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LOCALIZATION OF COMMERCIAL BANKING

by
Nugent A. L. Miller

Background

Like most of the major producing and financial sectors in the Caribbean, the commercial banking sector has been foreign-owned and has operated as part of the international branch network of the banks. While these banks were originally concerned with the financing of trade they extended their activities to the local sector by the financing of activities giving rise to trade and in respect of the mobilization of savings. From the earliest, too, they played a major role in the administration of payments. They have, however, been extremely lacking in the development of a diversified set of lending programmes and plans suited to the expansion of local economic activity. For a long time their lending policies had been based primarily on export agriculture and on the import trade, and though more recently there has been some diversification, the structure of ownership and organization appears to be such that major decisions and, in some cases, fairly routine decisions are taken at the centre of the branch system.

The banking system is the hub of the financial system, and if it is to perform a function fully consistent with the objectives of the society, its top interests must be within the society - in other words, ownership interest and management must be local.

Now that governments have become responsible for their own development it has become necessary to harness all forces in the system to achieving the economic and social goals of society. Thus it has become necessary to institute changes which would eliminate the

biases and prejudices towards certain groups in society inherent in the pattern of development and operation of the banks under the present system.

Localization should mean much more than a transfer of shares and top management positions to residents. As Neville Mitchell puts it, it should mean a transfer of mind and management[1] from the metropolitan to the local base, whereby new techniques and methods suited to bringing banking services to the broad mass of people in the economy.

Government Policy

Government policy in the sixties consisted of forcing the banks to utilize their resources inwardly. In Jamaica, for instance, only local assets qualify for inclusion in the statutory liquid assets ratio. In Trinidad and Tobago there were initially penalties for holding excessive balances abroad, but the Central Bank has now prescribed working balances for the banks. Also attempts have been made to channel bank credit away from non-resident borrowers by setting ceilings on aggregate lending to this category of borrower. On the personnel side the work permit laws were applied to the banking industry. It was found initially that there was a shortage of top level officers, probably due to a faulty recruiting system and to the expansion of banking facilities. The number of expatriate managers has been substantially reduced, however, since the localization emphasis.

[1] Neville Mitchell, Local Banks on the Increase, Financial Times, March 30, 1972.

The measures do not necessarily bring about the fundamental changes envisaged. It is contended, moreover, that when local personnel are given senior positions, decisions previously made at the local level are transferred to Head Office.[1] Moreover, local personnel drawn into the system soon become tools of the institutional structure and contribute significantly in perpetuating the existing values of the system. They often became more rigid in their application of bank policies. Furthermore, profits and other management income still flowed to the parent company abroad, because ownership and key management functions are retained.

The third step in the process is that of localizing ownership. In Jamaica and Trinidad and Tobago this means that the international banks should become locally incorporated and that equity should be sold to residents. The international banks have been asked to make available to the public a minimum of 51 per cent of the firm's equity over a period of five years. These governments have also indicated that they will allow new international banks to operate in their territories only if they introduced a new financial service. Thus at one point the Jamaican Government announced the impending entry of three additional American banks. It was intended that these banks should facilitate access to the capital markets of the mid-west and west coast of the United States. To date only one of these banks has begun operations and it has complied with government requirements by being locally registered and introducing a merchant bank.

[1] C.Y. Thomas, "The Struggle for the Trinidad and Tobago Banking System and the Role of the Proposed Workers' Bank". Proceedings of the 1st National Conference on the Workers' Bank of Trinidad and Tobago, August 1971.

In addition to this all governments have decided to encourage and promote the growth of new local banks. Thus, in Trinidad and Tobago the government intervened in the Bank of Montreal's attempts to purchase the equity of the other shareholders of BOLAM and bought the bank itself. BOLAM's Trinidad bank represented only a small fraction of that country's banking system, probably less than one per cent of its assets. A similar intervention at the time of transfer of Barclays D.C.O. shares to Barclays Ltd. and these banks' reorganization as Barclays International would have resulted in significant government control. More recently the Workers' Bank owned largely by the trade unions has been set up, and consideration is being given to converting existing savings banks into commercial banks as is evidenced by government statements with regard to the Government Savings Bank and by releases from the Trinidad Cooperative Bank. In Jamaica the local banking initiative appears to have come from a group of businessmen who with the help and participation of a foreign bank set up the Jamaica Citizen's Bank Ltd. It was intended that the bank should have 51 per cent local equity, but only 41 per cent was absorbed on the local market. The foreign bank as underwriters holds the difference but it is intended that it will be put on the local market at a convenient date. In the meantime the foreign bank has decided not to vote these shares. Like Trinidad, the Jamaica Government has indicated its intention to commercialize the Government Savings Bank. In Guyana, local banking has taken the form of the founding of the Cooperative Bank in which Government at present has the majority shareholding. The bank is based on the Cooperative move-

ment, and it is intended that the movement should eventually own 90 per cent of the equity. Unlike the other governments, the Guyana government is opposed to the localization of the international banks and its aim is to divert local savings from the international banks to the Cooperative Bank.

Policy Conflict

There appears to be a basic conflict inherent in a policy to localize existing international banks and at the same time to encourage new local banks. Whatever appeal the concept of nationalism may have had in promoting the new banks is now dampened by the localization of foreign banks. While one would expect a change in the quality of service which will flow from the new banks and that some support will eventually develop on these grounds, the issue is now confused, and may result in severe hindrances to the pattern of development of the new local banks. The disadvantages facing new local banks vis-a-vis established localized banks, embrace problems with regard to staffing, initial expenditure, branch extension, interest rate and other competition and equity issues.

Staff: New banks have generally relied on attracting some proportion of their initial staff from the established banks. The pattern is that a relatively junior officer in the international bank will assume a position of relative responsibility in the new bank. The problem here is that where the aim of the new bank is to revolutionize banking and to develop new policies and criteria suitable to serving the broad mass of people, the former staff member of the established

bank may be so immersed in the existing system that he is unable to reorient his thinking and make a genuine contribution to the movement.

Preliminary Expenses: The new bank's initial expenditure is likely to be extremely heavy. Apart from fixed capital costs and those incurred with the issuing of shares, the banks will have to undertake aggressive advertising and promotional programmes in order to put the bank's case before the public eye. Normally, the new banks cannot promise investors returns in the form of dividends until its initial expenses have been recovered. Indeed, the Banking Law of Guyana specifically prohibits the payment of dividends until all the bank's capitalized expenditure has been written off. The older banks have two advantages here. Their promotional expenses will be less because they are already established; and, second, the size of their business is large enough to enable them to pay dividends from the outset. The experiences of the Jamaica Citizen's Bank Ltd. and the Bank of Nova Scotia (Jamaica) Ltd. are cases in point. The latter bank was able to estimate dividends at the rate of 13% on the par value of its shares after the first year of operation. On this basis it could offer shares at twice their par value and still promise 6½%. An additional factor is that the new banks will be serving a less preferred section of the community from the point of view of profitability. Thus, though the Workers' Bank of Trinidad and Tobago is based on a large interest group its operations consist principally in serving small customers which is not attractive from a profitability point of view, and will lengthen the period between commencement of operations and returns to shareholders.

Branching: The second area of concern is in respect of branch expansion. In both Jamaica and Trinidad and Tobago the new banks will find the branches of a number of the older banks serving relatively small communities. Tunapuna, Trinidad, is already served by three banks, and there are two bank offices in nearby St. Augustine. New branches are likely to operate at a loss for some period of time and the multiplicity of established branches serving the various areas will lengthen the period of unprofitability.

Continued Expansion: The other important factor is that after the particular interest group, e.g. the workers, or the cooperatives, or the nationally conscious, has made its portfolio adjustment in response to the availability of securities of the new bank, expansion will be limited to the growth of the group's savings unless the bank can appeal to other sections of the community on other grounds. Such appeal may take the form of competing for deposits on the basis of interest rates and other inducements and on service charges. These are likely to squeeze profits and to raise rates on loans. Managers of one of the newer banks will readily admit that they pay a lot for their deposits, hence their lending rates tend to be high. The American banks in Trinidad and Tobago quote higher rates on instalment loans than other banks. Attracting deposits on an interest rate basis is likely to be frustrated by the fact that the older banks have very strong links with their larger customers. These customers may be willing to continue banking with the older banks at at small sacrifice of interest. In any case the older banks can and have managed to retain their customers by offering similar inducements.

It appears undesirable that the new banks should be faced with this type of situation. The American banks which entered the industry in the early sixties competed vigorously with the established banks, but they had the backing of the resources of the parent banks, and did not depend at the time merely on high interest deposits for loan expansion. At least in Trinidad and Tobago, however, these banks appear to have now become less aggressive. For the local banks the situation will be even worse if two or more of the local banks find themselves competing with each other for the deposits and international business which will readily shift or for branch location.

The problem could induce the new banks to get into areas of buoyant demand at the expense of the more essential areas. The Jamaica Citizen's Bank Ltd., for example, went heavily into instalment credit in the early days of its operation. This is understandable. Breaking into an industry served by six giants is no mean task, and, among other things, the bank has had to expand its business into areas of rising demand. The salaried class whose incomes were rising became an obvious preference.

All the above considerations tend to make the equity of the new banks less preferred to that of the older banks in which the public will have greater confidence as to the prospects of success. Luckily, in the case of the Workers' Bank, substantial support was given by the interest group involved even to the point of over-subscription. In addition, the older banks have established a long association with the wealthier section of the community who will be both willing and able to absorb the shares. The local issue of the Bank of Nova Scotia,

Jamaica, Ltd. was quickly taken up at twice the par value. That of the Citizen's Bank has not yet been fully taken up.

Equity

The basis on which a bank decides on its initial capital and the question of the adequacy of bank capital has seldom been raised publicly. The banking laws of the various territories all prescribe minimum capital requirements for the granting of a licence. Legislation in Trinidad and Tobago and Jamaica also provide maximum ratios of 20:1 in respect of deposits to paid up capital and reserve funds. The Guyana and Jamaica laws further limit bank accommodation to a single borrower to specified ratios of the bank's capital and reserves - 10 per cent in the case of Jamaica and 25 per cent in respect of Guyana. For all territories limits are prescribed in respect of unsecured credit and these limits are based upon shareholders' equity.

One of the primary uses of bank capital is for the provision of physical assets to enable the banking function to be performed. Another major purpose is to protect depositors against loss by serving as a buffer between deposits and the risks inherent in the banking business. Bank capital is often analysed in terms of a ratio to deposits as exemplified in the banking laws referred to above, or to total assets or to risk assets. All such ratios are subject to shortcomings. With regard to the ratio to deposits it may be argued that sudden deposit drains could inflict losses on banks by forcing them to liquidate assets at a loss or to borrow at penalty rates. In such a case the relationship should be based not only on total

deposits but also on the composition of deposits, more stable savings deposits, for instance requiring less capital than other banks. Bank losses are, however, more directly related to the assets side of the balance sheet, and this factor appears to have influenced the provisions of the banking laws where loan ceilings on individual loans are related to the quantity of capital. There are difficulties here, too. A simple relation to total bank assets will include riskless assets such as cash and Treasury bills. But even the other assets vary this degree of risk. Medium term loans to small enterprises, for example, may be more risky than short-term commercial loans. Hence the ratio of capital to other balance sheet items should be larger where it is desired that banks engage in more risky undertakings. The role of capital in risk protection will be reduced to the extent that bank assets and liabilities are made less risky by loan and deposit insurance, government guarantees and so on.

Indeed, as shareholders' equity increases in relation to other balance sheet items it will alter the maturity distribution of bank liabilities in favour of longer term securities and will enable the development of longer and more medium term loans and investments. In order to make this analysis more meaningful some analysts deduct the value of bank premises from shareholders' equity.[1] It may be argued in support of this that the two functions of protection against risk and provision of physical assets is thereby separated.

[1]See for instance, Submission of the Canadian Bankers' Association to the Royal Commission on Banking and Finance, Supplement to the Canadian Banker, Spring 1963, pp. 73-75.

As a matter of policy it seems that in an economy such as the Caribbean, shareholders' equity should be kept relatively high, and that international banks should not be permitted to sell their equity to local residents in order to achieve government targets. Rather, the proceeds of any local issue should be added to the existing equity. In the long run equity will be increased in absolute terms by annual additions to the banks' reserves. The banking laws provide for an addition of ten per cent of net profits before the payment of dividends. But it may even be necessary to increase capital through the sale of debentures.

Jamaican Experience

It is instructive to examine the behaviour of Jamaican localized banks in the light of this discussion. The Trinidad banks have only very recently announced minimum details in respect of their localization. We have to hand, however, the prospectus of the Bank of Nova Scotia, Jamaica, Ltd. That bank's freehold and leasehold properties together with furnishings, fixtures and equipment were valued at J$4,511,800. The parent bank was allotted shares at their par value of one dollar Jamaican equal to this value in payment for the transfer of its business to the Bank of Nova Scotia, Jamaica, Ltd. In addition the parent bank was allowed to subscribe for an additional number of Ordinary shares at their par value to make a total of 5,000,000 ordinary shares. The parent bank also agreed to absorb the sum of $130,000 in respect of costs incurred in connection with the transfer of assets and the local issue. The bank then offered

1,250,000 of its shares at a price of $2.00 to the Jamaican public thereby making a profit of $1,250,000, and resulting in a net capital outflow of $1,881,800 [$2,500,000 -($488,200 + $130,000)]. According to the prospectus additional shares will be offered out of its holdings to the Jamaican public. The absence of a capital gains tax in Canada appears to facilitate this type of arrangement. The bank has, however, not stuck rigidly to this last understanding. In 1969 its authorized capital was increased by J$500,000 and unappropriated profits were capitalized and applied in paying up 500,000 shares issued as bonus shares to members.

The new bank's ratio of shareholders' equity to deposits and total assets amounted to 5.8 and 4.5 per cent respectively. If the value of bank premises is deducted these ratios amount to 1.7 and 1.3 per cent. It should be noted that the ratios of shareholders' equity to deposits and shareholders' equity less bank premises to deposits were 6.1% and 4.6% for Canadian banks in 1961 and that these ratios were much higher in the earlier years of that country's banking. Ratios for the United States banks have been higher. Citizen's Bank ratios are naturally higher. Its shareholders' equity to deposits ratio at 30th September 1970 was 27.1% and when bank premises are deducted from capital it is 20%. These ratios are expected to fall as deposits grow. There is no absolute standard by which to judge the appropriateness of the ratios, but we argue that the ratio should rise as the banks become more and more independent of the parent banks.

One problem noted above is the question of the maximum loan permitted under the law. Some banks appear to interpret this as,

10 per cent of the local shareholding and reserves. It is, indeed, not unusual to find that the local limits of some unlocalized foreign banks exceeding those of the locally incorporated banks. In Jamaica, the law has been amended to make provision whereby arrangements can be made for the guarantee of loans and advances by such firms in such circumstances as will adequately protect the interests of shareholders and depositors in the bank. In reality this has meant guarantees by the parent bank. Concern has, however, been expressed in the Jamaican press over the willingness of the banks which have announced their intention to go local to guarantee their loans if they hold a minority of the share capital of the localized bank and management is effectively transferred to local hands. This should not be taken lightly. Banks with as much as 45 per cent equity holding have been known to allow their subsidiaries to go into liquidation. However, banks are free to examine and be selective about the loans they will guarantee just as they are about the loans Head Office now approves. Indeed, under the international branch system all loans are made by Head Office which theoretically sustains all losses. Under the new arrangement the guarantor stands to lose only the portion of the loan which it guarantees. If the quality of management and loan collection is good there appears little reason why the guarantees should be withheld. Where supplementary funds are required by the local bank these will undoubtedly be supplied on the basis of considerations of availability, opportunity cost, profits and risk. Exchange risks, for example, are likely to loom larger in negotiations than degree of ownership.

In view of the possibility that difficulties may develop in this area, it is pertinent to examine alternative mechanisms. Two courses seem to be open. First, there could be loan participation among local banks. This would result in a new limit set at the sum of the limits of the participating banks. The other course is to have loan participation with correspondents. This would depend on the factors mentioned above with regard to the movement of funds. In United States practise, participations are similar to guarantees in the sense that correspondents will accept only that part of a loan in excess of the originating bank's lending limit. With a guarantee, however, funds may not move and the guarantor becomes actively involved only if the borrower defaults. With a participation, except there is a reverse or counter participation, funds will move from the lending bank to the borrowing bank. Development of loan participation on a regional basis can further raise the limits on loans which may be granted without resort to non-regional centres of decision-making.

One point of interest is whether the government target of 51 per cent is adequate to ensure local control. It seems highly probable that where there is one shareholder with 49 per cent of the vote and a number of others with 51%, except the latter can be in agreement when there are differences of opinion, the 49 per cent shareholder will be in effective control. While it may be argued that this will happen even if we reduce the foreign share, we should endeavour to lessen the probability of its occurring. It is to be noted in this respect that recent Canadian legislation has limited foreign ownership in financial institutions, including banks, to 25 per cent. Some

West Indian economists have argued that skill and capital constraints are only minimal deterrents to complete localization.[1]

One final observation with regard to equity is perhaps worth making. Bank localization is part of a more extensive process of localizing financial institutions. Some of these institutions have very close relationships with banks and it is quite feasible for a localized bank (51% locally owned) to own a majority share holding of an insurance company or other financial institution which could then buy shares of the bank. Following on our above argument this type of arrangement could result in even greater effective foreign control.

Capital Outflow: It was demonstrated above that the localization of the Bank of Nova Scotia in Jamaica resulted in a significant outflow of capital. Mr. Neville Mitchell has introduced a theoretical model showing other devices which could yield the same result.[2] The Trinidad and Tobago Government is apparently aware of the problem and has stipulated that if the foreign parent bank wishes to repatriate the proceeds of the sale of its shares in the local bank it must do so without causing difficulty to the balance of payments of the country. Furthermore, that at least 75 per cent of the proceeds of the sale of any of its shares must be retained in the country for not less than five

[1]A. McIntyre and B. Watson, Studies in Foreign Investment in the Commonwealth Caribbean No. 1, Trinidad & Tobago, I.S.E.R. 1967, p. 60.

[2]Neville Mitchell, The Workers' Bank of Trinidad and Tobago: Its Structure, Policies and Plans, Proceedings of the 1st National Conference on the Workers' Bank of Trinidad and Tobago, August 25 & 26, 1971; p. 13.

years; and repatriation after this must be spread over a period of time and be subject to the directions of the Central Bank.[1] In view of the method of determining the capitalized value of the company, if the foreign bank is to continue as a shareholder we suggest that there is no reason why there should be any repatriation at all.

The Record of the new banks: The record of the Citizen's Bank is interesting. It appears as though it was originally intended that this bank should play a role in agriculture. This it has not done. Rather, it has had to concentrate its branches in the urban area where the deposits are, and it has had to go heavily into the consumer credit field, where the new customers and those who desired better terms than what they got from the finance companies, could be found. These policies were forced on it largely as a result of the competitive environment in which it found itself - a market dominated by big banks with country-wide branches and with the best customers in terms of size. The bulk of Citizen's deposits were therefore quite expensive. It even offered bonuses on savings deposits with a minimum balance of as low as $50. It was, therefore, almost imperative that it go heavily into the high interest lending.

The National Commercial Bank of Trinidad and Tobago has also grown rapidly in terms of deposit loans, and number of accounts according to its 1971 Annual Report. It seems to have established an effective relationship with its trust company in respect of mortgage

[1]Speech by Hon. G. Chambers, Minister of Finance, at Opening of Royal Bank of Trinidad and Tobago, Thursday 3rd February, 1972, p. 3.

lending. It has not, however, engaged in any branch expansion and i impact so far has been relatively limited.

In Guyana, the Cooperative Bank is apparently the fastest growing bank largely because it has received large accounts as a result of complementary government policy in the non-financial sector - namely, the national ownership of bauxite production and th Guyana External Trade Bureau. I understand that that bank now contr a substantial proportion of the deposits in the system, and that it has managed to commence branch expansion. The government appears to be committed to a policy of diverting savings from commercial banks to the National Cooperative Bank. The problem is that an eventual absence of competition may impair its efficiency.

Summary

The paper argues:

(1) The encouragement of new local banks and the localizati of existing foreign banks places the former at a serious disadvantage vis-a-vis the foreign bank.

(2) Localization will not be effective except there is a genuine reorientation of thinking in banks. Localized banks should perhaps have local representation on the Board of Directors of the parent banks.

(3) We should guard against the outflow of capital when a foreign bank seeks local equity participation.

(4) If there is a continued desire to match the term of liabilities with that of assets, the capital base of the banks should be strengthened to permit more diversification in lending. This factor involves a choice between having a few institutions with several windows or a number of institutions with specialist functions. If the latter choice is made funds will have to be channelled from the dominant institution to the latter.

(5) The 51% target of local participation ought perhaps to be increased.

In addition we should add that increased localization of the sector should imply a more developed inspection system. The part-time arrangement now existing in Jamaica, for example, is likely to be far from adequate as the parent banks gradually withdraw their "external" inspection services.