

Some Lessons for the CSME from the Retail Banking Sector in the European Single Market

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Abstract

The study examines trade in retail banking services in the European Union and seeks to derive lessons for the Caribbean in this regard. This would involve making a comparison of the European Union experiences with that of regulations in the CARICOM area. The study should be useful in informing imperatives for policy makers with respect to the CSME and also to the regional private sector.

1.0 Introduction

This paper discusses some of the key setbacks to cross-border trade in retail banking services within CARICOM drawing on the experience of the European Union where a longer experience of financial integration exists.

The relationship between the development of the financial sector and economic growth is well documented. Levine (1997) identified the key functions of financial intermediaries as: mobilization of savings, management of risk, collection of information relative to investment opportunities, and facilitating the trade of goods and services. Gross (2001), in support of endogenous growth theories, noted that financial intermediaries positively impact macroeconomic performance by reducing leakages in savings, allowing for the development of longer-term projects with higher returns and facilitating risk sharing.

In the Caribbean, the financial services sector is dominated by commercial banks which operate in a fragmented, highly concentrated industry characterized by high operating costs and high interest rate spreads (Henry, 2003). In its review of the Caribbean financial sector, the Caribbean Group for Cooperation in Economic Development (CGED) noted that fragmentation of the regional banking sector is due to the fact that the deposit base and lending portfolio of banks are restricted to domestic economies containing a narrow range of sectors.

In this regard financial integration, through cross border activity, is viewed as a means of increasing efficiency, realising higher returns and reducing risks through diversification. London Economics (2002), for example, projected that integration of bond, equity and bank markets in the European Union would have resulted in a 1.1% increase in the EU's GDP through a decline in financing costs. In addition, Giannetti et al (2002, in highlighting the inter-sectoral impact of financial integration, estimated the EU's manufacturing sector could derive significant gains through integration of the regional financial services sector.

To date CARICOM's experience in financial integration in general, and cross border trade in financial services in particular, have not resulted in the level of risk diversification and cost savings that were anticipated. The regional banking sector in pursuit of heightened cross border trade continues to be constrained by several challenges including macroeconomic fragility, foreign exchange constraints and regulatory issues.

Analyses of strategies adopted by the European Union to facilitate cross border trade of financial services between its member states

provide a useful context for the discussion of CARICOM's setbacks and identification of possible solutions.

2.0 Literature Review

Under The General Agreement of Trade in Services (GATS) framework, a typology for the modes of trade in services can be established as:

- Cross-border Supply: Cross-border supply of services where only the service cross the border;
- Consumption Abroad: Travel of consumers to a foreign country to consume in that country;
- Commercial Presence: Establishment of a commercial presence in that country where the services is to be provided;
- Presence of Natural Persons: Temporary movement of natural persons into the territory of the consumer in order to provide the service there.

The classification scheme can be very useful for analyzing financial integration. There is a lack of comprehensive statistics on these modes. Notwithstanding this, mode 3 is the most readily identifiable, as cross border ownership patterns emerges. With respect to CARICOM, Birchwood (2003) showed that in 2003, 13 per cent of the banks in the CARICOM region were owned by cross-border interest while 50 per cent were owned by extra-regional interest.

Gjersem (2003) noted that financial integration is a priority of policy makers in the EU since it can intensify competition, improve cost efficiency and price transparency. However, he noted that barriers exists with respect to different legal, administrative accounting, tax and consumer protection systems. For example, cross-border charges may vary heavily between banks and different payment methods, and the difference in fees may be triggered by the lack of a single multilateral payment system across Europe. Europe reflected

consolidation of banking sector, causing the number of banks to fall, though the number of branches remained the same.

Typically, the retail market tends to be segmented across national lines. Moreover, there is often a lack of harmonization of consumer protection rules and a lack of transparency of retail banking. Kleimier (2001) noted that consumers do not shop around nor banks try to seek out a cross-border supply of customers so that market segments are often domestically oriented.

A symptom of the market segmentation can be illustrated in CARICOM by observing the wide differential between interest rates across domestic territories in 2006. For example, the weighted average lending rate ranged from 9.9 per cent in the case of the ECCU to 17.6 per cent in the case of Jamaica.¹ At the same time, the average 3-month deposit rate varied between 2.5 per cent in Guyana and 8.5 per cent in Jamaica. In addition, spreads were between, 5.7 per cent for Barbados and 10.6 per cent for Guyana. Birchwood and Seerattan (2006) noted that the wide disparity of interest rate was pronounced as arbitrage remained weak.

Zdral et al. (2007) developed a 3 point schema to illustrate how the market may react to the penetration of foreign banks. They showed that at the left of the continuum, some markets may be at the beginning stages where foreign banks are now penetrating for the first time. These markets are characterized by low quality service and high interest margins. Under such circumstances, they noted that customers may lack knowledge of advances in financial products available and relationship banking follow traditional lines. At the

¹ Data obtained from the 2006 Report on Economic Performance and Convergence in CARICOM.

second stage, the penetration by foreign firms increase and banks become strategic investors. Customers now have increased knowledge of advances in products as competition increases and funding become cheaper. In the final stage they opined that at this stage, foreign banks are able to outdo local banks with respect to the use of internal controls, planning and know-how and they were able to increase their lending relative to local banks. An advantage that foreign banks can have over indigenous banks that may propel them is that they may be able to source cheaper funding from abroad and be in a better position to narrow spreads in the face of competition.

Ironically, studies have shown that integration of financial services market has been regarded as a mechanism for the increased contagion of risks particularly for small, open economies such as those in the region. Murphy (2000) observed that financial integration increases the ease with which shocks are transmitted between member states in the EU. Fonteyne (2006) noted, "Financial integration not only brings benefits, though; it also allows shocks to be transmitted more easily between countries". There is therefore agreement that an effective framework for ensuring financial stability is a critical component of an integrated financial market.

3.0 Review of cross-border activities in CARICOM

Birchwood (2003) noted the openness of the banking industry in CARICOM and found that the smaller territories reflected higher penetration ratios of foreign banks. He also noted that cross border ownership by indigenous banks was evolving, though not at the pace of the European Union. Henry (2003) further observed, that moves were been made towards consolidation across borders in the region with banks. With respect to commercial banks, the Caribbean Trade and Investment Report (2005) observed that "while some acquisitions

by commercial banks (domiciled in Trinidad and Tobago) were opportunistic, others were based on market and strategic considerations and the lure of higher profit”.

Cross-border activity within CARICOM’s financial services sector in the last decade has been largely driven by commercial banks headquartered in Trinidad and Tobago which sought to provide financial services to exporters from the home country (Trinidad and Tobago); service foreign subsidiaries of home country clients and participate in the banking systems of host countries.

The motivation for increased cross-border trade has been classified by the Caribbean Trade and Investment Report (2005) into “push” and “pull” factors. Among the push factors were:

- Liberalisation of the foreign exchange regime in Trinidad and Tobago which allowed banks to extend credit to residents in foreign currency and to grant cross border loans in US dollars.
- The need for risk diversification on sectoral, geographic and individual levels. This is important for commercial banks seeking to improve their international credit ratings.
- Increased competition in Trinidad and Tobago including the improved ability of large private sector and state enterprises to raise funds in the international capital markets.
- Using regional markets as a springboard to enter international markets

The pull factors for increased cross-border activity identified were:

- Domestic growth and expansion of other sectors in the economy. For instance, the Trinidad and Tobago manufacturing sectors which has expanded into other CARICOM markets.

- Provision of services to local clients which have moved to other Caribbean territories.

The preferred mode for the establishment of a presence in host countries by Trinidad and Tobago commercial banks, namely RBTT Bank and Republic Bank Limited, has been the establishment of setting up of branches and subsidiaries, each of which represents a different level of investment, in host countries.

Tables 1 and 2 highlights RBTT and RBL presence in the Caribbean as of March 31st 2007 and September 30 3006 respectively.

Table 1 RBTT Presence in the Caribbean

Company Name	Country of Incorporation	Percentage of equity capital held
RBTT Bank Limited	Trinidad and Tobago	100
RBTT Merchant Bank Limited	Trinidad and Tobago	100
RBTT Trust Limited	Trinidad and Tobago	100
RBTT Services Limited	Trinidad and Tobago	100
RBTT Insurance holdings Limited	Trinidad and Tobago	100
RBTT Insurance Agency Limited	Trinidad and Tobago	100
RBTT Overseas Limited	St. Lucia	100
RBTT Bank (Suriname) N.V.	Suriname	100
RBTT Albion Limited	Trinidad and Tobago	100
R&M Holdings Limited	St. Vincent and the Grenadines	100
RBTT Bank Caribbean Limited	St. Vincent and the Grenadines	100
RBTT Bank (SKN) limited	St. Kitts/Nevis	95
RBTT Bank Grenada Limited	Grenada	62
ABC Holdings N.V.	Netherland Antilles	100
ABC International N.V.	Aruba	100
RBTT Bank N.V.	Netherland Antilles	100
RBTT Bank International N.V.	Netherland Antilles	100
RBTT Bank Aruba N.V.	Aruba	100
RBTT International Limited	St. Lucia	100
RBTT Bank Jamaica Limited	Jamaica	100
West Indies Stockbrokers Limited	Trinidad and Tobago	100
RBTT Finance Limited	British Virgin Islands	100
RBTT Finance (BVI) Limited	British Virgin Islands	100
RBTT Trust Corporation	Barbados	100

RBTT Bank Barbados Limited	Barbados	100
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Source: RBTT Financial holdings Limited, Annual Report 2007

Table 2 RBL Presence in the Caribbean

Company Name	Country of Incorporation	Percentage of equity capital held
Republic Finance and Merchant Bank Limited	Trinidad and Tobago	100
Republic Investments Limited	Trinidad and Tobago	100
London Street Project Company Limited	Trinidad and Tobago	100
Republic Securities Limited	Trinidad and Tobago	100
Republic Bank Trinidad and Tobago (Cayman) Limited	Cayman Islands	100
Republic Insurance Company (Cayman) Limited	Cayman Islands	100
Republic Bank Trinidad and Tobago (Barbados) Limited	Barbados	100
Barbados National Bank Inc.	Barbados	65.10
BNB Finance and Trust Corporation	Barbados	65.10
Barbados Mortgage Finance Company Limited	Barbados	65.10
Republic Caribbean Investments Limited	St. Lucia	100
Republic Bank (Grenada) Limited	Grenada	51
Botanical Gardens Project Company Limited	Grenada	100
Republic Bank (Guyana) Limited	Guyana	51
Republic Bank (DR), S.A.	Dominican Republic	99.90

Source: Republic Bank Annual Report 2006

As shown in the Table 3, relative to foreign owned banks, RBTT and RBL have a significant presence in the region.

Table 3 Comparison of Branch Offices of Selected Banks in the Caribbean (November 2007)

Country	Bank of Nova Scotia	RBTT	Republic Bank Ltd	RBC	First Caribbean International Bank
Antigua and Barbuda	2	1	0	1	2
Bahamas	19	0	0	28	18
Barbados	8	4	8	8	13
Belize	9	0	0	0	6
Dominica	1	0	0	1	2
Grenada	3	4	8	0	5
Guyana	5	0	9	0	0
Jamaica	43	21	0	0	15
Monsterrat	0	0	0	1	0
St. Kitts and Nevis	3	1	0	2	3
St Lucia	1	3	0	3	4
St. Vincent and the Grenadines	1	2	0	0	2
Trinidad and Tobago	23	25	42	0	2
Suriname	0	5	0	0	0

Source: Caribbean Trade and Investment Report 2005; Various publications and websites

For RBTT and RBL, transactions are conducted in different languages, various domestic currencies and within a range of exchange rate

regimes (from floating to fixed). In addition, both RBTT and RBL are required to meet various regulatory and supervisory requirements specified by a number of authorities throughout the region.

Issues of cross border pledging of collateral, restrictions to market access, exchange rate risks and capital flow restrictions and inadequate harmonization of regulatory and supervisory functions within the region are among the primary hindrances identified by bankers with respect to deepening of cross-border trade in financial services in the region.

As cross-border activity outpaced regulators, the importance of an appropriate framework was underscored. To this end, the 2004 Draft CARICOM Financial Services Agreement (FSA) seeks to provide a framework that facilitates increased cross border trade in financial services while providing safeguards against risks within the sector. The FSA seeks to enable:

- i. Financial institutions to derive the benefits of greater operational efficiency from scale and scope economies through increased geographic markets;
- ii. Clients to enjoy lower transaction costs from greater competition;
- iii. Protection of depositors' funds through the application of effective national legislation and harmonized regional supervision of the financial services sector.

4.0 Cross border trade in banking services in the EU

Around the time of monetary unification, EU members' collective population stood at 374,566,000 with GDP of €7,472.50 billion. In

addition, commercial bank assets totalled in excess of 200% of GDP. The EU economies exhibited stable economic growth, particularly, Germany and England, and were therefore a fertile environment for domestic and regional expansion of the European financial services sector.

Murphy (2000) noted that the EU's legislative approach to a single market in banking is founded on three principles:

- (i) Each member retains its domestic banking and supervisory authorities
- (ii) Minimal harmonization occurs above the national level
- (iii) Directives are issued at the EU level

The first real impetus for cross-border banking regulation in Europe occurred in 1997 with the issuance of the First Banking Directive on Coordination of Credit Institutions. This Directive gave credit institutions (including commercial banks) the right to be established anywhere within the European Economic Community.

In 1988 PriceWaterhouse/Cecchini, at the request of the Commission of the European Communities, conducted an analysis of the banking sector within member states of the union. According to the report, the existing banking system was fragmented and highly concentrated, with excess capacity and lacking competition. The study also found that there was potential for scale and scope economies through geographic integration and the adoption of best practices. The removal of entry barriers was seen as critical to achieving increased competition and the attendant benefits for consumers.

A second major step in creating an integrated financial services sector was taken in 1989 when the Second Banking Directive on Coordination of Credit Institutions² was issued. This directive enabled a commercial bank to operate and provide services in any member states using a single banking license³. The Second Banking Directive was also a crucial step in the process of harmonization of bank supervision across member states. The three main components of this directive were:

- i. A definition of banking
- ii. The principle of home-country control or mutual recognition which meant that foreign banks would be supervised and conduct business according to home country rules and recognition
- iii. A single banking license/passport which allowed banks to establish a branch or subsidiary or to acquire another banks without the imposition of barriers by the host country⁴.

Subsequently, additional directives on cross-border supervision, removal of entry barriers, protection of deposits and capital adequacy requirements, inter alia, have been issued with a view to creating an integrated financial services sector.

Monetary unification gave a significant impetus to the integration process. Padoa-Schioppa, Member of the ECB board, (2000) commented that the “multiplicity of currencies” reinforce market segmentation whereas the “existence of a single currency and central

² This directive became effective on January 1, 1993. It stipulates the minimum capital requirements for establishment of a credit institution.

³ It should be noted that a non-EU bank could obtain a single license only if it owns or establishes a subsidiary in an EU country.

⁴ It was believed that this principle would motivate host countries to pass laws to make universal banking possible and level the playing field particularly where foreign banks had an advantage over domestic banks.

bank often unifies a banking system". Trichet, President of the ECB, (2007) noted that the euro has become a catalyst for the development of a single European market in financial service given:

(i) A significant decline in the cross-country standard deviation of interest rates in the interbank money market. For instance in January 1998 the deviation stood at more than 130 basis points for overnight rates but after the introduction of the euro, the differences are around two basis points;

(ii) The euro corporate bond market has grown significantly since 1999: in 2006 the outstanding volume of bonds issued by non-financial institutions was 12.5% up from 3.9% in 1999.

(iii) Between 1997 and 2005 there has been a portfolio reallocation of holdings of domestic equities to equity holdings issued in other parts of the euro area.

(iv) A significant increase in the share of long-germ debt securities issued in the euro area and held by residents of other euro areas.

Among the key benefits were historically low spreads between yields on sovereign bonds from different EU members after unification. Lower policy-determined interest rates and faster pass-through onto lending rates have been observed after the adoption of the euro particularly for "non-core Euroland countries" such as Spain and Portugal Kleimeier and Sander (2003).

In the last five years the preferred modes of cross-border activities in retail banking in the EU were:

- Establishment of branches and subsidiaries by Western European banks in Eastern and Central Europe
- Formation of transnational conglomerates
- Large cross-border mergers and acquisitions in the banking sector.

Gonzalez-Paramo, Member of the Executive Board of the ECB in 2006 noted that in the EU, banks prefer to achieve expansion through cross-border mergers and acquisitions (M&As) instead of establishing a local presence because they consider M&As to be “an important tool to attain a sizeable market share in the foreign market within a short period of time, given the possibility to benefit from the existing access to local distribution channels and the established customer base”.

The key challenge facing the EU relative to M&As is the need to ensure that the approval process is founded on prudential criteria and are consistently applied in all EU member states. Gonzalez-Paramo noted that the European Commission is revising Article 16 of the Codified Banking Directive, in order to:

- i. Clarify the applicable prudential criteria for the approval process
- ii. Enhance transparency
- iii. Strengthen cooperation between home and host countries.

It should be noted that cross-border banking has grown asymmetrically in the EU with greater integration in wholesale markets than retail markets. Fonteyne (2006) found that financial services providers, investors and clients operate on a European scale relative to wholesale financial services to the extent that these activities are increasingly concentrated in a few financial centres with

London emerging as the “most important” of these. Nevertheless, Fonteyne asserts that there are some aspects of the regional wholesale markets that are less integrated than others and cites differences in legislation which has hindered the integration of asset-backed securities; continued fragmentation of the region’s clearing and settlement system and the prevalence of national equity markets which results in cross-border trading being more expensive and less common than trading in local markets.

At present, retail banking services in Europe are much more fragmented than wholesale markets in Europe. Despite the increase in transnational mergers and acquisitions with Europe, barriers to entry persist owing to a significant degree of government owned financial institutions, differences in consumer protection regulations, contract law and taxation. Kleimeier and Sander (2003) found that consumer lending and mortgage markets were fragmented as a result of a lack of international arbitrage, a limited pass-through of interest rate changes onto lending rates and a limited nationally and internationally competitive retail banking environment

Where there has been progress in the movement towards integration of banking services within the EU the key hindrances to full integration which remain are:

- A fragmented clearing settlement system
- Variances in legislation which affect the use of collateral-based financial instruments
- A high degree of state ownership of financial institutions

- Differences in consumer protection law and taxation which mean that banks are required to adapt their products and forego important efficiencies.

5.0 Diversification of Macroeconomic Risk

There is the issue of whether investments across the CARICOM territories allow for the true diversification of macroeconomic risk factors for the investing entity. The CGCED report (1998) noted, for example, that in comparison with other developing countries, the economies in the Caribbean are “more susceptible to economic and financial volatility” given their small size, geographic locations and limited economic diversification. Added to this are persistently high public debt (attributable to deficit financing), geographic fragmentation, vulnerability to natural disasters, uncompetitive markets and rising inflation. These factors, inter alia, have been identified as reasons for the relatively high cost of banking in the region.

Given the CGCED’s conclusion that “macroeconomic stability and sound fiscal management are the bedrock for a robust financial sector”, macroeconomic stability is critical to the development and expansion of the financial services sector in the Caribbean.

Ten years after the CGCED’s report, its conclusion that “risk mitigation remains insufficient” holds true given that most financial investments in the Caribbean region are held by institutions in the domestic economies, thus making such investments much more vulnerable to exogenous shocks”. At present, Trinidad and Tobago commercial bank are among the largest lenders to regional governments and private sector enterprises.

Almost all of the members of CARICOM are dependent on tourism as the mainstay of their economy. The sector accounts for up to 30% of the annual GDP and has deep linkages with other sectors within the economies to the extent that growth in tourism arrivals and receipts result in increased economic activities in other sectors including construction, transport and other service sectors. Furthermore, the similarity in economic structure means that a large number of economies suffer the same shocks at the same time.

Since the regional credit institutions engaged in cross border activity are usually financiers of large public and private projects in the tourism sectors in CARICOM these institutions, in expanding across borders, have not experienced the risk diversification that their European counterparts have achieved through cross-border trade. Given the region's vulnerability to natural disasters and other events in tourism source markets such as (terrorism threats, domestic policies such as the requirement for passports to travel) or significant movement in currency value (appreciation/depreciation) cross border credit institutions are significantly exposed.

6.0 Foreign exchange and balance of payments constraints

As discussed earlier, the EU was able to eliminate exchange rate and cross-border risks and costs with the introduction of the Euro in 1999 – seven years after the completion of the Single Market. Murphy (2000) concluded that although the Single Market program began in 1993, it was the adoption of the Euro that has resulted in a “dramatic change” in the European Union's financial environment.

The largest CARICOM players in the regional banking sector operate in more than ten geographical areas, conduct business in up to four languages (English, French, Spanish and Dutch), manage transactions

in at least five currencies (TT\$, J\$, BD\$, US\$, EC\$) and navigate exchange rate regimes that range from floating to fixed. These add up to higher operational costs for providers, higher transaction costs for customers and exchange rate risks for the sector.

For commercial banks, balance of payment constraints pose a further impediment to heightened cross-border activity. Regional bankers have found that the Draft FSA has not adequately addressed the issue of the restriction of capital flows by territories which operate with a fixed exchange rate regime. The regional financial institutions have indicated that the constraints of these on currency convertibility and profit repatriation are an impediment to the expansion of the financial services sector across borders within CARICOM.

Commercial banks' ability to monetize collateral has also been impacted by capital account restrictions. For example, if a commercial bank in Trinidad and Tobago sells an asset in a territory with exchange controls, the proceeds cannot be repatriated without monetary authorities' approval.

7.0 Regulatory issues

The largest regional banks could find themselves regulated by a multiplicity of central banks in the region depending on their geographic reach into the regional markets. Furthermore, in some states, the regulatory and supervisory functions are split between Central Banks and Ministries and Finance which could make the reporting requirements for financial institutions engaged in cross-border financial trading even more burdensome.

Some regional financial institutions have found that CARICOM's Draft FSA fails to identify the specific regulatory structure that would

facilitate legislative harmonization throughout the region. As such, while various governments have approached supervision using a consolidated approach, CARICOM had produced various draft legislation for different aspects of financial regulation. What is needed therefore is consolidation of financial legislation that govern the various segments of the market.

At present, the EU is seeking to attain convergence at the regulatory and supervisory levels through:

- The Lamfalussy process⁵
- Harmonized adoption of Basel II
- New capital adequacy framework (adopted in 2004 by the Basel Committee of Banking Supervisors)

Gonzalez-Paramo, Member of the Board of the European Central Bank, (2006) noted that the harmonization of regulatory and financial reform must be viewed as “a gradual process rather than a single step” with an “institution-based approach” being most suitable but “by no means exclusive”. Gonzalez-Paramo, recommended the following to achieve harmonization of regulatory and supervisory functions in Latin America. These should be considered for the CARICOM region as well.

- i. Reforms in the national treatment of financial services legislation/tax treatment
- ii. Harmonization of accounting and auditing standards to attain transparency and comparability across sectors in the region

⁵ This is expected to achieve a shift from minimum harmonization to a level playing field

- iii. Participation in regional/international infrastructure network e.g. trading or settlement systems

8.0 Conclusion

While the FSA draws heavily from the framework⁶ established by the European Union which seeks to increase its regional cross border trade in financial services in general, and in commercial banking services in particular, it should be noted that:

- i. In the EU growth in cross border activity in wholesale and retail banking segments has been asymmetric: the significant⁷ expansion of trade in wholesale⁸ financial services within Europe contrasts with sluggish cross-border retail⁹ banking trade. Today, cross border retail banking is still conducted within a relatively fragmented system underpinned by variances in regulations and legislation between member states;
- ii. The divergences between the European Union and CARICOM relative to size, openness and economic diversification necessitate a unique approach to the crafting of regulatory, legislative, supervisory and operational frameworks for cross border trade in financial services in CARICOM

⁶ These include the various Banking Directives as well as the European Commission's Green Paper on Financial Services Policy

⁷ London has emerged as a leading centre for the provision of wholesale financial services in Europe. Cross border trade in investment banking as well as activity in the European bond and equity markets further expanded in the wake of the EU's monetary unification in 1999.

⁸ Wholesale financial services include investment banking, capital market activity as well as financial services to large private and public entities

⁹ Retail banking services are those provided to individuals and includes products such as current accounts, personal loans, mortgages, savings, pensions and personal investment instruments.

- iii. The EU's experience shows that the process of creating deeper financial markets through cross-border trade is a process which the EU itself is still in the midst of.
- iv. Private sector involvement is crucial to craft a feasible framework.

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