Caribbean Financial Institutions:
Market Structure and Legislation

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There have been some changes in the nature and behaviour of financial institutions and in the structure of financial systems in the less developed countries of the Caribbean over time, although the changes have not been as wide-ranging as one might perhaps have wished (and here I am talking mainly about the OECS countries and Belize, and I would hazard the guess that, at least insofar as domestically-oriented operations are concerned, the statement pretty much fits the UK Overseas Territories as well, despite their alleged role as offshore financial centres).

Commercial banks, with their focus on financing the export and import trades, domestic consumption, and residential and commercial construction and real estate, continue to dominate lending activity; and are the main final placement locations for the financial savings of individuals, business firms, and most Government agencies, holding the funds for other financial institutions as well. Other financial institutions, generally much smaller than the commercial banks (credit unions, public sector development banks, insurance companies, the national insurance schemes, a handful of other private institutions, even the rising number of moneylenders and pawnshops), hold their surplus funds as deposits in the commercial banking system; although, as I will discuss in a minute, some of them have begun to engage in some direct intermediation on their own. Private non-bank deposit-taking institutions, where they exist, are usually wholesale institutions affiliated with commercial banks; their purpose in the past was generally to raise resources for their groups without having to hold the level of reserves required of commercial banks by the central banks; as a result of changes in the legislation, their raison d'etre appears to be disappearing.

The more important changes in the behaviour of commercial banks have included:

> extension of residential mortgage lending to middle-class homeowners, following the demonstration by the mainly public sector development banks that this was a profitable segment of financial business;
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> loan financing of private sector non-traditional export production (my examples here include both hotel and non-hotel ancillary operations (eg, transportation, tour operations, restaurants) in tourism; shrimp farming; agricultural and non-agricultural export production. I emphasise export production because, while the banks have also provided loans for domestically-oriented production, the volumes have been small relative to total lending reflecting small market size in individual countries.

It may be interesting to note that a considerable part of this non-traditional lending has been undertaken by indigenous banks compared with the foreign-owned institutions that are still important players in the sector, probably reflecting the quest of the new institutions for market share; it may also be interesting to note that institution failure has been most evident in the indigenous group.

Commercial bank lending has, by and large, been profitable for well-run institutions, resulting in little incentive to change basic operating patterns. Given the high level of openness of Caribbean economies, a substantial loan transaction involves, apart from the interest flow, substantial foreign exchange commissions on the external payments that result from the loan, making regional institutions potentially more profitable, on a comparable size basis, than, say, US institutions (and of course the average interest spread would also be higher).

There have been cases in the region where commercial banks have taken Board directorships in business entities to which they have lent money. However, it is not easy to identify situations where they have taken equity positions as opposed to effective outright seizure of assets; and in fact most of the banking legislation in the region prohibit or restrict banks from ownership of non-financial operations, permitting acquisition only in satisfaction of non-performing loans, and then requiring sale at the earliest reasonable opportunity.

In respect of the other financial institutions, <u>credit unions</u> have generally retained their individual/family/community focus, with a concentration on consumption, education, and residential mortgage lending, although some institutions (certainly in Barbados and Belize) can no longer easily justify a "community" focus, have opened branches, and are in direct lending competition with commercial banks across the range of activities, and particularly to small and medium-sized entities (one credit union in Belize is as large asset-wise as the fourth largest of the six banks).

Like the commercial banks, the credit unions have generally not taken equity positions.

The <u>public sector development banks</u> (and at least one with private sector participation) have generally concentrated on lending operations in areas less attractive to commercial banks, with particular reference to production operations (especially to SMEs) and student loans, while maintaining their interest in the residential mortgage lending to middle-income borrowers that they had initially led. Unlike the commercial banks and credit unions that are funded by deposits and ownership shares, the development banks are mostly funded by Government-provided equity and loans, and by borrowing from international financial institutions, usually with a Government guarantee.

<u>Insurance companies and the national insurance (or social security) schemes</u> have been substantial cash generators (particularly the latter, which are mostly still in the "less mature" stages of their evolution). Some insurance companies in the LDCs have opted for a relatively conservative investment policy (and here I am not referring to those that are branches or subsidiaries of MDC or non-Caribbean operations), concentrating on residential and commercial

mortgage lending and on holding Government paper. One local insurance group in Belize has established a finance company, providing credit for instalment payments for its general insurance policies, and for funding leases and instalment purchases from the vehicle dealership that forms part of the group. This finance company, although authorized to do so, has not been taking deposits. Many of the individual country insurance companies are, however, small. The investment committees of social security schemes have increasingly been seeking private sector funds-placement opportunities, particularly as interest rates on bank deposits and Government paper have trended downwards, and issues have arisen relating to their operations viability, given their contributions rates, and the rates of return on their investments. In Belize these placements have included a Board director's seat for loans above a given minimum size, and a recent placement has taken the form of a share purchase, with an option to re-sell.

The moneylenders and pawnshops are small scale operators, charging usurious rates, usually financing the consumption requirements of poor people; although large numbers of poor people in small countries do make for quite luxurious lifestyles for some of these operators. But these institutions are not a significant source of business investment capital on the scale on which we should be focusing.

The earlier discussions have pointed quite clearly to the modus operandi of traditional venture capital funds. Traditional venture capitalists are not interested in equity placements for the long haul, preferring to take their profits in a public offering of shares in a venture that shows every sign of strong growth and profitability, or through a private sale. Obviously, this requires the existence of some kind of a functioning equity market, formal or informal. And there we have an issue. The performance of equity markets in the CARICOM Caribbean since their inception has been nothing to write home about; and the performance in the non-MDC Caribbean has been, well…

There is a formal market in the OECS; there is no formal market in Belize. Contributing to the situation has been a reported unwillingness on the part of existing private companies to go public, even those that show good performance but which at the same time rely heavily on the banking system for expensive working capital because they are basically undercapitalized. This state of affairs has been attributed to an unwillingness to yield control of business operations, even though only a minority fraction of the equity may be put up for sale. This situation, however, need not affect new operations that may attract the attention of venture capitalists, unless the concern over losing control is also an area of difficulty for entrepreneurs developing a new product or service and who are also short of funding.

Let me end by asking a series of questions:

Are entrepreneurs who are looking for financing looking for equity partners, or looking for lenders?

How can entities with surplus funds that are not looking for long-term placements recoup their investments in the absence of functioning equity markets? What accounts for the performance of regional equity markets? How do entities with surplus funds identify investment opportunities?

What are the kinds of products or services, and for what markets, that would attract the attention of funding providers?

What kinds of tax or incentives regimes would encourage funds providers? Should losses be fully written off against earnings, regardless of time periods? Are these types of operations compatible with a tax on gross income, regardless of profitability, as in the case of a business tax? Can securities markets function with a transfer tax on securities transactions? Should transactions in the financial sector be completely excluded from the VAT?

Can one expect the traditional financial institutions to engage in equity placements, and can one expect the financial system regulators to allow institutions utilising depositors' funds to engage in operations they may deem to be excessively risky?

Do we need to reexamine the roles of the public sector financing institutions with a view to filling financing gaps, of whatever kind, that may be holding back potential production? We need to understand that traditional venture capital forms an extremely small proportion of investible funds in the developed countries, although I would be the first to acknowledge the need for minimum critical mass, both for each placement, and to make a macroeconomic difference.

And, is it the case that we might be excluding an important element from this discussion: the human resource component? We need proactivity, motivation, innovation, risk-taking, the ability and willingness to identify and seize opportunity, organizational capacity … you know the words … to do the things that need to be done to achieve the purpose that we are here for: to identify the steps needed to be taken to achieve sustained per capita economic growth in this region that is shared equitably among this region's residents. And we need these capacities on a self-sustaining basis in both the public and private sectors. How do we go about developing this human resource capacity, and how do we retain it? In the meantime, the region's social fabric is unravelling.

One final comment. The level of party political polarization in some of our societies is now such that it is a serious constraint to the emergence of a single-minded focus on economic growth and development. I will not even mention the lack of political will that is playing havoc with our attempts to deal with the issues raised by small individual economic size.

Thank you for your indulgence.