Building Resilience in the Guyanese Banking System

By

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1.0 Introduction

Guyana's banking system is evaluated and policy recommendations are made to build resilience within the system. The outline of the paper is as follows:

- Section two discusses some of the major causes of financial crises
- Section three discusses policies to build resilience so as to help to prevent crises.

1.0 Introduction Cont'd

- Section four discusses banking system reform measures.
- Section five evaluates Guyana banking system soundness through a macro-prudential approach.
- Section six provides some policy recommendations and concluding remarks.

2.0 Causes of Financial Crises

Two major types of Financial Crises – Banking and Currency Crisis.

- The former involves insolvency of a large share of the banking system while the latter involves a forced change in parity, abandonment of a pegged exchange rate or an international rescue.
- They can occur independently of each other but can be a trigger by the other and are mutually reinforcing.
- Banking crises have often been accompanied by currency crises.

2.0 Causes of Financial Crises Cont'd

Banking crises can occur as a result of microeconomic structural and institutional problems such as –

- Poor management practices.
- Weak governance.
- Substandard regulations of banks.
- Distortions and incentives

2.0 Causes of Financial Crises Cont'd

A second view of banking crises is that they arise as a result of liquidity problems.

- When banks failed to deliver funds that the depositors are entitled on demand.
- Banks' experienced runs when depositors rush to withdraw their deposits because they expect the bank to fail due to real or imaginary solvency problems.
- This may also arise from excessive external debt and a sudden stop in capital flows.

2.0 Causes of Financial Crises Cont'd

Another view is that banking crises result from macroeconomic developments which adversely affect banks balance sheets as well as solvency in large parts of the banking system.

- Macroeconomic shocks includes major recession, substantial decline in terms of trade, high fiscal deficits and public debt, excessive lending in times of economic boom, currency crises as well as overvalued exchange rate regimes.
- These can create difficulties for borrowers from banks to repay their loans, thus increasing the vulnerability of banks and fostering crises.

3.0 Policies to Build Banking System Resilience

Crisis prevention efforts should focus on –

- Strengthening macroeconomic policies such as stable fiscal policy over the business cycle and non inflationary monetary policy.

- To promote sustainable economic growth and low inflation. In addition, they should avoid overvaluation of the currency, unstable fiscal and external current account deficits, unsustainable debts and excessive capital inflows.

- Provision of key infrastructure requirements for maintaining prudent financial institutions, fostering efficient markets and promoting a well functioning regulatory and supervisory structure.

3.0 Policies to Build Banking System Resilience Cont'd

The provision of key fundamental infrastructure requirements should include:

- Adequate prudential supervision and regulation, a system of laws and rules for corporate governance and property rights.
- A uniform set of transparent accounting standards, a set of rules for public disclosure of nonproprietary financial information and a facility that provides for external bank auditors and examiners.
- Banking regulation and supervision that is dynamic and evolving with technology, new competitive forces and new products. One important element is that of capital adequacy standards which should be complemented by large exposures rules.

3.0 Policies to Build Banking System Resilience Cont'd

Also important regulatory framework are:

- Liquidity Standards
- Information generation and disclosure on banks policy, portfolio and performance.
- Appropriate safeguard against contagion arising from international financial market volatility.

3.0 Policies to Build Banking System Resilience Cont'd

Other critical policies include:

- A strong and efficient financial market infrastructure is imperative to reducing banking system vulnerability, building robust infrastructure and helping to reduce risks from cross border transactions.

- Efficient exchange and payment systems also play a critical role in financial market infrastructure.

- The identification and assessment of major vulnerabilities of the banking system is crucial for building resilience through regular financial stability analysis and stress testing.

4.0 Guyana's Banking System Reform Measures

The main elements of financial sector reforms in Guyana can be analyzed under three (3) broad categories:

- Adjustments in the policy framework.
- Improvements in the stability and soundness of the financial institutions.
- Building institutional capacity in the sector.

4.0 Guyana's Banking System Reform Measures Cont'd

Adjustments in the policy framework primary objective was to bring about an improvement in the allocation of funds and to eliminate market fragmentation. The central feature in policy reform was:

- The removal of restrictions on interest rates, credit and foreign exchange transactions.
- The introduction of indirect instruments of monetary policy and financial control by the Bank of Guyana.

4.0 Guyana's Banking System Reform Measures Cont'd

Improving the stability and soundness of financial institutions was aimed at institutional strengthening and modernization of the system.

- This was brought about by effecting fundamental changes in the legal and regulatory framework with the enactment of the Financial Institutions Act (FIA) in March 1995.

- In May 1996, the FIA was amended to promote competition and eliminate concentration of interests in the financial sector.

- In 2004,the Act was amended to prevent abuse of the financial institutions by insiders, enhance corporate governance and strengthen the powers of the Bank of Guyana to deal with problematic licensed financial institutions.

4.0 Guyana’s Banking System Reform Measures Cont'd

- Prudential supervision and regulations have been strengthened with support from the IMF/World Bank Financial Sector Assessment Programme (FSAP).

- The FSAP provided a confidential evaluation of Guyana’s prudential financial regulation and supervision.

- The Bank of Guyana has adopted most of the recommendations as they relate to regulations based on the Basel I System core principles for supervision.

- Further support to strengthen the financial sector in Guyana will come under the Inter-American Development Bank (IDB), Financial Sector Reform Programme which seeks to improve regulatory framework, increase the system’s solvency and improve efficiency of credit entities.

4.0 Guyana's Banking System Reform Measures Cont'd

Building institutional capacity in the financial sector is being done through:

- Instilling a greater element of competition through introduction of private banks.
- Promoting market discipline through enhanced information disclosure requirements.
- Strengthening the supervisory process through on-site and off-site surveillance and stress testing.

5.0 Evaluation of the Banking System

- The analysis of the stability of Guyana's banking system is more effectively undertaken through a macro-prudential approach.

- The macro-prudential approach focuses on macroeconomic variables as well as aggregate micro-prudential banking system variables collated from individual financial institutions to determine viability.

- The macro-prudential approach is seen as an improvement or compliment of the micro-prudential approach.

5.0 Evaluation of the Banking System Cont'd

The evolution of a set of macroeconomic variables that may contribute to a banking crisis is summarized in Table 1.

Table 1

Guyana: Selected Real Sector and Financial Indicators

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Growth Rates of Real GDP (%)	7.96	6.18	(1.67)	2.96	(1.36)	2.28	1.15	(0.66)	1.58	(1.95)	5.13	5.37	3.10
Inflation Rates - end of period (%)	4.51	4.16	4.73	8.68	5.84	1.50	6.10	5.00	5.50	8.20	4.20	14.00	6.40
Overall Fiscal Balances (% of GDP)	(1.60)	(6.94)	(4.63)	(2.46)	(6.50)	(5.61)	(3.13)	(7.11)	(4.83)	(12.58)	(11.94)	(6.59)	(5.52)
External Current Account (% of GDP)	(7.60)	(14.00)	(13.70)	(9.30)	(15.20)	(18.30)	(14.60)	(11.20)	(8.90)	(19.20)	(27.50)	(21.50)	(25.50)
Real Interest Rate (%)	12.00	11.00	11.25	13.25	11.75	8.75	6.25	5.50	6.00	6.00	6.75	6.50	6.75
GDP per capita (US$)	766.00	808.30	777.50	770.30	773.00	777.50	829.20	837.80	862.80	900.90	992.40	1,111.00	1,233.60
Credit Growth (%)	72.02	23.56	15.55	7.69	4.51	1.03	0.44	(17.92)	(0.43)	8.35	17.85	18.71	21.80
Excess/Required Reserve	2.96	27.29	23.81	12.16	30.53	43.03	46.75	44.88	46.26	48.49	22.09	6.20	4.65
Private Sector Credit/GDP	7.19	8.37	9.84	10.29	10.90	10.77	10.69	8.84	8.66	9.57	10.73	12.09	14.29
Bank concentration (index) [1]	2,358.16	2,144	2,120	1,889	2,358	1,504	1,404	2,341	2,271	2,146	2,204	2,155	2,163

Source: Bank of Guyana Annual Reports, IMF Publications, Author's Calculation

1) Measured using the Herfindahl-Hirschman Index (HHI). The HHI of a market is calculated by summing the squares of the percentage market shares held by the respective Banks. The HHI indicates: an unconcentrated market when it is below 1000; moderate concentration when it is higher than 1000 but less than 1800; and high concentration when it is above 1800.

5.0 Evaluation of the Banking System Cont'd

- Table 1 shows that there has been stability on the macroeconomic front with modest economic growth, low inflation, and acceptable levels of internal and external balances, lower external debts, and relatively stable exchange rate has augured well for the economy.

- It has helped to avert a currency crisis, improved investors and depositors’ confidence, reduced vulnerabilities, withstood external contagion and built resilience in the banking system.

5.0 Evaluation of the Banking System Cont'd

Table 2 below displays a set of banking system macro-prudential variables that can be used to assess the Strengths and weaknesses of the banking system.

- The (CAR), which captures banks’ overall financial soundness, has hovered at 14 per cent between 1996 and 2008, well above the 8 percent minimum level required by law.
- The banking system maintained reserves well in excess of the required amount.
- The asset quality of banks improved during the 1996-2008 period. This is reflected in the decline in the levels of non-performing loans.

Table 2

Guyana: Selected Performance Indicators of the Commercial Banks

	1997	1998	1999	2000	2001	2002	2003[1]	2004	2005	2006	2007	2008
Capital adequacy												
Capital to risk-adjusted assets	13.3	16.96	16.73	16.15	16.16	14.29	12.73	14.28	14.36	15.47	15.02	14.94
Tier I capital to risk-weighted assets	13.73	16.81	16.67	15.78	16.34	13.39	12.8	14.09	14.5	15.36	14.51	15.01
Tier II capital to risk-weighted assets	0.21	0.18	0.85	0.77	0.7	0.6	0.4	0.4	0.2	0.11	0.53	0.14
Capital to total assets	7.74	10.28	10.59	9.46	9	7.9	6.1	5.35	6.23	6.68	6.90	7.03
Frequency distribution of banks capital ratios[2]	6	7	7	7	7	7	5	6	5	5	6	6
Lending to connected parties[3]												
Related party loans to total loans	3	4	4	5	5	5	6	6	5	3.79	3.67	4.51
Related party loans to capital base	20	20	23	28	27	27	30	26	21	18.23	16.91	22.67
Director exposure to related party exposure	28	20	25	1	3	4	4	1	2	2.03	1.36	1.67
Asset composition												
Business enterprises to total loans	76.2	76.2	76.2	76.6	75.6	72	66.6	51.6	57	54.33	50.68	51.32
Agriculture to total loans	16.3	17.5	14.6	15	14.5	12.9	8	7.3	7.8	6.08	4.90	5.62
Mining and quarry to total loans	2.2	2.4	2.2	1.8	2.5	2.2	2.3	1	1.3	1.70	1.23	1.95
Manufacturing total loans	28.3	26.9	28.7	28.7	27.8	26	23.1	21.4	18.6	18.98	16.84	15.98
Services to total loans	29.6	29.5	30.7	31.1	30.8	30.9	33.2	31.8	29.3	27.57	27.71	27.76
Households to total loans	19.4	19.3	17.9	16.1	14.9	17.2	20.1	17.5	17.1	21.02	22.34	20.22
Top 20 borrowers per total loans	27.6	27.7	26.9	27.9	23.2	25.2	48.5	45.4	44.5	46.69	39.21	33.19
Top 20 borrowers per capital base	192.1	151.6	144.5	146.1	121.6	131.3	239.5	203.2	195	224.43	180.78	166.78
Asset quality												
Nonperforming loans to total loans	24.3	30.3	31.4	35.7	38.2	37.15	23.3	17.8	13.9	11.59	10.65	5.29
Nonperforming loans to total assets	13.1	17	18.6	19.2	18.9	16.2	8	5.7	4.3	3.82	3.65	1.99
Nonperforming net of provisions to capital and reserves	57.2	64.72	67.6	87.53	90	80.5	62.9	41.7	29.4	26.55	19.79	4.53
Provision for loan loss to nonperforming loans	51	56	54.5	49.4	49.1	53.71	33.3	39.7	44.4	41.04	54.20	79.09
Total on balance sheet assets to capital and reserves	891.6	862.1	798.2	901.9	936.4	1076.6	1179.3	1216.7	1224.4	1177.91	1,184.88	1,089.70
Large exposure to capital base	361.5	285.4	276.2	285.2	253.3	267.1	369.3	314.02	305.1	320.48	267.50	195.49
Nonperforming loans [G$ million]	**10,946**	**15,636**	**17,635**	**20,612**	**21,504**	**20,058**	**10,561**	**8,135**	**6,907**	**6779**	**7,288**	**4,547**
Earnings and profitability												
Return on assets	1.4	2.95	1.28	0.65	0.48	0.44	1.21	1.37	1.74	0.59	0.59	0.57
Return on equity	11.7	25.83	10.64	5.57	4.37	4.45	13.68	16.44	21.27	6.92	6.85	6.31
Net interest income to gross income	41.8	35.96	37.85	33	32.5	39.5	44.3	47.4	50	48.61	44.71	46.93
Non interest expenses to gross income	34.26	40.41	42.08	40.8	44.8	53.4	51.9	51.51	44.85	37.77	35.82	38.72
Personnel expenses to noninterest expenses	37.19	34.7	31.21	36.63	33.68	37.07	32.51	36.74	40.58	44.10	38.12	30.31
Net operating income to average total assets	5.72	3.9	1.32	0.83	0.7	0.61	1.37	1.75	2.42	0.87	0.79	0.8
Operating expense to average total assets	9.7	10.1	10.8	10.52	9.9	8.49	6.98	5.65	5.98	1.40	1.82	1.76
Operating expense to total income	79.7	82	89	92.27	93.24	93.55	83.19	79.14	71.15	61.52	69.79	68.8
Liquidity												
Interest expense to average earning assets	15.46	17.62	7.44	7.57	6.73	4.75	3.46	3.24	3.12	0.74	1.19	1.03
Net interest income to average earning assets	15.19	13.85	6.01	4.86	4.5	4.8	5	5.55	5.93	1.51	1.57	1.61
Liquid assets to total assets	30.57	26.16	25.11	25.47	23.5	23.9	26.4	33.3	32.5	33.01	26.47	29.79
Customer deposit to total loans	154.6	148.29	140.86	157.51	169.06	195.13	248.46	272.29	282.38	264.36	256.71	227.85
Customer deposit to total loans and investments	**108.06**	**109.44**	**107.95**	**109.32**	**110.94**	**111.89**	**118.89**	**121.29**	**124.81**	**120.14**	**123.40**	**112.8**

[1] This comprises 6 commercial banks excluding GNCB, which was privatised in March 2003.
[2] Number of commercial banks with ratios greater than the 8 percent minimum capital adequacy ratio.
[3] Related parties include directors, senior officers and shareholders with 20 percent or more shares.
Source: Bank of Guyana

5.0 Evaluation of the Banking System Cont'd

- Provisions for bad loans as a percentage of non-performing loans were satisfactory, averaging approximately 50 per cent between the 1997 and 2002 increased to 79 percent in 2008.

- The composition of the banking system earning assets has changed to vary risks during 1996-2008.

- Credit to the private sector as a percentage of total bank assets grew from 47.8 per cent in 1996 to 51.7 per cent in 1999 but thereafter declined to 37.4 per cent in 2002 and further to 27.6 per cent in 2008.

5.0 Evaluation of the Banking System Cont'd

- Diversification of credit across sectors have also taken place with the real estate and the household sectors accounting for about 62 percent of total credit in 2008 compared with 23 percent in 1996.

- The holdings of public sector securities (treasury bills) by banks as a percentage of total assets declined from 22 per cent in 1996 to 12.8 per cent in 1999. However, this holding has increased to 22 per cent in 2008.

- Although the level of exposure of the banking system to government securities is large, default risks have been extremely small but market risks are a matter of concern due to potential changes in relative prices.

5.0 Evaluation of the Banking System Cont'd

- Banks overseas holdings/investments as a percentage of total assets increased from 4 per cent in 1996 to 21.2 per cent in 2008. Their net overseas holdings as a percent of capital and reserves increased from 15 per cent in 1999 to 162 per cent in 2008.

- This shift in portfolio reflects the diversification from loans but it has exposed the banking system to contagion from external factors.

- The banking system remained profitable during 1996-2008 and this profitability has provided a liquidity buffer against shocks. Banks' ratio of net profit to equity (ROE) and net profit to assets remained relatively stable.

5.0 Evaluation of the Banking System Cont'd

Measured by the Herfindahl-Hirschman Index, the level of concentration in the Guyana banking system is quite high.

- The Herfindahl-Hirschman Index has been above 1800 for all years between 1998 and 2008, except for 2001 and 2002.
- The high concentration level reflects the small number of banks in Guyana as well as the share of the two largest banks which account for almost 60 percent of total assets.
- It is important to note that the banking institutions have been facing competition from overseas institutions as well as from non-bank financial intermediaries.

5.0 Evaluation of the Banking System Cont'd

Bank of Guyana has been assessing the health of the banking system quarterly through an analysis of micro prudential indicators. This is been supplemented with stress testing to identify potential vulnerabilities under various scenarios.

- The Bank’s assessment of the risk profile of financial activities in the commercial banking system during the 1997-2009 period shows that the system is exposed to credit, operational, market, legal/compliance, reputational and liquidity risks.
- Although the severity and directions of these risks vary among banks, they remain modest and stable for the banking system.
- However, operational and credit risks are the major concerns for the Bank of Guyana.

6.0 Policy Recommendations and Concluding Remarks

- The outturns from reform measures have helped the banking system to cope with various shocks and alleviate vulnerability.
- Notwithstanding, the Government of Guyana is committed to further entrenched macroeconomic stability, to implement structural reforms and to further strengthen the financial system which would undoubtedly help to build resilience in the banking system.
- In the area of macroeconomic stability, the authorities are committed, in a transparent manner, to sustain fiscal consolidation efforts, to reduce the external current account deficit and to pursue prudent monetary policy focusing on low inflation.

6.0 Policy Recommendations and Concluding Remarks Cont'd

Notwithstanding progress that is being made in the banking system, the authorities are aware that continuous oversight and strengthened prudential regulations are required to maintain banking system stability in light of the existence of risks and lessons from the recent developments in the global financial crisis.

- The still high levels of non-performing loans require strong regulatory oversight to safeguard banks from insolvency as well as against the expansion and concentration of loans in real estate and consumption.

- Regulatory oversight also has to be strengthened as it relates to the increases in overseas investments by banks and the contagion effects these bring. In view of the increases in loans to the real estate sector, the risks of the banking system to an asset market boom and bust will have to be closely monitored by the authorities.

6.0 Policy Recommendations and Concluding Remarks Cont'd

- This will require the traditional measures of inflation by the consumer price index for the conduct of monetary policy to be expanded to include asset price inflation. In addition, paying increasing attention to other macroeconomic variables that may signal banking system weaknesses is important.

- The regulatory and supervision framework will have to be flexible and forward looking with appropriate minimum standards for liquidity and capital. The main objective must be to improve incentives by increasing transparency in supervisory authority and industry alike.

- While domestic financial institutions need to strengthen their resilience through enhancing their risk management capability, international cooperation can play an important role. This will not only strengthen the global financial system but also improve the soundness of the national banking system in Guyana.