

COMMERCIAL BANK COSTS AND EARNINGS IN THE  
EAST CARIBBEAN CURRENCY AREA

by

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Paper Presented at the Eleventh Annual Regional Monetary Studies  
Conference, Basseterre, St. Kitts, October 29-31, 1979.

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### INTRODUCTION

This paper is more a progress report than a conventional conference paper for one basic reason. Critical gaps in the data supplied by the respondent banks, as well as non-response in crucial cases precluded definitive tabulations of the structure of costs and earnings within the banking industry, as well as prevented statistical examination of some hypotheses about these aspects of commercial bank behaviour. It is hoped that with the co-operation of the banks and the East Caribbean Currency Authority, the data deficiencies will be quickly remedied.

The purpose of this report is to describe within the limitations of the existing data the structure of costs and earnings, and the levels of operating margins in the commercial banking industry. The variables are described across countries and through time. These descriptions permit some qualitative judgement about the degree of homogeneity of the industry within countries and within the area as a whole. They also allow some insight into the operational and social efficiency of the banks.

The subset of respondent banks is described first. The following section describes the structure of costs and earnings and the levels of operating margins. Some comparisons are then made with the Caribbean Community MDC's in the penultimate section.

\* The success of this study is critically dependent on primary data supplied by the commercial banks. The co-operation of respondent banks is gratefully acknowledged.

## THE RESPONDENT BANKS

The descriptions in this paper are based upon returns by sixteen of the twenty-six banks operating in the ECCA region, excluding Montserrat. In the case of the non-respondents, two had ceased operations by the time of the study, and three did not begin operations before 1977. The respondent banks are all foreign-owned, so that the following remarks can be taken as descriptive of expatriate banking in the Leewards and Windwards Islands. At the end of 1977, these banks controlled 38 per cent of industry deposits in Dominica, 67 per cent in St. Lucia, 45 per cent in St. Vincent, 100 per cent in Grenada, 59 per cent in St. Kitts-Nevis, and 72 per cent in Antigua. The results should therefore be reasonably representative of industry behaviour in most of the islands. In all cases, except Dominica, the data period is 1972 to 1977. The data for Dominica pertain to 1974 to 1977.

## I: COSTS, EARNINGS, AND PROFITABILITY

### COSTS

Table 1 presents some details on the structure of operating costs in the commercial banking industry. The Table is built up by averaging individual bank data into country data per annum, and then further averaging the annual country data over the data period, i.e. 1972 to 1977. Finally country data are averaged over countries to produce the column describing the ECCA-wide situation.

Dealing first with the overall picture for ECCA (Column 1), it can be observed that labour costs are a relatively large proportion of



total operating costs. On average, they accounted for 26 per cent over the period. However, the main cost item is interest paid on time and savings deposits. Interest on time deposits accounted for 28 per cent, and interest on savings deposits for 16 per cent. The larger share of time deposits in total interest costs reflects the higher rates of interest paid on time deposits, since time deposits are a smaller proportion of total deposits in all countries of the currency area. (For data on deposit composition, see Guishard's paper on Commercial Bank Liabilities).

Charges on money balances owed to financial institutions within the ECCA area have not been a large cost item. Likewise for balances due to the banks' control offices, whether regional or metropolitan. In contrast, control office 'administrative' charges accounted for as much as 6 per cent of total costs. Some investigation into the nature of the services provided by control offices and the reasonableness of these charges might be worthwhile from the standpoint of efficiency at both the industry and societal levels.

A very small proportion of bank costs arise from provisions for loan loss. On average over the period, provisions for loan losses represented only two per cent of total operating costs. Such a small percentage allocation no doubt reflects the low incidence of loan defaults experienced by the banks. From another point of view, it may attest to the conservative, risk avoidance behaviour of commercial banks in the ECCA region.

It is apparent from the percentages in Columns (2) to (7) of

Table 1 that the cost structures of individual countries' banking industries vary somewhat from the ECCA average. Labour costs form a higher proportion in St. Kitts-Nevis than in the other countries. Interest costs on time deposits are considerably higher than average in Antigua, and much lower in St. Kitts. There are also sizeable country deviations for interest costs on savings deposits, and provision for loan losses. However, despite the country deviations which possibly reflect local peculiarities as well as weaknesses of the data, it is clear that the structure of costs within the commercial banking industry is very homogeneous for the East Caribbean Currency area.

There is less homogeneity at the country level, particularly in relation to interest charges on balances due to other financial institutions and control offices, and in relation to administrative charges imposed by control offices. Very surprisingly, labour's percentage share of operating costs tends to be out of line for usually one bank in each country. The supporting data for these observations are (in the interest of time) not reported here, but the existence of significant intra-bank differences in cost structures underscore the advisability of using individual bank data to test hypotheses about banking behaviour.

Table 2 presents details on the structure of costs through time. The data reveal that labour costs declined as a proportion in the mid-1970's, but rose to its former level in 1977. Interest on time deposits tended to be at a higher level from 1972 to 1976, but fell markedly in 1977. Interest on savings deposits rose as a

TABLE 2

PERCENTAGE ANNUAL COMPOSITION OF BANK COSTS: REGION

<u>COSTS</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Labour	30.2	29.3	24.5	25.3	25.8	31.6
Interest on Time Deposits	30.4	29.8	28.8	34.1	29.6	20.9
Interest on Savings Deposits	19.0	17.2	20.2	16.2	11.4	10.4
Interest on ECCA Balances	2.2	2.3	2.3	2.4	2.9	2.3
Interest on Control Office Balances	1.8	1.9	1.3	1.1	1.4	1.9
Control Office Charges	7.4	7.9	7.0	7.0	6.5	8.2
Occupancy	5.9	5.6	4.7	4.4	4.3	4.6
Furniture and Equipment	2.5	4.0	2.1	1.3	1.6	1.6
Provision for Loan Loss	0.5	1.6	2.0	1.5	1.9	3.3
Other	0	0	7.1	6.7	14.6	15.2
<b>TOTAL:</b>	<u>100</u>	100	100	100	100	100

proportion with the higher interest rates which prevailed in 1974, but subsequently continued its basically downward trend. Other interest costs, 'administrative' charges, and provisions for loan resources were relatively stable proportions of total operating costs.

### EARNINGS

Table 3, which was constructed with the same methodology as Table 1, presents the average structure of commercial bank current earnings on a regional and country basis. It can be readily observed from Column 1, that interest on loans and advances are the major source of bank income, on average accounting for 61 per cent for the area as a whole. The large share of loan income reflects the fact that loans and advances are a large proportion of total bank earning assets. (See Liburd's paper on Bank Assets for details on asset portfolio structure). Second in importance are foreign exchange earnings. These comprise roughly 15 per cent of total earnings over the period 1972 to 1977. This finding confirms the widely held view that, in these trade dependent economies with weak domestic financial structures, foreign exchange transactions are a large proportion of bank activities and generate a sizeable share of bank income.

Interest on local government securities do not comprise a large proportion of bank earnings. On average, this income component accounted for roughly 4 per cent, a not surprising result in the light of the small issues, limited marketability, and low interest rates





prevailing for government securities. Interest income on balances due by financial institutions within the region, other than control offices, account for a similarly small proportion of total earnings. It would appear that no net income is derived from these inter-bank transactions in short-term balances. Service charges on demand deposits constitute an even smaller share (2 per cent) of bank earnings. These charges are largely in the form of ledger fees. As in other countries, the banks in the ECCA area appear to regard their demand deposit functions less as a direct source of income and more as a means of generating loanable funds.

Turning to the issue of homogeneity of earnings structures across the region, it can be said that in general the structures of earnings are quite uniform. There are, however, a few important differences, again reflecting differences in the economic structures of the islands. First, it is noticeable that interest income on government securities in Antigua and Dominica are a much larger proportion than in the other countries. These two governments, unlike their counterparts, tend to issue substantial amounts of Treasury Bills. Second, a surprising zero is recorded for balances due to St. Kitts by other institutions within the area. Third, again for St. Kitts-Nevis, an atypicality is observed for interest income derived from investment balances in control offices, regional in this case. On average, the banks in St. Kitts earned 13 per cent of their total income from balances held by their regional offices. Comparison with Column (3) in Table 1 shows that St. Kitts banks were net earners on these kinds of transactions.

The structure of commercial bank earnings is considerably less homogeneous at the country level. Significant differences were observed for firm level data not reported here. These differences exist for large earnings components such as loans and advances, and foreign exchange earnings, as well as for relatively minor ones as regional short-term balances. For example, in one country a single bank's interest earnings on loans and advances were as low as 20 per cent, compared to median values of closer to 50 per cent. In another country, one bank's earnings from foreign exchange transactions constituted only 9 per cent of its total earnings compared with 23 per cent and 21 per cent for the two other firms in the industry.

The structures of earnings on a regional basis are very stable through time, as can be seen from the data in Table 4. There were of course some annual variations, and in the case of interest on ECCA balances, a tendency for an increasing share from 1975 onwards. However, the predominant overall feature is one of temporal stability.

#### PROFITABILITY

The issue dealt with now is: How well has the banking industry been doing? Table 5 utilises three indicators, none of which are strictly measures of profitability since in no case is capital employed the denominator. The realized current operating margin (defined as net total current earnings  $\div$  total operating costs) is a measure of

TABLE 4

PERCENTAGE ANNUAL COMPOSITION OF BANK EARNINGS: REGION

<u>EARNINGS</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Interest on Government Securities	4.1	3.9	3.8	3.4	2.6	4.4
Interest on Loans	56.9	63.1	66.3	64.4	59.3	58.2
Interest on ECCA Balances	2.2	1.6	2.7	4.6	6.3	5.3
Interest on Investment in Control Offices	1.5	3.6	2.9	1.9	3.9	2.0
Service Charges on Demand Deposits	2.6	2.2	2.1	1.5	1.5	1.7
Foreign Exchange Earnings	14.2	15.9	15.0	16.0	16.5	16.6
Other	18.5	9.7	7.2	8.2	9.9	11.8
TOTAL:	100	100	100	100	100	100

TABLE 5

FINANCIAL SUCCESS MEASURES, AVERAGE 1972-1977:  
REGION AND COUNTRIES

<u>MEASURES</u>	(1) <u>REGION</u>	(2) <u>ANTIGUA</u>	(3) <u>ST. KITTS</u>	(4) <u>DOM.</u>	(5) <u>GREN.</u>	(6) <u>ST. L.</u>	(7) <u>ST. V</u>
OPERATING MARGIN	27.3	24.4	23.8	30.5	16.6	33.3	35.2
GROSS PROFITS AS % TOTAL CURRENT EARNINGS	23.4	17.6	34.7	27.8	18.6	17.3	24.2
AFTER TAX PROFITS AS % TOTAL CURRENT EARNINGS	13.8	11.2	20.6	16.7	9.9	10.3	14.3

total markups out of which the enterprise meets non-current expenses, taxes and profits. The profits indicators tell us the proportion of current earnings that might be regarded as profits. They are crude measures of profitability in that no allowance is made for non-current earnings and non-current costs. Nonetheless, all three measures are useful since an enterprise which is not doing well by any of these criteria is unlikely to be doing well by any profit measure, and since it seems reasonable to assume that the converse holds.

It can be observed that operating margins are quite high for the region as a whole, and for individual countries, except Grenada. Likewise gross profits are a high percentage of total current earnings. These indicators imply that the banking industry is very profitable. Together with the earlier observation about the low percentage provisions for loan loss, the evidence leads to the tentative conclusion that the industry in the region as a whole and in individual countries is a high-return, low risk one. If this is true, the banks are having the best of both worlds: they are doing very well without taking chances. The atypicality of this configuration of risks and returns might explain the relative absence of credit innovation in the ECCA region. There is no profit incentive to innovate, regardless of how socially desirable such credit innovations may be.

Table 6 contains time series information which is helpful in making judgements about the temporal stability of bank 'profitability'. Considerable stability obtains for the region and for individual coun-

TABLE 6

ANNUAL GROSS PROFITS AS PERCENT OF TOTAL CURRENT  
EARNINGS: REGION AND COUNTRIES

<u>YEAR</u>	(1) <u>REGION</u>	(2) <u>ANTIGUA</u>	(3) <u>ST.KITTS</u>	(4) <u>DOM.</u>	(5) <u>GREN.</u>	(6) <u>ST. L</u>	(7) <u>ST. V</u>
1972	22.7	21.1	24.5	n.a.	20.6	15.0	32.1
1973	26.3	20.5	44.8	n.a.	18.3	12.3	35.5
1974	24.8	11.2	34.8	33.2	17.8	20.3	31.6
1975	21.1	17.2	37.9	26.1	14.5	15.1	15.6
1976	19.6	15.6	33.2	18.2	19.3	18.9	12.3
1977	25.0	20.1	32.0	33.8	20.8	22.2	21.2
MEAN	23.4	17.6	34.7	27.8	18.6	17.3	24.2

tries, with the exception of St. Vincent where 'profit rates' (in our use of the term) declined significantly after 1974.

#### COMPARISONS WITH CARICOM MDC's

The question addressed in this section is: To what extent are the characteristics of ECCA commercial banks similar to those of banks in the more developed Commonwealth Caribbean countries? In terms of cost structures, the industries in the three territories are quite similar with respect to the share of interest costs on deposits to total current operating costs (Table 7). Jamaica is more like the ECCA region with regards to labour costs. Labour costs are generally a larger proportion of costs in Trinidad and Tobago. More importantly, provisions for loan losses are a much smaller proportion of costs in the ECCA region than in either Jamaica or in Trinidad and Tobago. This difference is not explained by the bad debt problems in Jamaica in 1976 and 1977, nor by the tendency of loss provisions to rise as a proportion in Trinidad and Tobago in 1977. The underlying reason might well be the greater conservatism of bankers in the ECCA region who are not subject to much governmental nor competitive pressure for change and innovation.

Table 8 compares the profile of bank earnings in the three territories. Interest on loans and advances is by far the largest source of earnings in Jamaica and in Trinidad and Tobago, as is the case for the ECCA region. However, the weight of this source of



TABLE 7

PERCENTAGE COMPOSITION OF BANK COSTS, AVERAGE 1972-77:  
ECCA REGION, JAMAICA, TRINIDAD & TOBAGO

<u>COSTS</u>	<u>ECCA</u>	<u>JAMAICA</u>	<u>TRINIDAD</u>
Labour	25.8	25.4	30.5
Interest on Time Deposits	28.2	26.9	44.8
Interest on Savings Deposits	15.8	17.0	
Provisions For Loan Losses	1.9	4.9	3.1
Other	28.3	25.8	21.6
TOTAL:	100	100	100

SOURCE:-

- i) Central Bank of Trinidad and Tobago Quarterly Economic Bulletin 3, 4, December 1978 Appendix.
- ii) Department of Statistics, Jamaica, Monetary Statistics 1979.

TABLE 8

PERCENTAGE COMPOSITION OF BANK EARNINGS, AVERAGE 1972-77:  
ECCA REGION, JAMAICA TRINIDAD & TOBAGO

<u>EARNINGS</u>	<u>ECCA</u>	<u>JAMAICA</u>	<u>TRINIDAD</u>
Interest on Government Securities	3.8	7.2	6.3
Interest on Loans	61.5	76.1	70.9
Service Charges on Demand Deposits	1.8 )	13.5	6.8
Foreign Exchange Earnings	14.7 )		n.a.
Other		3.2	n.a.
TOTAL:	100	100	100

SOURCE :-

- i) Central Bank of Trinidad and Tobago Quarterly Economic Bulletin 3, 4, December 1978 Appendix.
- ii) Department of Statistics, Jamaica, Monetary Statistics 1978.

income has generally been less in the ECCA countries for the entire period. This is a reflection of the fact that loans to assets ratios tend to be lower in the ECCA countries than in the more developed Caricom countries. The influence of the greater degree of government domestic debt financing in Jamaica and in Trinidad and Tobago on bank earnings from government securities is shown by the much smaller proportion of earnings accounted for by this component in the ECCA region compared with the two former countries. The data does not permit a three-region comparison of the shares of foreign exchange earnings and of service charges on deposits. However, the similarity between ECCA and Jamaica with respect to these two components is evident from Table 8.

The final comparison is between operating margins in the territories. For the period 1972 to 1977, realized operating margins averaged 27 per cent in the ECCA region compared to 12 per cent in Jamaica, and 35 per cent in Trinidad and Tobago. Though the average for Jamaica was depressed by small negative margins in 1976 and 1977, these do not distort the overall conclusion that ECCA margins tend to be higher than those in Jamaica, and lower than those in Trinidad and Tobago. However, while Trinidad and Tobago is in some respects a boom economy, the ECCA economies are in no such state. It is difficult in these circumstances to justify the high return-low risk configuration of commercial banks in the ECCA region.

FINAL REMARK.

This report has presented basically descriptive information on costs, earnings, and efficiency in the commercial banking industry in the Leewards and Windward Islands. The next stage of the exercise involves first, the refinement of the estimates of structure and levels of costs, earnings and profits, and second, the statistical examination of behavioural hypotheses about the facets of banking operations.

There is at least one important research and policy inference to be drawn from the empirical description produced in this report. Specifically, the atypicality of the coincidence of very high margins and low risks in this industry raises sufficiently fundamental issues of social efficiency in banking to warrant close scrutiny by both researchers and policymakers.