally speaking, there is an abundance of persons with such training from among whom the banks can recruit. However, one concern is that entry-level pay in commercial banks is uncompetitive with that for comparable positions in the public service. This may be reflective of the compensation model which is used by the banks, i.e. hourly rates of pay.

Mid- and senior-level bank managers are required to have some competence in accounting and finance, in particular. Here again there are several individuals who have professional qualifications such as the ACCA, CGA and CFA. Many managers acquire skills on the job but it is often the case that it becomes necessary to bid away senior civil servants who are sufficiently qualified and experienced. This is possible because it is at these levels that compensation becomes attractive to public servants. Increasingly influenced by Head Office practices, changes in the domestic labour market and technological demands, banks are now hiring persons with human resources management and information technology skills.

One glaring shortcoming, however, is the failure or reluctance of the banks to recruit more persons with skills in disciplines like economics, statistics and mathematics. This would enhance their in-house research and analytical capabilities and break the current relatively-high dependence on central banks and other government agencies for data which are crucial to decision-making. The real issue here is that traditionally the banks have not embraced academic qualifications. An alternative to such recruitment is to provide basic training for personnel with the necessary background.

Access To and Use of Technology

It would be expected that, given the demands of the public for service equivalent to that in metropolitan countries and their own high profile in the economies, commercial banks would be leaders in access to and use of technology. Unfortunately, this is not necessarily true; indeed, in some cases the most technologically-driven financial institutions are non-banks. It also is not true to say that branches of international banks tend to use more modern technology than domestic or regional banks.

One conclusion that can be drawn here is that the cost of accessing appropriate technology is not a determinant of its use, given that international banks continue to have strong financials. Secondly, it may be that decisions regarding the use of technology are influenced by the general state of technology in the host country, i.e., what the market can bear. It is also true that where access to technology is a problem, there is always the option of out-sourcing the function. However, it may well be that this is not advisable given the highly confidential and sensitive nature of some aspects of banking.

Use of technology has also been a function of initiatives undertaken by central banks, e.g. the introduction of clearing and settlement systems which necessitated the acquisition of compatible hard- and software.

A question which needs to be answered is how the provision of hi-tech services has impacted the operational efficiency of banks. Here we are referring to services like ATMs, telephone and on-line banking. Certainly the use of these tools has allowed them to reduce traffic, and by extension the utilisation of labour, in the banks. It should also lead to cost-savings and increased profitability if, as it is argued, labour accounts for the largest proportion of expenditure. There is no evidence that these savings have been passed on to consumers. It has been since the introduction of these modern services that other bank charges have risen or been imposed, resulting in much public condemnation.

One externality which has resulted from the introduction of the new technology is the costs it imposes on some account-holders. These include older customers, who are uncomfortable with, or distrust, these services as well as those account-holders with no access to computers. They are now forced to bear the charges of making transactions at the counter. Generally, because of the small size of the host countries, there is a certain intimacy associated with banking and there is a limit to how far the banks can go in depersonalizing their operations.

Legislative Framework

The regulation of commercial banks in the region is done under authority which reposes in the various Central Bank Acts, territorial Banking Acts and Financial Institutions Acts. Over the years there have been several amendments to the legislation as the authorities sought to keep up with changes in the industry and international requirements. What is not known is whether these amendments have led to greater or lesser harmonization in the legal framework.

By and large, the commercial banks are regulated by the central bank. However, in some jurisdictions, the central bank also has oversight of insurance companies and/or credit unions. Given the importance of commercial banks to the economies of the region, a case may be made that it is best for them to be regulated in all countries, as a group in which they are no other entities. Moreover, this would enhance the application of monetary policy, inasmuch as it is not always clear whether all monetary policy directives should apply to non-banks. This is one example of the need for harmonization of the legislation under which the banks operate.

The still-to-be-signed Financial Services Agreement should address most of the legislative issues.

Financing the Service Sector's Needs

There is little reason to believe that commercial banks are keen to finance the service sectors. They tend to prefer investing in projects which offer quick and/or guaranteed returns, as a result of competition in the market and pressure from shareholders. Consequently, the allocation of credit by the banks is heavily-skewed towards personal consumer loans and government securities. Neither selective credit controls nor moral suasion appears to have significantly altered this pattern during the last three decades. Indeed, even when the economic structure of the economies was more merchandise-based, foreign-exchange earning sectors like manufacturing and agriculture never attracted a lot of bank lending because of the high risks and/or low returns associated with them.

Activities which are defined as services include tourism, transportation, insurance, communication, construction, financial services, consultancies, computer and information services, medical services, merchanting, personal, cultural and recreational services. On examination, there are very few of these which would on present criteria, attract significant bank credit. Tourism marketing benefits from state involvement. However with respect to other operational expenses (labour, utilities and food supplies) tourism which earns significant foreign exchange, is no more likely to have access to credit than wholesale and retail trade, which is a user of foreign exchange.

The irony is that many of the service sectors have shown tremendous promise and can provide the diversification which is so badly-needed to raise long-run growth rates in the region. This is where venture capital comes in. The word"venture" assumes that the risks are very high and that the investment may or may not be recouped. Venture capital is therefore precisely the kind of financing model which suits many of the new services. The question here is how many banks or institutions generally are willing or able to afford such a scheme. However, when it is realised that the sums to be set aside would be very small in relation to any bank's total assets, that amount could be part of the annual provisioning for bad debt. The banks should realise that the trade in services is expanding very rapidly which means that the prospects for business and recovery of the investment are good. The alternative approach for governments is to establish a venture capital corporation with broad flexibility.

Incentives - Fiscal Support

Based on the continued profitability of commercial banks, it cannot be argued that corporation tax rates are burdensome. Indeed in several countries it is offshore banks that account for the majority of tax revenue. In light of the weak state of government finances currently and in the medium-term, it is unlikely that there will soon be any leeway for lower rates. However, governments may wish to consider how they can work with the banks to advance certain national development goals. Tax allowances should be accorded for investment in a wide range of activities. Apart from research and development, the list should include educational and social projects, like strengthening communities, promoting health awareness and sporting activities as well as empowering young people.

Opportunities from trade agreements

Given the limited opportunities for expansion in the Caribbean region, commercial banks should examine how existing trade agreements can provide business opportunities. There are two agreements which offer some possibilities in this regard - CaribCan which was negotiated with Canada in 1986 and the Economic Partnership Agreement (EPA) signed with the European Union by some territories in 2008.

The CariCan Agreement allows for the promotion of "business opportunities" between the parties. It appears to have been rather narrow in scope and is to be renegotiated on expiry in 2011. Banks and other service providers must lobby from early to ensure that the new pact offers realistic opportunities for investing in Canada.

The EPA is a different prospect altogether since it opens up a market of some 500 million persons. To the extent that, with the withdrawal of Barclays Bank, there are no European entities left, Canadian banks which operate in the Caribbean should be just as eager as the domestic entities to exploit the EPA.

At a general level, the EPA acknowledges the fact that regional integration is important to the achievement of greater economic opportunities (Article 4). This opens the door for banking institutions across the Caribbean to collaborate in pursuing business initiatives in the EU. A question which needs to be addressed, therefore, is how the banks can use mergers, acquisitions and strategic alliances to build the critical mass which would allow them to compete with European banks.

Article 7 of the EPA makes provision for developmental cooperation between the signatories in areas such as building institutional capacity as well as improving infrastructure and technological capability. Clearly, these are aspects of some banks' operations that would need to be enhanced in the quest for greater efficiency and this offer needs to be pursued.

With respect specifically to the trade in services, the definition of 'cross-border supply' seems to make provision for Caribbean entities to service European consumers without having a physical presence on the Continent (Article 75). The Agreement allows for the "temporary presence of natural persons for business purposes". This group includes managers, specialists, graduate trainees, business service sellers and contractual service suppliers. Presumably, this temporary arrangement allows for some scanning of the business landscape prior to making any major commitments.

Articles 76 and 77 taken together mean that there would be no upper limit on the quantum of business which may be conducted or on the number of Caribbean service providers. The EU must accord to CARIFORUM banks the same treatment that is given to their own banking institutions and most favoured nation status is also provided (Article 79).

In considering their options, the banks will need to examine the issue of how reciprocity and most favoured nation status can be exploited. There is a large diaspora of Caribbean people who would welcome the opportunity to do business with home-based institutions. A niche in this regard could be the area of remittances where studies have shown that there needs to be more official channels for repatriation of funds and additional players to drive down the costs of doing so.

Institutional Requirements

In order for banks to thrive there must be the necessary institutional support. This will have implications for the quality of supervision and the soundness of the financial system. There must be a clearly-designated Ministry or Department which is the sector's link with the decision-makers. Then there is the need for supportive bodies which help to maintain financial stability. A good example is a Deposit Insurance Institution, but at present only a few jurisdictions have one.

It would also be useful to have an anti-trust agency that can look after the public interest since the banking sector is characterized by imperfect competition. Some analysts see it as oligopolistic, in which case there would be issues emanating from collusion or dominance. If there is monopolistic competition, issues of product differentiation and wasteful advertising come to the fore. There should also be mechanisms for dialogue with workers unions and civil society. Such dialogue would be more effective if the banks are members of employers associations and also have their own groupings.

3. CROSS-SECTORAL LINKAGES

The links with the rest of the economy are horizontal as well as vertical. A horizontal relationship exists where the enterprise to which the finance and advice are provided has only one tier of operations. This occurs, for example, if the bank lends funds to a retailer who simply buys goods for resale. A vertical link may be more dynamic; this could be a case where the bank provides financing to say an industrialist to purchase raw materials, produce an item, market it and perhaps export it. There vertical links are more dynamic by nature because there are more opportunities to add value, thereby increasing employment opportunities. The banks should forge more dynamic sectoral links but most of these possibilities may exist in activities which hold little interest for the banks.

The banks are also well-placed to develop intra-sectoral linkages which have a developmental purpose. This happens, for example, if a bank makes a loan to a tourism establishment to finance the purchase of domestically-produced food or furniture. Manufacturing and agriculture are given a filip and the multiplier effects may even be stronger if the establishment is purchasing the items for the first time.

However, the banks can supply much more than finance to the other sectors. For example, they can through their advisory services help firms, small ones in particular, to become more productive and efficient. This would be in the banks' interest, since an efficient firm is more likely to bring business to the bank and less likely to default on loans. In this connection, the banks may wish to be pro-active and consider a scheme whereby increased efficiency is matched by concessional loan rates.

4. CONSTRAINTS

There are several constraints which can prevent the banks from making the largest possible contribution to Caribbean Society. These are of both an internal and external nature:

Internal Constraints - over which the banks have some control - include the following:

(i) the absence of an analytical culture (this can hamper the institutions' ability to make well-informed decisions)

(ii) negative public perception of the industry (the view that the banks are concerned only about the bottom line as evidenced by the imposition of, or increase in, bank fees and charges)

(iii) a lack of uniformity in the availability of new technology or use of outdated technology (this keeps the institutions, and by extension, their customers on the fringes of international banking)

External Constraints – over which the banks have little or no control – include:

(i) pressure to maintain a certain level of employment (gains in efficiency may be pointing to a reduction in the labour force but this option is unpopular in labour-surplus economies like those in CARICOM)

(ii) the trend in monetary policy or regulatory requirements (this may be good for the country but bad for business)

(iii) competition from non-banks (credit unions, finance companies, trusts and merchant banks that may have to meet less stringent regulation)

(iv) the small size of the regional market or small size of institutions (combined with the number of institutions, limits the volume of business per institution, making it difficult to enjoy economies of scale)

(v) the existence of different banking cultures (this has implications for the mergers and acquisitions that are needed to increase operational efficiency and be externally- competitive)

(vi) out-dated legislation (that can hinder the development of the industry)

5. RECOMMENDATIONS

(a) Policy Actions

The Banking Sector should:

(i) establish programmes and policies to ensure that their human resources needs will be met. These should make provision for the recruitment of skills which are ancillary to their core disciplines, as well as continuous training, both in-house and through partnering

(ii) be pro-active with respect to developments in the sector. The banks do not always have to wait on governments to set the agenda or make suggestions for the industry. One example in this regard is the idea for a CARICOM numeraire currency which was first mooted by a bankers' association. Another issue which would benefit from a jump-start by the banks is the old currency convertibility initiative

(iii) take steps to improve its public image. This can be achieved through public education which explains what banking is about and its benefits to the society

The Governments should:

(i) sign the CARICOM Financial Services Agreement as soon as possible. This should quicken the pace of financial integration and the establishment of the regional capital market

(ii) undertake some technical work on a regional basis to better understand the relationship between various levels of taxation and the profitability of the banks. This would help to determine whether tax policies are injurious to the growth of the banking sector and if any incentives are warranted. It would be useful for this work to be undertaken as part of the movement towards the harmonisation of fiscal policy

(iii) establish watchdog agencies that would be charged with protecting the interests of consumers. Examples of these are anti-trust bodies and deposit insurance corporations

(iv) establish a supra-national body to facilitate the efforts of banks to take advantage of opportunities provided in trade agreements

The Central Banks should:

(i) continue to use moral suasion to get the banks to allocate a higher proportion of their credit to the foreign-exchange earning sectors. However, they should examine the feasibility of re-introducing credit ceilings on lending for particular activities

(ii) create positions of banking ombudsman to look after complaints about bank fees and charges

(iii) use public education to make consumers more aware of regulatory practices as well as changes in monetary policy and in the financial environment

(b) <u>Data Gaps</u>

The Banks should:

(i) endeavour to produce and publish a wider range of financial information and analysis

(ii) seek to become familiar with all policies, programmes and agreements which may impact their current and future operations

(c) <u>Legislative Changes</u>

The Governments should:

(i) make whatever amendments are necessary to ensure that there are no inconsistencies between the pieces of legislation under which the banking sector is regulated

(ii) wherever possible harmonise the legislation

(iii) regulate the banking sector as a distinct group

(iv) strengthen the legal provisions relating to governance requirements