

1985 Conference

THE PROFITABILITY OF COMMERCIAL BANKS  
IN THE ECCB AREA

By

E. LIBURD and J. FERRACHO

RESEARCH DEPARTMENT

EASTERN CARIBBEAN CENTRAL BANK

THE PROFITABILITY OF COMMERCIAL BANKS  
IN THE ECCB AREA

\*\*\*\*\*

INTRODUCTION

By far the most important financial institutions in the ECCB Area are commercial banks. They comprise branches of foreign banks, indigenous banks and foreign-owned locally incorporated banks<sup>1/</sup>. The branches of four foreign banks dominate the banking system and operate in more than one territory. These branches which are not locally incorporated constitute only a small proportion of the global operations of their respective parent banks. The indigenous banks are those with at least 51% local ownership and they range from those with little or no government involvement to those which are wholly government owned. The third group, the foreign-owned locally incorporated banks have only recently been established in some territories. They do not have a regional network and their operations are still very limited.

At the end of 1984, the indigenous banks and the locally-incorporated foreign banks held assets amounting to \$631.6m, about 35% of the area's total. Approximately 96% of these assets were held by the indigenous subgroup. For the purpose of analysis in this paper, these banks are grouped and discussed under the general heading of "local banks", as distinguished from the foreign branch banks, hereafter referred to as "foreign banks", which accounted for some 65% of commercial bank assets, in an amount of \$1,161.7m.

This paper examines the trends in the relative profitability of these two groups of banks during 1982-1984<sup>2/</sup>, and attempts to explain the observed differences in their financial performances.

---

1/ The Eastern Caribbean Central Bank area is comprised of Antigua & Barbuda, Dominica, Grenada, Montserrat, St. Kitts & Nevis, St. Lucia and St. Vincent & The Grenadines.

2/ The income and expenditure data for a more extended period of analysis are not available.

## THE DECISION MAKING PROCESS

Since the level and structure of interest rates are the most important factors affecting the profitability of commercial banks, it would seem that an appropriate point of departure is a review of existing policies involved in their determination. In the first instance it is important to note that in the period covered by this paper, the commercial banks operated in an environment in which they were largely free to set their own interest rates, though they must do so closely in line with their competitors<sup>3/</sup>. Indeed a recent IMF study conducted by Grant-Suttie and Vaez-Zadeh, noted that the interest rate policy of the major commercial banks, may be considered as seeking to achieve a target rate of return on capital. In these circumstances, the overall level of deposit rates is set to ensure that bank resources grow at the desired rate. Given these deposit rates and projections of the bank's asset and liability portfolio, lending rates are set to achieve the target rate of return on capital.

In general the target growth rate for a bank's resources will reflect past trends, loan risks, investment opportunities, the cost of raising additional resources and a bank's desire to hold prudential reserves. The more risky the loans, the more reserves the bank will require. The less interest elastic is the public's demand for deposits, the higher is the cost of raising additional resources and the lower is the incentive for banks to increase them if viable investment opportunities are few. Therefore a combination of risky loans and a low interest elasticity of demand for deposits by the public will lead to unambitious targets for bank assets growth and to low rates offered for deposits.

In practice, the overall level of interest paid on deposits have generally been low and correspondingly, so have been the cost of funds. In the period 1982-1984 however, these rates increased slightly reflecting a tightening of liquidity in the banking system. The increase was more in relation to time deposit rates as those on savings rose very little.

---

<sup>3/</sup> The ECCB effective January 1985 introduced a minimum rate of 4% to be paid on savings deposits with the objective of assisting financial intermediation and to reward and encourage savings.

The market for time deposits is much more competitive, and on those occasions when the growth in bank resources fell below requirements, leading to pressure on liquidity, it was usually the interest rate on time deposits rather than savings that had been raised.

It was noted earlier that in the profit targeting exercise, once deposits rates are projected, lending rates are adjusted to achieve the desired rate of profits. Grant-Suttie and Vaez-Zadeh, in the IMF study referred to earlier, observed that the major banks in carrying out these calculations assume initially that the average rate of growth for all the main items of the balance sheet remain unchanged and profits are projected at the going rates of interest. If projected profits fall below the target, this provides an indication that lending rates should be raised.

This type of analysis may serve to explain the often observed downward rigidity in lending rates, even in the light of excess liquidity in the banking system.

#### COST AND EARNINGS

The aggregate net income before taxes for all banks increased from \$25.5m in 1982 to \$40.3m in 1984 at an average annual rate of 25.8% and in an economic environment that was relatively depressed<sup>4/</sup>. This increase in net income for all banks consistently outpaced the growth in assets, and as a consequence, the return on assets rose steadily from 1.94% to 2.47%, as shown in Table 1. The improvement in net income occurred despite a decline in gross interest earned and a rise in interest cost in relation to assets. The higher funding cost coincided with a period of tight liquidity in the banking system, a consequence of the economic recession. The resulting decline in the interest margin for all banks was however offset by an increase in non-interest income and a reduction in non-interest expense.

---

4/ During this period the economies of the ECCB area experienced declining commodity prices and tourist arrivals as well as the lingering effects of natural disasters in 1979 and 1980.

TABLE I  
Income and Expense as Per Cent of Average Assets  
Of Commercial Banks in ECCB Area (a)

	1984			1983			1982		
	Local	Foreign	All Banks	Local	Foreign	All Banks	Local	Foreign	All Banks
Gross Interest Earned	7.28	8.00	7.73	7.22	8.15	7.82	8.42	7.54	7.78
Gross Interest Expense	<u>3.92</u>	<u>3.05</u>	<u>3.37</u>	<u>3.88</u>	<u>3.27</u>	<u>3.49</u>	<u>3.86</u>	<u>2.73</u>	<u>3.05</u>
Net Interest Margin	3.36	4.95	4.36	3.34	4.88	4.32	4.56	4.81	4.73
Non-Interest Income	1.34	2.38	1.99	1.32	2.26	1.93	1.33	2.03	1.83
Loan Loss Provision	0.38	0.13	0.22	0.36	0.11	0.20	0.69	0.17	0.31
Other Non-Interest Expense	2.95	4.06	3.65	3.03	4.48	3.96	3.31	4.71	4.32
Income Before Taxes	1.38	3.11	2.47	1.27	2.25	2.10	1.90	1.96	1.94
Taxes	n.a.	n.a.	n.a.	0.46	1.12	0.89	0.93	0.97	0.96
Net Income	n.a.	n.a.	n.a.	0.81	1.43	1.21	0.97	0.99	0.98
Average Assets (EC\$M)	602.9	1,029.0	1,631.9	517.9	938.3	1,456.2	367.4	946.7	1,313.8

(a) The presentation in this Table follows that by R.T. Cole, "Financial Performance of Small Banks, 1977-80" Federal Reserve Bulletin (June 1981).

The growth in net income reflects the performance of the foreign branch banks whose net income relative to assets rose from 1.96% to 3.11% over the period. In contrast the performance of local banks deteriorated as net income to assets fell in the respective years from 1.90% to 1.38%.

In relation to the foreign banks, one of the factors underlying the improvement in profitability was an increase in net interest income, reflecting the net effect of increasing gross interest revenue and expenses. Because the increase in interest earned has outpaced the increase in interest expense, net interest income as a percentage of assets (net interest margin) has steadily improved from 4.81% in 1982 to 4.95% in 1984. Other factors contributing to the improved profitability of the foreign banks during the period were a reduction in non-interest expense relative to assets from 4.71% to 4.06% and an increase in non-interest income from 1.83% to 2.38%<sup>5/</sup>.

The situation in relation to the local banks however was markedly different. In contrast to their foreign counterparts, their gross interest income in relation to assets fell from 8.42% to 7.28%, while interest expense rose from 3.86% to 3.92%. Also, while for the foreign banks, non-interest income contributed significantly to their improved profitability, in the case of the local banks, non-interest income to assets increased only marginally. Like the foreign banks however local banks were successful in reducing non-interest expenses from 3.31% to 2.95% of assets.

One possible explanation for the lower interest income ratio of the local banks relative to their foreign counterparts, is the higher concentration of public sector credit in the portfolio of the local banks<sup>6/</sup>. At the end of December 1984, the ratio of public sector credit to total credit was 38% for local banks and 13.5% for foreign banks.

---

5/ The main components of non-interest income are commission and income from foreign exchange transactions and service charges, while non-interest expense includes mainly wages and salaries, occupancy and maintenance expenses.

6/ Public sector credit is defined to include loans, overdrafts, Treasury Bills and debentures.

Indeed in absolute terms credit extended by local banks to the public sector was some 70% more than that extended by foreign banks. As governments often obtain interest rate concessions in relation to the rate charges to other borrowers, the proportionately higher public sector loans in the portfolio of local banks reduce their interest income relative to that of the foreign banks.

Another factor in the comparatively lower profitability of local banks, is their proportionately higher interest expense. The local banks have traditionally found it necessary to offer higher interest rates for deposits. (See Table II). This is reflective of their late entry into the industry, and the existence of non-price factors that favours the foreign banks, not the least of which is confidence, which may often be misplaced. Bourne (1974) observed that local banks seeking to break into the industry can use, among other means, interest rates to compete with their foreign counterparts. He noted that this option may not be very sound since it can involve the bank in an expensive campaign with uncertain results, as interest rate increases would raise operating costs and likely provoke corresponding action by competitors. Further this strategy was seen as exposing the younger and financially weaker institutions to a kind of battle it was least able to win.

Despite these insightful observations by Bourne, the local banks in the ECCB area have consistently maintained deposit rates that are somewhat higher than those offered by the foreign banks. The existence of this disparity suggests that the local banks have not made a sufficiently large impact on the foreign bank share of the market, given the latter's target rate of return and desired rate of growth of resources. If however, the margin were to widen much beyond the present differential, the resulting shift in deposits may induce the foreign banks to compete more actively.

A plausible explanation of the continued maintenance of the deposit rate differential by local banks, is that while their share in total deposits have increased steadily to 36% by the end of 1984, their share of private sector deposits has not grown proportionately, accounting for only 27%.

Consequently, the ratio of private sector deposits to total deposits at the end of 1984 for local banks was 64% compared with 95% in the case of their foreign competitors. From the point of view of the local banks therefore the interest rate differential may be necessary in order to attract a sufficient amount of private sector deposits.

TABLE II

Minimum and Maximum Interest Rates

On Loans and Deposits

Of Local and Foreign Banks, 1980-1984\*

	Prime Lending Rate	Other Lending Rate	Interest Rates on Deposits			
			Savings	3 Months	6 Months	12 Months
<u>1980</u>						
Local	8.0 - 11.0	10.0 - 12.5	3.0 - 5.0	4.0 - 6.5	4.0 - 7.5	5.0 - 7.0
Foreign	8.0 - 9.5	11.0 - 16.0	2.5 - 3.5	4.0 - 6.0	3.0 - 7.0	3.0 - 7.5
<u>1981</u>						
Local	7.4 - 10.3	10.0 - 14.0	3.0 - 5.0	4.0 - 7.4	4.5 - 8.0	4.75 - 9.0
Foreign	8.0 - 13.0	11.0 - 16.0	2.5 - 7.5	3.0 - 7.0	3.5 - 8.0	3.5 - 9.0
<u>1982</u>						
Local	8.0 - 12.0	10.0 - 14.0	3.0 - 5.0	4.5 - 8.0	4.75 - 8.5	4.8 - 9.0
Foreign	8.5 - 13.0	9.0 - 18.0	2.5 - 5.0	3.5 - 7.5	3.0 - 8.5	3.0 - 9.0
<u>1983</u>						
Local	8.0 - 13.0	10.0 - 18.0	2.5 - 6.0	5.0 - 11.0	5.5 - 12.0	6.0 - 13.0
Foreign	8.5 - 14.0	12.5 - 18.0	2.5 - 6.3	3.0 - 8.5	3.0 - 9.5	3.5 - 10.0
<u>1984</u>						
Local	6.0 - 14.0	10.0 - 18.0	2.5 - 5.0	5.0 - 11.0	5.5 - 12.0	6.0 - 13.0
Foreign	8.3 - 13.0	12.0 - 22.0	2.5 - 6.3	3.0 - 8.0	3.0 - 9.5	3.5 - 10.0

\* The rates are those existing at the end of December in each year.



Another factor that has led to the relatively greater cost of funds for local banks is their higher ratio of time to total deposit. While the liability composition changed substantially for all banks from 1982 through 1984, the shift to more expensive funding sources was significantly greater for local banks, as Table III shows. The share of demand and savings declined for all banks, but the magnitude was greater in respect of local banks, and correspondingly the share of time deposits for foreign banks was relatively lower.

TABLE III

Deposit Structure of Commercial Banks  
Percentage Distribution of Total Deposits\*

	1982	1983	1984
<u>All Banks</u>			
Average Demand Deposits	18.3	17.4	17.1
Average Time Deposits	37.3	42.9	45.6
Average Savings Deposits	44.4	39.7	37.3
<u>Foreign Banks</u>			
Average Demand Deposits	18.5	17.8	18.2
Average Time Deposits	31.7	26.0	37.8
Average Savings Deposits	48.8	46.2	44.0
<u>Local Banks</u>			
Average Demand Deposits	17.0	19.0	19.1
Average Time Deposits	50.3	47.3	56.5
Average Savings Deposits	32.7	33.7	24.3

\* Based on Average End of Month Data

## STRUCTURE AND SPREAD OF INTEREST RATES

The quoted interest rates shown in Table II merely convey a representative order of magnitude of the structure of interest rates. To more effectively evaluate the rate of interest on bank deposits and lending rates to customers, some type of weighting procedure is required. In the case of lending rates, the weights should be assigned according to the volume of lending at each customer rate of interest<sup>7/</sup>. Moreover, some quoted interest rates for consumer and other types of loans, where the so-called "add-on method" of charging interest had been used, would have to be adjusted upwards before the weighting procedure is applied.

In regard to deposits, the quoted interest rate usually represent the rates actually paid to customers, except for savings where the method of discounting, produces actual rates that are lower. By and large however, quoted deposit rates are a better approximation to actual rates than are quoted loan rates.

The limitations of currently available data do not permit this type of weighting procedure. An approximation of the average rate charges for loans, the average rate paid on deposits, and an average interest spread can however be obtained by calculating the ratio of interest income on loans in a particular year to average loans outstanding in that year. A similar calculation can be made in respect of the interest cost of funds to average total deposits; the two ratios are then compared to arrive at the implied average interest spread as shown in Table IV.

This table shows that for local banks the average cost of funds was consistently one per cent higher and the average lending rate two percentage points lower. As was alluded to earlier, the latter result may be attributable to the higher proportion of public sector loans in their portfolio, on which a concessionary interest charge was allowed. It is seen also that while the implied average interest spread narrowed for both groups of banks, it was much more substantial in the case of local banks thus widening the spread differential of the two groups of competitors.

---

<sup>7/</sup> See A.G. Chandavarkar (1971)

TABLE IV

Interest Rate Spread

	1984			1983			1982		
	Local	Foreign	All Banks	Local	Foreign	All Banks	Local	Foreign	All Banks
(1) Interest paid on Deposits as % of Average Total Deposits	4.95	3.88	4.28	4.72	3.73	4.08	4.17	3.08	3.39
(2) Interest paid on Deposits as % of Average Interest Earning Deposits	5.85	4.74	5.16	5.64	4.54	4.94	4.88	3.86	4.17
(3) Interest from Loans as % of Average Total Loans	9.30	11.85	10.90	9.50	11.97	11.10	9.23	11.13	10.57
Implied Interest Spread (3-2)	3.45	7.11	5.74	3.86	7.43	6.16	4.35	7.27	6.40

*Table 4/10/84  
Indicates 7  
quarters off work.*

LOAN-LOSS PROVISION

Asset quality is an important aspect of financial performance. Eventually, deteriorating asset quality surfaces as increased loan-loss provision and actual loan losses. As seen from Table I, the loan-loss provision as a percentage of assets declined for both groups of banks. However, the rate of provision for local banks of 0.69% in 1982 and 0.38% in 1984 was substantially higher and was a factor in their relatively lower profitability. The comparative figures for the foreign banks were 0.17% and 0.13% respectively. The same relative position of the two groups is observed when the loan-loss provision as a percentage of average loans are considered as shown in Table V.

TABLE V

Loan-Loss Provision as % of Average Loans

1982-1984

	1982	1983	1984
Local Banks	1.06	0.60	0.61
Foreign Banks	0.28	0.18	0.21
All Banks	0.51	0.32	0.36

While the decline in these ratios are an indication that asset quality may have improved for all banks, they also suggest that the loan and more generally the asset portfolio of local banks were perceived to be more risky than those held by their foreign competitors. Since as was noted previously, there is a high concentration of public sector loans in the portfolio of local banks, it is possible that the relatively higher level of perceived risks may be associated with these loans.

## CONCLUSION

The respective financial performance of the local and foreign banks operating in the ECCB area in the period 1982 to 1984 differed markedly. It appears that in respect of foreign banks economic growth may not be as important a determinant in profitability as one would have thought - net profits before taxes as a percentage of assets having grown substantially despite a climate of general economic stagnation during the period. By contrast, this ratio for the local banks declined.

A policy of profit targeting, whereby the cost of funds and balance sheet trends are projected and lending rates varied in a break-even exercise to arrive at the desired profit margin, may partly explain the success of the foreign banks.

Differences in the composition of both the asset and liability portfolio of the two groups of banks also contributed to the disparity in profitability. The local bank loan portfolio contained a larger proportion of public sector loans that yielded lower returns relative to those obtainable in the private, and were apparently more risky. On the liabilities side, the cost of funds to local banks were generally higher on two accounts, they held a proportionately larger amount of high cost time deposits and on average they offered higher interest rates than their competitors.

If local banks are to play an increasingly important role in the economies of the area, and to eventually achieve parity with their foreign counterparts, it is necessary that policy be instituted to allow them to develop appropriate operational systems and be provided with greater opportunities for profit. This requires that attention be given to increases in the return which local banks earn from loans made to public sector enterprises. It will also be necessary to ensure that their lending operations allow them sufficient liquidity to compete for sound private sector loans and by so-doing improve the skills of marketing their services in a competitive environment.

REFERENCE CITED

1. BOURNE, C.

The Political Economy of Indigenous Commercial Banking in Guyana,  
Social and Economic Studies, Volume 23, No.1, March 1974.

2. CHANDAVARKER, A.G.

Some Aspects of Interest Rate Policies in Less Developed  
Economies: The Experience of Selected Asian Countries, in  
Money and Monetary Policy in Less Developed Countries,  
edited by W.L. Coats, Jr. and D.R. Khat.

3. COLE, R.T.

Financial Performance of Small Banks 1977-80,  
Federal Reserve Bulletin, Volume 67, No.6, June 1981

4. GRANT-SUTTIE, R.I.

VAEZ-ZADEH, R.

Interest Rate Structure and Policy in the ECCA Region, July 1982  
IMF Study, unpublished